

Valuation for ESOP Purposes

The National Center for Employee Ownership
Introduction to ESOPs

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Who Determines Value? How Often is this Done?

Under IRS Code Section 401(a)(28)(C), a closely held company that has an ESOP must conduct an independent appraisal of its shares each time the plan acquires stock and as of the end of each plan year thereafter.

Overview

- The valuation of ESOP stock must meet the requirements of both the Internal Revenue Service (“IRS”) and the U.S. Department of Labor (“DOL”).
- In addition, members of the American Society of Appraisers (“ASA”) must be in conformity with the Uniform Standards of Professional Appraisal Practice (“USPAP”).
- The appraiser should be aware of and also consider the applicable case law that has developed regarding the valuation of closely-held shares for ESOP purposes.

Who is the Appraiser's Client?

- The point of the appraisal is to protect the interests of the ESOP participants from paying more than fair market value.
- The appraiser's client, by law, is the ESOP trust, no matter who actually writes the checks to cover the fees.
- The letter of engagement should clearly specify that the appraiser is working for the ESOP.

U.S. Department of Labor

- The DOL is the government body that administers ESOPs.
- In 1988, the DOL issued proposed regulations regarding ESOPs stating that the ESOP cannot pay more than “adequate consideration.”

Department of Labor

Proposed DOL Regulations on Adequacy of Consideration:

- Value assigned must reflect a figure within an acceptable range.
- Valuation must be determined as of the date of the transaction.
- Independent appraisal by party not participating in the transaction.

U.S. Department of Labor (Cont)

Adequate Consideration – The fair market value of a privately held company.

Fair Market Value – The amount at which the capital stock of the company would change hands between a willing buyer and a willing seller, each having reasonable knowledge of the relevant facts, neither being under any compulsion to act.

IRS Revenue Ruling 59-60

The following factors, although not all-inclusive, are fundamental and require careful analysis in each case:

- The nature of the business and the history of the enterprise from its inception.
- The economic outlook in general and the condition and outlook of the specific industry in particular.
- The book value of the stock and the financial condition of the business.
- The earning capacity of the company.
- The dividend-paying capacity of the company.
- Whether or not the enterprise has goodwill or other intangible value.
- The price, size, and type of interests sold previously and the size and type of the interests to be valued.
- **The market price of interests or stocks issued by companies in the same or a similar line of business and actively traded in a free and open market, either on an exchange or over-the-counter.**

Approaches to Business Valuation

- Asset-Based Approach
- Market Approach
- Income Approach

Approaches to Business Valuation

- Asset-Based Approach
 - Adjusted Book Value Method
 - Liquidation Value Method

Approaches to Business Valuation (Cont.)

- **Market Approach**
 - Previous Sales of or offers for the Company's Stock
 - Sales of Similar Companies
 - Sales of Stock of Publicly Traded Companies

Approaches to Business Valuation (Cont.)

- **Income Approach**
 - Capitalization of Earnings Method
 - Discounted Cash Flow Method

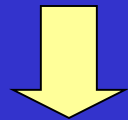
The Relative Levels of Value

Control Value

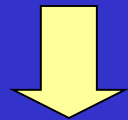


Premium for Control

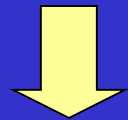
Minority Discount



Marketable, Minority Value



Lack of Marketability Discount



Nonmarketable, Minority Value

What Discounts/Premiums Apply in Valuing Shares in a Closely-Held Company

Control Premium

- **Appoint or remove management or determine their compensation;**
- **Set policy or change the course of business;**
- **Acquire or liquidate assets;**
- **Make acquisitions of other companies;**
- **Liquidate, dissolve, sell, or recapitalize the company;**
- **Receive any remuneration for withdrawing from the Company;**
- **Force the sale of the Valued Interest to the Company;**
- **Determine the amount and timing of any dividends to shareholders; or**
- **Amend the Articles of Incorporation.**

What Discounts/Premiums Apply in Valuing Shares in a Closely-Held Company (Cont.)

- Making acquisitions of other companies;
- Liquidating, dissolving, selling, or recapitalizing the company;
- Selling or acquiring treasury shares;
- Registering the company's stock for a public offering;
- Declaring and paying dividends; and
- Changing the Articles of Incorporation or Bylaws

What Discounts/Premiums Apply in Valuing Shares in a Closely-Held Company (Cont.)

Minority Discount

A minority interest in a closely held corporation is generally held to be worth less than its proportionate share of the value of all the outstanding shares. This is because minority shareholders generally cannot effect control of the company. The magnitude of a minority discount depends on the shareholder's inability to exercise any or all of a variety of rights typically associated with control.

Control vs. Minority Value?

Based upon the DOL regulation, it is reasonable to conclude that even if an owner sells less than a controlling interest in a corporation to an ESOP in an initial transaction, he or she may still be able to sell in the initial transaction at a controlling interest or enterprise value provided he or she commits to allow the ESOP to purchase a sufficient amount of additional company stock to bring the ESOP's ownership to a controlling interest within a reasonable period of time of the initial transaction.

Premium for Control and Discount for Minority Interest

- Size of control premium is influenced by many factors but most frequently falls in the 10% to 40% range.
- This equates to a minority discount range of 9% to 29%.

Marketability Discount

- Securities of privately owned companies are not readily tradable on an established exchange and may require a discount for their lack of marketability.
- Non-ESOP Shares
 - Minority blocks of non-ESOP stock typically have a discount in the 25% to 45% range.
 - Control blocks of stock are generally more readily marketable than minority blocks.

Marketability Discount for ESOP Shares

- ESOP shares have a put right. The effect of this put option is generally to improve the marketability and liquidity of the security.
- Marketability discounts for ESOP shares typically range from 0% to 15%.

Is the Marketability Discount Reduced at all by the ESOP Put Option

Marketability of Securities

Where the trust is the purchaser of securities that are subject to “put” rights and such rights are taken into account in reducing the discount for lack of marketability, such assessment will include consideration of the extent to which such rights are enforceable, as well as the company’s ability to meet its obligations with respect to the “put” rights, taking into consideration the company’s financial strength and liquidity.

Can the ESOP Pay Less Than the Appraised Value if the Owner Wants to Sell for Less

By law, an ESOT cannot pay more than adequate consideration for the employer stock it purchases. The proposed DOL regulations establish a two-part test for determining what is adequate consideration:

Department of Labor

- Written documentation requirements:
 1. Statement of purpose
 2. Relative weight accorded to different valuation methodologies
 3. Documentation of valuation performed based on Revenue Ruling 59-60
 4. Control premium issues
 5. Marketability considerations

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