

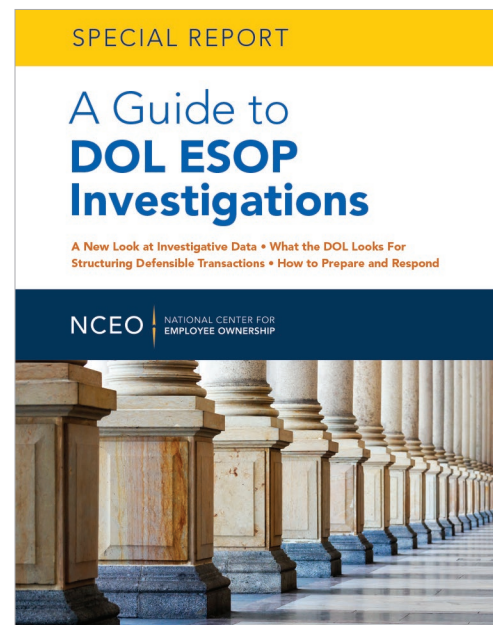
Prerequisites for Defensible ESOP Transactions: A Case Study

Michael Coffey, Daniel Cooper, and James Joyner

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Prerequisites for Defensible ESOP Transactions: A Case Study

MICHAEL COFFEY, DANIEL COOPER, AND JAMES JOYNER

The primary focus of DOL investigations is any transaction between the ESOP trustee and sellers to the trust. While ongoing administrative and valuation issues can raise concerns, these problems are typically resolved at little or no cost and very rarely result in DOL-initiated litigation.

So what can you do to make your transaction between a seller and the ESOP trustee more defensible? You should, of course, have an independent outside trustee and a truly independent appraisal firm, fully document compliance with the guidelines set out in the DOL's fiduciary process agreements (or indicate why they do not apply to your transaction), and keep the seller at arm's length from the transaction process. These issues are discussed more fully in chapter 1 of this publication.

In this chapter, we look at some key specific issues about how the transaction is priced and structured. Imagine that you have an ESOP company—we'll call it Oz Inc.—whose ESOP bought the remaining 40% owned by an outside shareholder. The seller and founder thought he was being generous by accepting "a conservative valuation." He was willing to finance the transaction on "very favorable terms." The advisors were well respected in the ESOP community, and the prior year generated record profits. Next year's forecast looked even better.

But there were early signs of trouble. There were some early indications of recession, and first quarter revenues were down, with declining backorders. The customer base was very concentrated, and repurchase obligations loomed.

1. So how justifiable were the projections really?
2. Was the transaction adequately stress-tested?
3. Was the valuation and/or outlook really "conservative?"

4. Was everything significant taken into account, including possible downturns and the projected, albeit unrecorded, liability of stock repurchase obligations?
5. Did they have a stress-test model with key variables that would "ripple through" the projections to show the financial position of the company in 5 to 10 or more years?

At some point after the transaction, the DOL saw a decline in stock value (note that one way that plaintiff attorneys and the DOL can "red flag" transactions is to look for sharp declines in ESOP asset value in Form 5500 filings). It decided to investigate. The DOL contended that the ESOP trustee and appraiser:

1. Relied on financial performance estimates that had little or no connection to the actual financial performance of the company;
2. Used growth projections that were overly aggressive and unsupported in light of the market outlook;
3. Assumed a competitive position that was unsupported from industry data;
4. Relied on unreliable and stale financial information;
5. Failed to duly account for declining performance within the company and in the broader economy; and
6. Failed to adequately consider or quantify the risks inherent in the company's business model, including customer concentration and cyclical trends.

The DOL also had concerns about the timeline for the deal. It contended that the seller was opti-

mistic and shunned bad news and was driven in part by estate planning goals. The company engaged a transaction trustee on November 16, 2006. The trustee engaged an appraiser four days later. A draft appraisal report was issued on April 11, 2007, and the deal closed four days later. That accelerated timeline may be reasonable under some circumstances, but it raises concerns that there was not enough time for the extensive vetting both the trustees and appraiser needed to do.

Of course, the company, trustee, and appraiser disagreed with the DOL. There was a reasonable argument that the DOL was using 20-20 hindsight, and that these issues might be salient now but were not foreseeable at the time. But now the issue was subject to an intensive and costly investigation and potential litigation.

One key issue is what the basis for the out-year projections was. For instance, they may simply project historical trends forward or assume some modest level of growth. This may be defensible in certain industries (e.g., grocery chains) that do not exhibit any significant cyclicity; however, extrapolating 3% year-over-year growth for a construction company in 2019 and beyond is less appropriate. Such extrapolation will often fail to reflect the variability (i.e., strong cyclicity) of contractors as an economic expansion ends and a recession begins (note: as of this writing in mid-2019, the U.S. is in its 10th year of consecutive GDP growth).

Take a company, for instance, that used earnings growth averages for the prior 30 years. That seems like a good idea—it incorporates ups and downs. Say that is 6% per year. But on further review, in the first decade of that period, growth was 8%, the second 6%, and the third 4%. Does the 6% number still make sense? A stress test ideally looks at a number of potential risks as well as potential upsides and assigns probabilities to them to come up with the most defensible number. In terms of stress-testing equity valuations and taking a long-term look at pricing, one technique employed by stock market analysts is the cyclically (inflation) adjusted price to earnings ratio.¹ As a practical matter in 2019, this may require

the trustee team to ask for more than five years of historical financial data so that ups and downs at the subject company between 2005 and 2010 can be analyzed. This level of analysis is often not performed, however, and such work would not necessarily prevent something economically unexpected (and catastrophic) from happening. Moreover, it is difficult in real time to forecast the end of any economic expansion, and so ESOP deals in “high-beta” sectors will ideally have contingent consideration provisions (e.g., clawbacks). The rationale for using clawbacks is more compelling when the ESOP is buying 100% of the company’s equity in a single transaction. This is because a fully-leveraged buyout eliminates the equity component of a company’s capital structure, which is an important buffer during a downturn.

Further elements of stress testing ask:

- What variables are critical to deal support during and after the loan?
- How can one plan for inevitable fluctuations in the market?
- Does meeting the loan covenants in itself mean the deal is good for the participants?
- What remedies are available to keep a leveraged ESOP operating in an underperforming company?
- Which of these remedies must be incorporated in the initial deal documentation?
- What are the safety margins for various financial parameters of a deal to be relatively confident of valid stress testing? The company may not be able to accommodate a full-blown recession, but would be able to do OK in a more modest downturn. How much less income would result from these various downturns? In situations like these, the trustee needs to show that assumptions have been effectively evaluated. What if the large customer went away, shrank, or sought other suppliers?

In this valuation, the asset model was not deemed relevant. The appraisal instead relied on the income

1. Many cyclically adjusted valuation approaches are deployed by analysts. A well-known approach of this kind is the Shiller CAPE Ratio. See, e.g., Jeremy J. Siegel, “The

Shiller CAPE Ratio: A New Look,” *Financial Analysts Journal* 72, no. 3 (2016), 41-50, <https://www.cfapubs.org/doi/abs/10.2469/faj.v72.n3.1>.

approach. There was a terminal value based on a multiple of EBITDA. The DOL questioned the discount rate, the weighted average cost of capital, and the company-specific risk that was applied, among other things. The DOL also objected to using terminal value calculations based on accumulated EBITDA; it has used a different model (the Gordon growth formula), sometimes coming up with terminal rates of just 5% to 10%, sometimes lower. The DOL and some in the valuation community advise against using an “exit” EBITDA multiple to determine a terminal value. This advice is given because if an exit multiple feeds into an analyst’s DCF calculations, then they have, perhaps unwittingly, conflated the market approach and the income approach.

The best defense is to use an income-based approach in the terminal period of a DCF analysis and then as a backtest to look at the implied EBITDA multiple against common-sense benchmarks, including multiples available from GF Data Resources LLC.² The advantage of using the DCF approach to calculate the terminal value is the enhanced granularity. For instance, the terminal value will factor in the cash flow impact of (1) capital expenditures and (2) ongoing investments in working capital as the subject company grows. Giving up on this level of detail within the time horizon of the DCF analysis often presents problems by obscuring key assumptions. As a fiduciary, the trustee must understand all of the key assumptions. They cannot be buried.

The DOL argued all of the transaction support and deal design documentation was focused on the “financial engineering.” Virtually nothing dealt with the employee benefits resulting from the deal. There was one worksheet that showed the loan payments as a percentage of eligible payroll, but nothing showing share allocations, benefits to participants, repurchase obligations, etc. If the company had met its targets and paid the ESOP loan off in seven years, the earnings would have to remain strong to cover the allocation of 100% of the company equity to a retirement plan, but that was not measured. The repurchase obligation was largely ignored. All of this

could raise issues about how a fairness opinion would have viewed this transaction from the standpoint of existing ownership in the ESOP.

The DOL also may look at ESOP performance differently than people in the ESOP community might. For instance, a DOL official told attendees at an NCEO meeting of plan advisors that no company can consistently outperform the market, so any projections that assume this are per se unreasonable, even if the company has a long track record of doing so. There is substantial research that ESOP companies do outperform the market long-term, but that may not be persuasive to the DOL or to judges who are, after all, not experts in valuation, much less ESOPs. If the DOL subscribed to the Appraisal Foundation’s Uniform Standards of Professional Appraisal Practice (USPAP), the ground rules for the experts testifying before judges would improve. Such a change could provide much-needed clarity to the ESOP community (companies and practitioners).

This transaction did not involve elements of deal structure that could be seen as unfair to participants. The DOL has particularly challenged deals where sellers received what the DOL argued were unreasonable amounts of warrants as part of seller notes. This issue is further discussed in chapter 1 of this publication.

The kind of model described here has many variations. These kinds of scenarios, unfortunately, are always a possibility, even though, as the data reported in this publication show, DOL investigative activity, contrary to common perception, has actually declined significantly in recent years. While the risk inherent in transactions cannot be eliminated, it can be reduced.

During investigation or litigation, you will discover that the prudent expert standard is always higher than anything you imagined. The DOL and courts look for healthy skepticism, true independence, and demonstrable objectivity. ESOP trustees must evaluate (and document) every little thing, assuming that they will be relentlessly challenged by an at times irrational, adverse party. Having no conflict is not enough; unswerving loyalty to participants and beneficiaries is necessary.

No deal can be bulletproof. But erring on the side of caution and extensive procedural prudence can make your company much less likely to have problems.

2. GF Data collects and publishes valuation data contributed by over 200 lower-middle market private equity funds and other deal sponsors. See <https://www.gfdata.com>.