ESOP VALUATION

PROVIDED IN *GREATBANC TRUST*

IT IS IMPERATIVE

for those in the business valuation community involved in providing ESOP services to understand the importance of recent developments regarding the expectations of the IRS, and especially the Department of Labor (DOL), for overseeing qualified retirement plan compliance. More than ever before, the DOL has moved toward a position of aggressive enforcement of transactions that fall short of compliance with the rules designed to protect plan participants against owner and manager malfeasance.

DOL Activity

In most instances, the DOL "hammer" is being applied to plan trustees that are saddled by statute with a fiduciary obligation to plan participants. This fiduciary obligation carries with it great exposure and a very real personal risk for the trustees. All internal (inside company) trustees, as well as others who may be found to serve as such even without the actual title by virtue of their level of involvement as plan fiduciaries, need to seek counsel so as to fully understand the substantial breadth of this obligation and the responsibilities that they may have as a result of the governing federal rules. These rules are primarily set forth in the Employee Retirement Income Security Act of 1974 (ERISA).

Even more disconcerting, however, are recent attempts by the DOL to expand the fiduciary obligation to include the business valuator. One need only pay attention to public messages divulged by DOL representatives to sense an increased level of angst and challenge in their enforcement of the qualified plan rules. Nowhere is this more evident than in the arena of business valuations prepared for ESOPs. The valuation serves as a platform for facilitating ESOP purchase and sale transactions, as generally mandated by the governing provisions of the plan documents. IRS rules require the valuation to be prepared as near to the stock acquisition transaction date as possible, and then on an annual basis thereafter.

The issue with which the DOL has its greatest dismay is the overall quality of the business valuations. In a relevant article that appeared in the Wall Street Journal, titled "U.S. Increases Scrutiny of Employee-Stock-Ownership Plans," the authors quote DOL deputy assistant secretary Timothy Hauser as saying that the Labor Department is the plaintiff in 15 lawsuits related to ESOPs, with "virtually all" the cases alleging shoddy estimates of what a company's shares are worth. [1] Mr. Hauser is further quoted as saying that "Valuation is the first, second, third and fourth problem" in ESOP compliance.

DOL Proposal. To accord greater control over business valuations performed for ESOPs, and the business valuators who prepare them, in October 2010 the DOL introduced a proposal that would have classified business valuators as fiduciaries of the ESOPs for which the work was performed. This was a stunning development and the proposal was met with much resistance. It was ultimately withdrawn by the DOL in September 2011, although the intent remains to reintroduce the rule at a later date. The DOL's withdrawal of the proposal does not indicate a lessening of the resolve by that agency to address current business valuation quality issues. In 2010, Virginia Smith, Director of Enforcement at DOL's Employee Benefits Security Administration, stated of ESOPs:

> This is an area that is rife with problems from our perspective. I suppose there's some good ones out there. If anybody knows of any let me know. I've yet to find one.[2]

Such electrifying comments clearly demonstrate that the business of business valuation, as it relates to ESOPs, is not business as usual. As such, business valuators, and the trustees who engage them, must be more careful than ever in ensuring that the work performed meets professional standards and, that an exceedingly high level of due care is applied to all aspects of the business valuation process.

While the DOL has been moving cautiously in the development and release of regulatory or other authoritative guidance in addressing this all-important issue, one recent legal settlement resolving a lawsuit brought against a third-party trustee and the sponsor company offers unique new insight into fiduciary responsibilities associated with qualified plans, including the government's expectations of valuators.

Background

It is very useful to look to the significant recent legal settlement agreement in a DOL lawsuit brought against GreatBanc Trust Company (an independent trustee), The Sierra Aluminum Company (the company whose shares were sold to the ESOP), and the ESOP itself.[3] In attempting to establish those steps that a trustee or a business appraiser must take, in order to meet DOL expectations, the *GreatBanc* settlement provides significant insight.

The *GreatBanc* case was filed in the U.S. District Court for the Central District of California in September 2012. On 6/2/2014, the parties in the case reached a rather unusual settlement, which included a defined set of "process requirements" that GreatBanc must follow in the future when it is hired to assist with the purchase by or to an ESOP of ownership shares in a private company.

While the process requirements agreed to in this case are not official authority of any type and, as such, do not represent regulatory guidance for any other unrelated party, they do shed a great deal of light on the current

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mood of the DOL. They can, and should, be viewed as an indication of what that agency will expect when reviewing business valuations and transactions involving the purchase or sale of privately held securities in a qualified plan context. In fact, the aforementioned Wall Street Journal article includes a comment from Phyllis C. Borzi, an assistant DOL secretary, "Others in the industry would do well to take notice of the protections put in place by this agreement."[4]

In evaluating such a sea change in enforcement activity, it is prudent, and necessary, to carefully review these developments in detail and to glean the pertinent information needed to assist those with fiduciary responsibility for ESOP valuations and members of the business valuation community in ensuring that the compliance mandates set forth in the *GreatBanc* settlement are met.

Definition of Fiduciary. Before dissecting the *GreatBanc* settlement, the practical starting point is to first look at the term *fiduciary*, as it is defined in ERISA. Under that law, a fiduciary is defined as any person with respect to a [qualified] plan, to the extent he or she:

1. Exercises any discretionary authority or control over the management of the plan.
2. Exercises any authority or control over the management or disposition of the assets of the plan.
3. Renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan.
4. Has any discretionary authority or discretionary responsibility in the administration of the plan.[5]

Given this baseline definition, it is clear and unequivocal that ESOP trustees, as well as a variety of others, are subject to any and all fiduciary requirements imparted under the Internal Revenue Code by the IRS, as well as ERISA and any and all guidance addressing this topic as issued by the DOL. Much commentary has been produced over a very long period suggesting Congress intended to keep the definition broad, to protect plan participants from misuse of assets and other wrongdoing as a result of bad actions by a wide range of individuals having some influence over the plan.

In meeting their fiduciary responsibilities with respect to an ESOP valuation, it is inarguable that the plan trustees have a duty to prudently select appraisers. However, it is commonly understood among ESOP practitioners, that in addition to taking appropriate steps to properly vet candidates to undertake the valuation, the trustee is further required to ensure that the key assumptions are reasonable under the facts and circumstances at the date of valuation. In the present author's experience, the failure by the trustees to fully comprehend the propriety of the projections, and the assumptions underlying those projections, is the most common reason for value overstatement and DOL dissatisfaction with the valuation of the company securities in question.

While this level of responsibility is seemingly accepted, practical application of the rules can sometimes be subject to interpretation. For the first time, the *GreatBanc* settlement provides a more direct and clear description of DOL expectations. In a 6/3/2014 press

1 Simon and Needleman, "U.S. Increases Scrutiny of Employee-Stock-Ownership-Plans," Wall St. J., 6/22/2014, online at http://online.wsj.com/articles/u-s-increases-scrutiny-of-employee-stock-ownership-plans-1403484135.

2 Comments at American Society of Pension Professionals and Actuaries 2010 Los Angeles Benefits Conference.

3 Thomas E. Perez v. GreatBanc Trust Company, DC-Calif., Case 5-12-cv-01648-R-DTB, 6/2/2014.

4 Note 1, *supra*.

5 ERISA section 3(21)(A).

release issued by the DOL, U.S. Secretary of Labor Perez referred to the process requirements set forth in Attachment A to the settlement agreement as "safeguards … to protect ESOPs."[6]

Primary Issue. While the case arose due to the alleged overvaluation of the Sierra Aluminum Company shares being acquired by the ESOP, the primary issue that led to the settlement was the trustee's failure to investigate the credibility of the assumptions (thereby resulting in unrealistic and aggressively optimistic projections), factual bases, and adjustments to financial statements that went into the appraisal.

Framework of the Settlement

The mechanical framework of the *GreatBanc* settlement is twofold. The document first contains a nine-page narrative describing the terms of the negotiated settlement. In the narrative, under paragraph A, GreatBanc, as Trustee, agreed to pay approximately $4.7 million to the Sierra Aluminum Company ESOP, primarily as returned consideration for having the ESOP purchase shares from the prior owner at an inflated valuation. Paragraph B adds the imposition of a penalty of $477,272.23 payable to the DOL.

The second key element of the document includes a separate attachment at the end of the narrative, labeled on a blank title page simply as "Attachment A," without further titling or description. On the top of the first complete page of Attachment A, however, is an overall header, "AGREEMENT CONCERNING FIDUCIARY ENGAGEMENTS AND PROCESS REQUIREMENTS FOR EMPLOYER STOCK TRANSACTIONS." In total, Attachment A is 11 pages in length, wherein there are introduced 13 separate and distinct *process requirements* that are labeled alphabetically as paragraphs A through M. These paragraphs in Attachment A to the settlement agreement are those that are most meaningful to other trustees and members of the business valuation community. Exhibit 1 to this article sets out the topics attached to each paragraph within Attachment A.

New and Expanded Requirements

Included among the process requirements are items that represent new responsibilities or requirements for GreatBanc. Other items may not be new, but in some ways represent an expansion of various current requirements and expectations. Lastly, there seem to be items that should have already been considered in conjunction with any quality business valuation prepared in accordance with professional standards.

To avoid confusion throughout the balance of this article, references to specific alphabetized paragraphs in Attachment A and the settlement agreement are intended to be considered as one and the same, referring specifically to the second key element of the Settlement Agreement. Throughout the following discussion, the word, *Trustee*, will be capitalized to remain consistent with the document where direct language from Attachment A is included. Finally, *valuation advisor* and *business valuator* are used interchangeably and are intended to have the same meaning.

Selection of Valuation Advisors

The most substantial changes may be those that seem to create new or expanded fiduciary obligations on the part of the Trustee. Paragraph A of the settlement agreememt, *Selection and Use of Valuation Advisor—General*, sets out very specific guidelines for the selection of that firm, or individual, who is undertaking the valuation assignment. While the document notes that the Trustee will engage a "qualified valuation advisor," invariably, the norm in the past, it also provides that the Trustee will:

1. Prudently investigate the valuation advisor's qualifications.
2. Take reasonable steps to determine that the valuation advisor receives complete, accurate, and current information necessary to value the employer's securities.
3. Prudently determine that its reliance on the valuation advisor's advice is reasonable before entering into any transaction in reliance on the advice.[7]

In the present author's experience, the first and second items are normal operating procedures for most Trustees in selecting valuation advisors. The third item, while seemingly reasonable, is more difficult to assess in its future effect on trustees. The purpose of engaging the valuation advisor is to obtain a skill set beyond those the Trustee generally maintains. While a Trustee may be capable of "prudently" evaluating the facts and assumptions contained in the business valuation report, it is more questionable as to exactly how he or she will gauge the reasonableness of the conclusion of value and the sufficiency of the procedures used by the valuation advisor.

Conflicts of Interest. Paragraphs B and C appear to impose new and substantial requirements on the Trustee. Paragraph B, *Selection of Valuator Advisor—Conflicts of Interests*, adds severe limitations to who the Trustee may engage to perform the valuation. The Trustee is not permitted to use a valuation advisor that has previously performed work—including, *but not limited to*, the preparation of a preliminary valuation—"for, or on behalf of, the ESOP sponsor (as distinguished from the ESOP), any counterparty to the ESOP involved in the transaction, or any other entity that is structuring the transaction (such as an investment bank) for any party other than the ESOP or its Trustee." The paragraph goes on to limit the Trustee from selecting a valuation advisor that has a "familial or corporate relationship" (such as a parent-subsidiary relationship) to any of the aforementioned persons or entities.

Finally, Paragraph C, *Selection of Valuation Advisor—Process*, sets forth what the present author believes to be a new requirement on Trustees, as well as business valuators. Paragraph C states, "The Trustee will obtain written confirmation from the valuation advisor selected that none of the above-referenced relations exist." While the written confirmation represents a new requirement, it represents only a portion of what the DOL is looking for in additional documentation with regard to valuation advisor selection. Paragraph C also

EXHIBIT 1
GreatBanc Settlement Agreement, Attachment A Paragraph Topics

Agreement Concerning Fiduciary Engagements
and Process Requirements for Employer Stock Transactions

- **Para. A—** Selection and Use of Valuation Advisor—General.
- **Para. B—** Selection of Valuator Advisor—Conflicts of Interests.
- **Para. C—** Selection of Valuation Advisor—Process.
- **Para. D—** Oversight of Valuation Advisor—Required Analysis.
- **Para. E—** Financial Statements.
- **Para. F—** Fiduciary Review Process—General.
- **Para. G—** Fiduciary Review Process—Documentation of Valuation Analysis.
- **Para. H—** Fiduciary Review Process—Reliance on Valuation Report.
- **Para. I—** Preservation of Documents.
- **Para. J—** Fair Market Value.
- **Para. K—** Consideration of Claw-Back.
- **Para. L—** Other Professionals.
- **Para. M—** Untitled.

mandates that the Trustee prepare a written analysis addressing the following topics:

1. The reason for selecting the particular valuation advisor.
2. A list of all the valuation advisors that the Trustee considered.
3. A discussion of the qualifications of the valuation advisors that the Trustee considered.
4. A list of references checked and discussion of the references' views on the valuation advisors.
5. Whether the valuation advisor was the subject of prior criminal or civil proceedings.
6. A *full* explanation of the basis for concluding that the Trustee's selection of the valuation advisor was prudent.

A substantial portion of these procedures are generally considered in the typical valuation advisor selection process. However, even though these steps may have been routinely undertaken, the recording and demonstration of these steps in a formal memorandum is a new requirement—one that has generally not been observed in the past. It would seem that a control questionnaire could be developed by the Trustees or valuators to assist Trustees in complying with this mandate.

There are some relief provisions in paragraph C that allow the Trustee to forgo the analysis set out above if certain conditions are met, including:

- The Trustee previously performed the analysis in connection with a prior engagement of the valuation advisor.
- The previous analysis was completed within the 15-month period immediately preceding the valuation advisor's selection for a specific transaction.
- The Trustee documents *in writing* that it previously performed the analysis, the date(s) on which the Trustee performed the analysis, and the results of the analysis.
- The valuation advisor certifies that the information it previously provided pursuant to item (5) above (whether the valuation advisor was the subject of prior criminal or civil proceedings) is still accurate.

Thus, while the actual analysis is not required on a yearly basis, the relief provisions do not totally eliminate the obligation of the Trustee to complete an annual written statement or memorandum with more limited disclosures. In addition, in those years where a full analysis is not completed, it will be incumbent on the Trustee to gather a "certification" from the valuation advisor as to whether he or she was the subject of prior criminal or civil proceedings. Interestingly, the original analysis does not appear to require a certification.

More alarming for the business valuation advisor should be the required disclosure of whether he or she has been the subject of prior criminal or civil proceedings, with no regard for the circumstances, purpose, or results. Without further clarification, it would appear that such a requirement strips the valuation advisor of "due process" and seemingly deems that any legal proceeding, criminal or civil, automatically carries with it some taint as to the quality of that professional's work. Clearly, legal actions, civil, in particular, can be undertaken to accomplish any number of outcomes and may not have any bearing on the expertise or quality of work of any specific valuation advisor on any specific project. Thus, the implication of the provision agreed to by GreatBanc seems to require disclosure, even if the matter is positively resolved in favor of the valuation advisor. The provision smacks of the IRS proposal several

[6] U.S. Department of Labor, Release Number 14-1043-NAT.

[7] Note 3, *supra*, Attachment A, paragraph A.

years ago that attempted to subject business valuators to penalty cases via what became known as the "4477 letter," without affording practitioners "due process," a problem that was later remedied after substantial challenge and testimony from the business valuation community.

Supplemental Disclosures

Paragraph D of Attachment A, *Oversight of Valuation Advisor—Required Analysis*, sets forth a number of supplemental disclosures that the Trustee must request the valuation advisor to insert into her report. If the valuation advisor fails to honor this request the responsibility falls to the Trustee. Many of these supplemental disclosures will prove common and familiar to business valuators following professional standards; however, some are new and rather complex. Under subparagraph D 1, the supplemental disclosures must include:

1. The identification of the individuals responsible for providing any projections reflected in the valuation report.
2. With respect to those individuals, conduct reasonable inquiry as to:
   - Whether those individuals have, or reasonably may be determined to have, any conflicts of interest in regard to the ESOP (including, but not limited to, any interest in the purchase or sale of the employer securities being considered).
   - Whether those individuals serve as agents or employees of persons with such conflicts, and the precise nature of any such conflicts.
1. Record, in writing, how the Trustee and the valuation advisor considered conflicts in determining the value of employer securities.

In effect, the provision layers a new level of responsibility on the valuation advisor and serves to dramatically expand his or her role in the assignment. To carefully assess and determine who, within the sponsor company, may have had a conflict of interest under this provision is to, in effect, go to the "intent" of the person preparing the projections.

Subparagraph D 2 of Attachment A requires that the Trustee request of the valuation advisor a "written opinion" as to the reasonableness of any projections and that he or she explain, in writing, "why and to what extent the projections are or are not reasonable." This requirement sets forth certain reasonableness criteria by which to make this evaluation, including comparison to the "company's five-year historical averages and/or medians and the five-year historical averages and/or medians of a group of comparable public companies (if any exist)" for a defined set of evaluation criteria including:

1. Return on assets.
2. Return on equity.
3. EBIT (earnings before interest and taxes) margins.
4. EBITDA (earnings before interest, taxes, depreciation, and amortization) margins.
5. Ratio of capital expenditures to sales.
6. Revenue growth rate.
7. Ratio of free cash flows (of the enterprise) to sales.

Subparagraphs D 3 through D 7 set out additional specific procedures intended by the DOL to assist with determining the projections' reasonableness. Most, if not all, of these requirements are elements of the normal business valuation process that should be included in the final ESOP valuation report if professional standards have been met.

Stock Purchase Prudence. Subparagraphs D 8 and D 9 relate specifically to ESOP valuation assignments. However, careful readers will note that one requirement for consideration under subparagraph D 8 is "the prudence of the stock purchase." This requirement links the valuator with the transaction decision, which the present author finds to be out of the realm of the business valuation process. Complying with this requirement will require that the business valuator step into, perhaps unwittingly, the shoes of the Trustee and assume the associated fiduciary responsibility that accompanies that position. To do so may cause a "back door" way for the DOL to ascribe fiduciary status to the valuation advisor.

Subparagraph D 9 requires that the Trustee request that the valuation advisor, analyze and document in writing:

1. Whether the ESOP sponsor will be able to service the debt taken in connection with the transaction (including the ability to service the debt in the event that the ESOP sponsor fails to meet the projections relied on in valuing the stock).
2. Whether the transaction is fair to the ESOP from a financial point of view.
3. Whether the transaction is fair to the ESOP relative to all other parties to the proposed transaction.
4. Whether the terms of the financing of the proposed transaction are market-based, commercially reasonable, and in the best interests of the ESOP.
5. The financial effect of the proposed transaction on the ESOP sponsor, and document in writing the factors considered in such analysis and conclusions drawn there from.

Expansion of Historical Duties. Clearly, items 2, 3, and 4 above significantly expand the valuation analyst's historical duties to include the expression of a fairness opinion on the effects of the transaction to various parties. Again, this provision appears to supplant business valuator responsibilities with those of the Trustee.

In complying with professional standards, most valuation analysts are likely to undertake certain of the above-noted

ment, the fact that Attachment A requires a written opinion poses a worrisome development for business valuators. This is especially true given the eerily similar language to the AICPA guidance.

Paragraph D of Attachment A thus presents new challenges to the business valuator, as most assignments will require working with employees of the sponsor company whose actual independence is imperfect at the outset. Given this likely scenario, in most instances, it appears that the DOL is looking to valuation advisors to undertake analytical procedures and other steps to facilitate a confirmation of the reasonableness of the projections. This is a daunting undertaking, as noted above, and well beyond the level of activity generally required under professional standards, and one that creates a significant new level of exposure for the valuation community.

procedures to obtain some level of comfort as to the reasonableness of the projections. However, what is most disconcerting is the requirement that the justification for the projections' determination as reasonable or not reasonable be accounted for in a written narrative that includes an explanation, as well as an opinion, as to the reasonableness. Such a requirement leaves little or no room for unexplained judgment and will require an expansion of business valuator procedures to accomplish this task.

As most business valuators will concede, the determination of the reasonableness of any set of financial projections can take on a life of its own with innumerable steps and procedures specific to any subject company and industry. Exactly what additional diligence will be required by the DOL in expressing this opinion is unknown at this time, but erring on the side of caution by extending analytical procedures beyond historical practices and professional standards would seem the proper and logical course of action by valuation analysts.

The AICPA has published authoritative guidance for its membership in AT Section 301, *Financial Forecasts and Projections*,[8] which limits engagements relating to "prospective financial statements" to an examination, compilation, or agreed-upon procedures engagement. The requirements imposed on AICPA members in the conduct of a compilation are far below that level of effort required in an examination to express an opinion as to the reasonableness of the prospective financial statements. An agreed-upon procedures engagement can become very detailed, as those procedures to which the practitioner and the client "*agreed*" can become quite extensive. However, neither a compilation nor an agreed-upon procedures engagement results in the expression of an opinion. Such is not the case with an examination, which requires that the practitioner's standard report include "the practitioner's opinion … that the underlying assumptions provide a reasonable basis for the forecast or a reasonable basis for the projection given the hypothetical assumptions."[9]

The word "opinion" is always of concern to those practitioners holding a CPA license or any member of the AICPA. The word should convey a sense of concern to any business valuation practitioner, as well. While the AICPA guidance does not directly apply to any element of the *GreatBanc* settle-

8 AICPA, *Statements on Standards for Attestation Engagements, AT Section 301, Financial Forecasts and Projections.*

9 *Id.*, paragraph 33f.

Audited Financial Statements

Paragragh E, *Financial Statements,* imposes a requirement that the Trustee and the valuator request "audited" financial statements for the previous five years with an unqualified opinion. If something less than audited financial statements are issued, it is up to the Trustee to determine if it is prudent to rely on those statements. Further, if it is decided to proceed without audited financial statements, the Trustee must "document the basis for the Trustee's reasonable belief that it is prudent to rely on the financial statements and explain, in writing, how it accounted for any risk posed by using qualified or unaudited statements." The document goes on to advise that, "While the Trustee need not audit the financial statements itself, it must carefully consider the reliability of those statements in the manner set forth herein."

Process Requirements

Paragraph F, *Fiduciary Review Process—General*, provides process requirements directed at the Trustee related to any transaction involving the purchase or sale of employer securities that are not publicly traded. Few of these requirements *(Continued on page 47)*

ESOP Valuations

(Continued from page 11) appear unreasonable, and most do not affect the valuation advisor directly. However, subparagraph F 3 requires that the Trustee, "Document in writing its bases for concluding that the information supplied to the valuation advisor, whether directly from the ESOP sponsor, or otherwise, was current, complete and accurate."

This provision reads very much like a client representation letter generally obtained in the course of a financial statement audit, and may actually serve to benefit the business valuator if such a document were to be completed by the Trustee and collected and maintained in his or her work papers. While not a replacement for due care and diligence in meeting professional standards, such information could serve to protect the valuation advisor from litigation should the conclusion of value set forth in the final report be found to be erroneous and based on "bad" or "incomplete" information.

Documentation. Paragraph G, *Fiduciary Review Process—Documentation of Valuation Analysis,* requires that the Trustee formally "document in writing its analysis of any final valuation report relating to a transaction involving the purchase or sale of employer securities." The provision goes on to dictate those topics that require the Trustee's attention and "will include the Trustee's conclusions regarding the final valuation report's treatment of each topic and explain in writing the basis for its conclusions."

The topics noted, among others, include marketability discounts, minority and control premiums, projections, sponsor company strengths and weaknesses, discount rates, normalization adjustments, consistency, market comparables analysis, and valuation methodologies employed. The listing contains 16 specific items, most, if not all of which, should already be set forth in a valuation prepared under professional standards. Again, however, the DOL expands what might normally be evaluated in conjunction with determination of a conclusion of value to include "the proposed transaction's reasonably foreseeable risks as of the date of the transaction."

As this paragraph is directed at the Trustee, it does not expand the scope of the valuation advisor's role in the engagement. However, it might prove necessary for the valuation advisor to step beyond the valuation to address "reasonably foreseeable risks" attendant to the transaction in order to assist the Trustee meet his or her fiduciary obligation.

Trustee Review. Paragraph H, *Fiduciary Review Process—Reliance on Valuation Report*, addresses the process by which the Trustee will review and facilitate an understanding of the measures and procedures undertaken in the course of the business valuator's assignment and expression of an opinion as to the value of the employer securities. For the most part, the provisions represent simply good, prudent business practice, which the present author has observed as being common practice by Trustees of ESOPs. However, Attachment A requires that the entire process be memorialized in a written document, including the names of all persons responsible for the proposed transaction and material points of disagreement, and why and whether any of the disagreements were known prior to the Trustee's approval of the transaction. Subparagraph H 3 requires that the Trustee *not* proceed with the transaction if those responsible for performing the review and analysis believe that the valuation is not consistent with the data and analysis therein.

Both Paragraph I, *Preservation of Documents,* and Paragraph J, *Fair Market Value,* are fairly benign, the former setting forth the detailed recordkeeping required of the Trustee, and the latter restricting transactions in the employer's stock to be accomplished at no more than fair market value. This latter requirement is absolutely pointed at overvalued shares in ESOP transactions intended to cash out selling shareholders at unrealistically high values at the expense of the plan participants.

Claw-Back Consideration. Paragraph K, *Consideration of Claw-Back*, requires the Trustee to consider whether it is appropriate to request a claw-back arrangement or other purchase price adjustments to protect the ESOP against the possibility of adverse consequences in the event of significant corporate events or changed circumstances. The Trustee's consideration of this item is to be memorialized in writing. What is troublesome about the provision in Paragraph K is the DOL's extension of the claw-back or purchase price adjustment to *adverse consequences in the event of significant corporate events or changed circumstances.* Neither is explained in the Attachment, and both would seemingly convey the desire by DOL to be able to adjust the transaction fair market value for events occurring after the date of the transaction. It would seem more appropriate to limit the claw-back or purchase price adjustment potential to faulty assumptions and incorrect application of generally-accepted business valuation principles. While this may have been the actual intent of the parties agreeing to the settlement, the language leaves ample room for misinterpretation and expansion of business valuator risk when performing such engagements for an ESOP Trustee.

The final two paragraphs of Attachment A are perfunctory in scope and offer no real changes to Trustee responsibility or those of the valuation advisor. Paragraph L, *Other Professionals,* allows the Trustee to acquire the services of any qualified professionals necessary to exercise its powers in a fiduciary manner. Paragraph M, which is untitled, notes that the settlement is not intended to specify all of the Trustee's fiduciary obligations.

Significance of DOL Conduct

Though these process requirements are not in any way authoritative or direct guidance (except to the parties to this particular litigation), given the nature of recent DOL attacks on business valuations related to ESOPs and the attitude and expectation of the DOL, it would seem foolhardy to simply dismiss them as being irrelevant. What has occurred with this settlement is an end around to publishing regulations or other authoritative guidance at the DOL while still presenting a forum for

as well as ongoing valuations required by IRS or DOL mandates.

The other unfortunate circumstance associated with such classifications is the likelihood that certain smaller companies may not be able to consider ESOPs as a transition alternative, thereby, forcing companies and senior generation owners to adopt alternative exit strategies that could lead to less-effective business continuance opportunities.

The DOL withdrawal of the proposed regulation in 2011 puts this issue on hiatus for the time being. However, it is likely that the DOL will introduce a similar provision at some point. When this may be is not exactly known. At the date the regulation was withdrawn (9/19/2011), the Department announced that it would re-propose the rule in early 2012. However, the proposed rule has not yet been reintroduced.

expressing the department's dismay over the quality of recent valuations. To that end, the information contained in Attachment A is meaningful and, at least to some degree, expands business valuator responsibilities beyond historical norms. The process requirements are insightful, however, in that they do offer a map, and to not consider their implications in conjunction with any valuation assignment would be a mistake. It would seem probable that any future attacks on the validity of business valuation reports by the DOL in the courts will follow the provisions of the *GreatBanc* settlement and these process requirements.

Prudent Man Standard. As noted at the beginning of this discussion, another area that emphasizes some of what is contained in the *GreatBanc* settlement is reflected in the DOL's November 2010 regulations that would have categorized business valuation firms as ERISA fiduciaries when they perform valuations of employer securities, as would be the case in an ESOP setting. The DOL withdrew the proposed regulations in September 2011, but has announced plans to propose a similar rule in the future.

Under ERISA, any fiduciary would be subject to the "prudent man rule," contained under Section 404 of that legislation. Essentially, the prudent man rule requires fiduciaries to act prudently and maintain an undivided loyalty to the plan participants and their beneficiaries in respect of the plan[esq]s governing provisions. Note that the *prudent man standard* is a higher standard than the *reasonable man standard* that is inherent to the corporate laws in many states. In addition to the higher prudent man performance standard, classification as an ERISA fiduciary carries with it risk that the fiduciary may be held personally liable for his or her breach of these duties and responsibilities to act prudently.

The practical implications of classifying business valuators as fiduciaries would be far-reaching. The first element of this classification must focus on how best to protect oneself from the additional exposure of fiduciary status and the potential for governmental and plan participant challenges that could result in penalties, fines, and financial damages. The primary avenue for this would be fiduciary liability insurance—a costly, but necessary remedy. The offsetting cost of this insurance would be borne by plan participants, as costs of valuations conducted under this level of responsibility would have to increase. It is likely that this cost would be equally applicable to initial planning and fairness opinions,

Conclusion

What is the business valuator to take away from all of these developments? The game is over for inflated valuations intended to serve as a mechanism to cash out shareholders with unrealistically big paydays on the backs of the employees/plan participants staying behind. The DOL is going to shut the door on shoddy and poorly crafted business valuations, either through continued and increasing attacks in the courts, or through statutory and regulatory pronouncements.

The best way to navigate through these changes is to ensure that, as the valuation analyst or advisor, one understands the many nuances to ESOP valuations and takes the time and effort to conduct the course of the assignment in compliance with all applicable professional standards. Additionally, the valuator must stay current and look carefully to DOL legal decisions, such as the *GreatBanc* case discussed herein, to garner an understanding of DOL expectations. While these steps will not guarantee success, they will allow the business valuator the best chance of defending his or her work product and sustaining the transaction, while affording the plan trustee the greatest chance to prove that he or she has met their fiduciary obligations to the plan participants. ●