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Thought Leadership in Breach of Fiduciary Duty Tort Claims: Valuation and Damages Analyses

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Thought Leadership

Insights

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Thought Leadership in Breach of Fiduciary Duty Tort Claims—Valuation and Damages Analyses

Editors for This Issue: Frank ("Chip") Brown, CPA, and Katherine A. Gilbert

Fiduciary Duty Thought Leadership

Business Valuation Thought Leadership

Forensic Analysis Thought Leadership

Willamette Management Associates Insights

2017 Recipient of the Apex Literary Award

Forethoughts

This *Insights* issue provides thought leadership with regard to valuation and damages analyses in the context of breach of fiduciary duty tort claims. A breach of fiduciary duty may arise in various situations, including the mismanagement of trust investments and the ESOP payment of more than adequate consideration for sponsor company stock. The measurement and reporting of economic damages are often important components of breach of fiduciary duty tort claims.

This *Insights* issue addresses the measurement of economic damages in breach of fiduciary duty tort claims, including the use of the "but-for" investment portfolio to measure trustee breach of fiduciary duty damages. This is an important topic because judicial precedent establishes "but-for" analyses as one method to estimate economic damages in such breach of fiduciary duty claims.

This *Insights* issue also presents business valuation and forensic analysis thought leadership on a variety of topics including (1) the payment of ownership control consideration in an ESOP acquisition of sponsor company stock and (2) the assessment of the reasonableness of shareholder/employee compensation in closely held corporation taxpayers.

Each discussion presented in this *Insights* issue was developed by legal counsel and/or damages analysts with significant experience in breach of fiduciary duty matters. Willamette Management Associates analysts provide independent financial adviser, economic damages, forensic analysis, and valuation consulting services relating on a variety of fiduciary-related matters. These forensic analysis services often include both consulting expert services and testifying expert services.

About the Editors

Chip Brown

Frank "Chip" Brown, CPA, is a managing director of our Atlanta office. Chip leads the firm's ERISA litigation and ESOP advisory services practice.

Chip's practice includes valuation consulting, forensic analysis, and transaction advisory services. He often works with (and through) the legal advisers for closely held businesses as well as with trustees for ESOP sponsor companies. In addition, Chip performs forensic analysis and dispute advisory services for a variety of matters—including breach of fiduciary duty tort claims. These forensic services include both valuation and economic damages measurement analyses.

Chip performs valuation and transaction advisory (opinion) services including fairness opinions, solvency opinions, fair market valuations, and other financial advisory opinions on a variety of transactions.

Chip has served as an expert witness on a variety of matters in various state courts and in the U.S. District Court. He has also been retained for both the plaintiff and defendant side as an expert on valuation and fiduciary advisory related to ESOP investigation and litigation matters.

Chip has authored numerous thought leadership professional journal articles and professional textbook chapters. He has also delivered thought leadership presentations to numerous professional associations and conferences.

Katherine A. Gilbert

Katherine Gilbert is a vice president in our Atlanta office. Her practice includes business valuation, economic analysis, and financial opinion services. She works predominantly in the firm's wealth management valuation services practice. This practice includes a wide variety of valuation and financial advisory services performed for gift, estate, generation skipping transfer, and income tax purposes and for transaction pricing and structuring purposes.

Katherine has performed the following types of valuation and economic analyses: merger and acquisition valuations, fairness opinions, ESOP formation and adequate consideration analyses, acquisition purchase price allocations, business and stock valuations, and lost profits/economic damages analyses. She has prepared these analyses for the following purposes: transaction pricing and structuring (merger, acquisition, liquidation, and divestiture); taxation planning and compliance (federal income, gift, and estate tax; transfer tax); ESOP transaction and financing; and strategic information and planning.

Katherine is a member of the National Association of Certified Valuators and Analysts, holding the CVA designation. She is also a non-CPA associate member of the American Institute of Certified Public Accountants. Katherine is also a member of the ESOP Association.

Thought Leadership Discussion

Overview of the "But-For" Investment Portfolio to Measure Trustee Breach of Fiduciary Duty Damages

Kyle J. Wishing and Nicholas J. Henriquez

The "but-for" investment portfolio is a tool that damages analysts may use to estimate economic damages when there is an allegation of a trustee's breach of fiduciary duty with regard to the management of an investment. In its simplest form, the "but-for" investment portfolio estimates the value of a portfolio but for the alleged breach of fiduciary duty. Judicial precedent establishes the "but-for" investment portfolio analysis as one method to estimate economic damages on a market adjusted basis. While the concept of a "but-for" investment portfolio analysis is simple, the construction of a "but-for" investment portfolio is often complex. This discussion, from a damages analyst perspective, provides (1) a historical context for the "but-for" investment portfolio in case law, (2) an overview of common breaches of fiduciary duty, and (3) an examination of important areas involved in the construction of the "but-for" investment portfolio.

Introduction

The "but-for" investment portfolio is one version of the "but-for" test, which asks the question: "but for the existence of X, would Y have occurred?"[1]

The "but-for" investment portfolio analysis is one method that may be applied to measure damages related to an alleged trustee breach of fiduciary duty with regard to an investment or investment portfolio. The damages analyst constructs the "but-for" investment portfolio to estimate the value of the investment portfolio but for the alleged trustee breach of fiduciary duty. Economic damages are then calculated by subtracting:

1. the ending value of the actual trust investment portfolio (i.e., the actual portfolio suffering from the alleged breach of fiduciary duty) from
2. the ending value of the "but-for" trust investment portfolio.

The "but-for" investment portfolio analysis provides a market-adjusted estimate of economic damages designed to make the trust beneficiary whole. The "but-for" investment portfolio analysis is intended to capture opportunity cost, whereas other methods for estimating damages may overlook—or inappropriately estimate—the trust beneficiary's opportunity cost.

Fiduciaries in breach of fiduciary duty cases involving an investment portfolio may include, but are not limited to, trustees, investment managers, and financial advisers. The fiduciary is typically the defendant in the breach of fiduciary duty dispute. The plaintiffs in the breach of fiduciary dispute may include, but are not limited to, investors and trust beneficiaries. This discussion focuses on trustees as fiduciaries (or defendants) and trust beneficiaries as plaintiffs.

In a trustee breach of fiduciary duty dispute, the damages analyst role is to provide an estimate

of economic damages related to the alleged breach of fiduciary duty. The damages analyst may create multiple "but-for" investment portfolios to estimate a range of hypothetical scenarios, which can be used to estimate a range of economic damages.

The damages analyst typically does not opine on causation or liability aspects of the legal claim. The damages analyst typically operates based on the assumption (or legal instruction) that there was a breach of fiduciary duty. The burden of proving the antecedent of a breach of a fiduciary duty is not part of the damages analyst role.

The concept of a "but-for" investment portfolio is relatively straightforward, but the construction of a "but-for" investment portfolio is often complex. The analyst generally constructs the "but-for" investment portfolio according to:

1. the investment objectives and constraints of the beneficiary or
2. the investment objectives and constraints provided in the trust's governing documents (i.e., trust agreements, investment policy statements, etc.).

There are many variables that can affect the "but-for" investment portfolio damages analysis, such as determining the initial economic damages amount, assessing alternate investment suitability, setting alternate investment asset allocations, establishing rebalancing criteria, and understanding portfolio income tax consequences.

This discussion (1) provides historical precedence for the "but-for" investment portfolio, (2) summarizes common allegations in breach of fiduciary duty disputes, and (3) examines the construction of the "but-for" investment portfolio and the accompanying complexities in its construction.

History

The "but-for" investment portfolio is a product of case law. In 1978, the judicial decision from the Second Circuit Court of Appeals in *Rolf v. Blyth, Eastman Dillon & Co., Inc.*,[2] adjusted economic damages based on changes in the stock market.

In the *Rolf* decision, the Second Circuit concluded economic damages by adjusting the plaintiff's "gross economic loss" for the change in value of "any well-recognized index of value, or combination of indices, of the national securities market during the period commencing with defendant's [breach of fiduciary duty]."

It is noteworthy that, in the *Rolf* matter, markets generally declined, so the influence of the market adjustment was to decrease the amount of economic damages.

In 1981, the Fifth Circuit Court of Appeals decided a case that involved churning in a brokerage account. The court determined that the broker initiated unauthorized and/or excess trading or churning.[3] Judge Goldberg colorfully described the excessive commissions paid to the broker as "skimmed milk" and the decline in the plaintiff's portfolio value as "spilt milk."

Judge Goldberg explained the calculation of economic damages as follows: "In order to approximate the trading losses caused by the broker's misconduct, it is necessary to estimate how the investor's portfolio would have fared in the absence of the such misconduct. The trial judge must be afforded significant discretion to choose the indicia by which such estimation is to be made, based primarily on the types of securities comprising the portfolio."

The court upheld the jury's estimate of economic damages, which incorporated the decline in domestic equity indexes. However, the court's opinion referenced the use of a "specialized portfolio" that would more accurately estimate damages. The "specialized portfolio" referenced by the court opinion is analogous to a "but-for" investment portfolio.

The *Donovan v. Bierwirth*[4] matter involved market-adjusted damages and the use of a "but-for" investment portfolio. In *Donovan v. Bierwirth*, the Secretary of the Department of Labor filed suit against pension plan trustees for the Grumman Corporation Pension Plan. The complaint alleged a breach of fiduciary duty for improperly buying Grumman Corporation securities on behalf of the pension plan.

The trustees, who were also Grumman Corporation executives, acquired Grumman securities to block a tender offer for a controlling ownership interest made by the LTV Corporation.

The Grumman stock purchase was at an elevated price, as the share price increased from $26.75 per share to $35.88 per share as a result of the tender offer announcement. The Grumman stock traded between $36.00 and $39.34 during the tender offer period (prior to the enjoining of the tender offer for antitrust purposes).

When the tender offer failed, the Grumman stock price decreased to approximately $23 per share. Approximately 17 months later, the trustees sold the shares of Grumman stock at the then-current price per share of $47.55. Pension plan beneficiaries received a total benefit of $11.41 per share due to capital gains and dividends over their holding period.

The district court dismissed the case, concluding that the pension plan beneficiaries were not damaged due to the gain earned by holding the Grumman Corporation stock. However, in the Second Circuit Court of Appeals, Judge Pierce reversed the district court decision.

Judge Pierce determined that "ERISA section 409 requires a comparison of what the [Grumman Corporation Pension] Plan actually earned on the Grumman investment with what the Plan would have earned had the funds been available for other Plan purposes."

Judge Pierce elaborated on the calculation of economic damages as follows:

> In determining what the Plan would have earned had the funds been available for other Plan purposes, the district court should presume that the funds would have been treated like other funds being invested during the same period in proper transactions[5]

Plaintiffs provided a range of economic damages based on three alternative "but-for" investment portfolios that were available to Grumman Corporation pension plan participants during the damages period.

Breach of Trustee Fiduciary Duty

The prudent investor rule is the standard that trustees are held to in 43 states, the District of Columbia, and the U.S. Virgin Islands.[6]

The prudent investor rule is established in the Uniform Prudent Investor Act. The prudent investor rule is described as follows:

> A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
>
> A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.
>
> A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

Two common federal laws that may be relevant to breach of fiduciary duty cases are the Securities Exchange Commission ("SEC") Rule 10b-5 and the Employee Retirement Income Security Act ("ERISA") section 409.

SEC Rule 10b-5 deals with fiduciaries trading securities based on misrepresentation and omissions of facts. SEC Rule 10b-5 is used to protect investors and trusts from fraud related to investments and/or transactions due to a breach of fiduciary duty.

ERISA section 409 holds fiduciaries personally liable for a breach of fiduciary duty. Imposing personal liability on fiduciaries allows the Department of Labor to enforce liens on the fiduciaries' property, future income, or accounts to pay debts associated with a breach of fiduciary duty in a retirement fund.

There are many ways in which a trustee breach of fiduciary duty can occur. The following nonexhaustive list presents the actions that may result in a breach of fiduciary duty:

1. The sale of property for less than fair market value
2. The purchase of property for more than fair market value
3. The sale of property in violation of duty to retain and the subsequent appreciation of value in the property
4. The sale of property in violation of duty to retain and the subsequent depreciation of value in the property
5. The fiduciary generating excessive profits
6. An improper investment that decreases in value
7. Failure to remain loyal to a specified or predetermined asset allocation
8. The misuse of funds for personal usage,
9. The sale of trust property to the trustee[7]

Generally, the most contested portfolio management breach of fiduciary duty issues relate to:

1. excess fees and/or expenses regarding an investment or portfolio and
2. the suitability of an investment or portfolio.

This discussion focuses on these two issues.

Fees and/or Expenses

Excess fees and/or expenses in breach of fiduciary duty disputes are often related to:

1. excess trading to generate fees (also known as churning) or

2. charging undisclosed fees and/or expenses.

We first examine the issue of excessive trading in an account which leads to generating excess fees and expenses.

In the case of *Hatrock v. Edward D. Jones & Co.*,[8] the Ninth Circuit defined churning as, "when a securities broker engages in excessive trading in disregard of his customer's investment objectives for the purpose of generating commission business." It is important to note that a plaintiff may hold a fiduciary liable for churning without proving loss causation. In other words, churning can occur even when the plaintiff generates a positive return.

Fiduciaries often charge several types of fees and expenses in exchange for portfolio management services and expertise. Common types of fees include an assets under management ("AUM") fee, performance fees, account fees, redemption fees, exchange fees, purchase fees, and others.

Due to the significant amount of fees, it is important for a fiduciary to effectively communicate the fees and/or expenses charged on the investment portfolio. A fiduciary may breach its fiduciary duty by charging undisclosed or excessive fees.

The following example relates to an undisclosed fees case. In 2015, the Securities and Exchange Commission charged private equity fund advisers within the Blackstone Group L.P. with:

1. failure to disclose the practice of accelerating monitoring fees,
2. failure to disclose a legal fee agreement providing it with a greater discount on its legal fees than the discount the funds received, and
3. failure to adopt and implement written policies and procedures designed to prevent violations of the Investment Advisers Act of 1940, among other charges.

The case settled out of court with the Blackstone Group L.P. paying roughly $29 million to the affected fund investors.[9]

Investment Suitability

An additional manner in which a breach of fiduciary duty can occur is through improper investments based on suitability. In laymen's terms, suitability is whether or not an investment is appropriate for a trust. Fiduciaries often consider several factors when determining the suitability on an investment, two of which are the risk profile and investment goals of the trust.

Each trust has its own unique risk profile, which is based on the trust's objectives and constraints. The portfolio managers typically develop an Investment Policy Statement ("IPS") for the trust portfolio. The IPS characterizes a trust's objectives and constraints which, in turn, provides a framework for the fiduciary to determine investment suitability and asset allocation.

Risk tolerance is based on the propensity and the ability to assume risk. For example, in general, an older, retired client may have a lesser ability to assume portfolio risk than a younger client given:

1. less human capital,
2. a shorter investment time horizon, and
3. a greater need for current income.

Investment goals are another factor often considered when determining investment suitability. If the goal of the portfolio is capital appreciation or maximizing returns, then it may be improper for the fiduciary to recommend a significant allocation to U.S. Treasury securities. However, if the goal of the portfolio is to maintain value, then recommending U.S. Treasury bond investments could be perfectly acceptable.

The trust governing documentation is another factor that a fiduciary typically considers prior to determining the suitability of an investment.

Let's suppose that a stock broker suggests to a trust to invest in Google just after its initial public offering. However, trust bylaws forbid it from investing in equity securities other than utilities. While the stockbroker provided the trust with what we now know as a phenomenal investment, the fiduciary would not be allowed to execute the trade on behalf of the trust due to its bylaws. The governing documents may also place limits on asset allocations and portfolio rebalancing.

Hindsight Bias

Any decision can be subject to hindsight bias. Hindsight bias occurs when a past event appears obvious after the event has transpired. Making investment choices is extremely difficult and, especially, any "poor" or "missed" investments can be subject to hindsight bias.

In investment portfolio breach of fiduciary duty disputes, the plaintiff has the benefit of hindsight, whereas the fiduciary (or defendant) is always looking at the portfolio or a specific investment in the portfolio in the present. In these instances, the issue is not investment performance—but rather investment suitability.

An example of hindsight bias is the Great Recession in 2008. In the wake of the Great Recession, many institutions and individuals sued investment banks for failure to avoid investment losses on mortgage-backed securities and collateralized debt obligations. In reality, very few investors utilized investment strategies to take advantage of the economic downturn.

The Great Recession example could be viewed by beneficiaries as either a "poor" or a "missed" investment opportunity. Investors who took short positions in collateralized debt obligations made millions; therefore, not investing in the short position exemplifies a "missed" investment opportunity.

Alternatively, investors who took long positions in collateralized debt obligations lost big on housing market defaults; therefore, investing in the long position exemplifies a "poor" investment opportunity.

Hindsight bias may lead plaintiffs to question why their fiduciary did not recognize either "poor" or "missed" investment opportunities, which can lead to a legal complaint. Thus, fiduciaries should be weary of the hindsight bias associated with a plaintiff's complaint of breach of fiduciary duty.

Breach of fiduciary duty claims are often trial before a jury. Jury trials can favor the plaintiff in cases where improper investments are alleged because, similar to the plaintiff, jurors are often subject to hindsight bias.[10]

The fact that jurors are also subject to hindsight bias adds additional pressure on fiduciaries facing improper investment allegations.

Transparency and Documentation

One way for fiduciaries to protect themselves against allegations of breach of fiduciary duty is through transparency and documentation.

Transparency and documentation of all fees that will be charged on the account can mitigate breaches of fiduciary duty for excessive fees. Documenting any and all proposed investments and transactions and the outcomes can help defend against a churning allegation. Documenting the outcome of any proposed investment or transaction may also aid in a defense against improper investment allegations based on hindsight bias.

If the fiduciary documents why a particular investment was either made or not made, then it could remove the crux of the plaintiff's complaint. This is because the investment decision was documented at the time of the proposition.

Construction of the "But-For" Investment Portfolio

While the logic behind the "but-for" investment portfolio is relatively straightforward, the construction of a "but-for" investment portfolio can be complex—depending on the facts and circumstances of the litigation. The "but-for" investment portfolio is developed to demonstrate what the value of the actual investment portfolio would have been but for the alleged breach of fiduciary duty.

The "but-for" investment portfolio is created on the date of the initial breach of fiduciary duty. The "but-for" investment portfolio consists of securities that are appropriate for the trust. The "but-for" investment portfolio is then analyzed over the economic damages period according to the facts and circumstances of the portfolio. Economic damages are measured considering, in part, the difference between the "but-for" investment portfolio ending balance and the actual investment portfolio ending balance.

There are numerous factors for the damages analyst to consider in the construction of the "but-for" investment portfolio. These factors are generally considered with regard to the trust governing documents and the approved (or understood) investment policies for the actual investment portfolio. These factors include the following:

- Economic damages period(s)
- An assessment of the breach or breaches of fiduciary duty
- Investment suitability/asset allocation
- Tax considerations
- Treatment of investment portfolio cash flow

- Frequency of rebalancing
- Application of fees/expenses

The failure to consider and incorporate these factors into the "but-for" investment portfolio may result in a calculation of economic damages that is inconsistent with economic reality. Any of the above-listed factors may be disputed as part of the litigation process.

Often, the damages analyst will create multiple "but-for" investment portfolios—based on varying assumptions for the factors listed above. The multiple "but-for" investment portfolios may be used in conjunction with the actual investment portfolio to produce a range of economic damages. That range can assist the finder of fact in determining an appropriate economic damages measure once the finder of fact opines on the contested issues.

Economic Damages Period

Defining the appropriate economic damages period is important for constructing the "but-for" investment portfolio and, ultimately, providing an indication of economic damages. While this fact may seem straightforward, the economic damages period may be disputed.

It is a common practice for legal counsel to advise the damages analyst to construct "but-for" investment portfolios with different starting and ending dates to account for the unresolved economic damages period. The different dates add to the overall complexity of the damages analysis.

Assessment of the Breach or Breaches of Fiduciary Duty

There are certain instances when the timing and amount of the initial damage from the breach of fiduciary duty is disputed.

Take for instance a claim of a breach of fiduciary duty due to a concentrated stock position. A stock position may become concentrated because the investment outperforms the rest of the portfolio. If the portfolio does not have established rules for trading a concentrated stock position, it may be difficult for plaintiffs and defendants to agree upon a sale date, sale price, and percentage of the concentrated position sold.

This variable alone can greatly influence the estimate of economic damages. The variation and the assessment of the initial breach of fiduciary duty adds to the overall complexity of the damages analysis.

Investment Suitability/Asset Allocation

The asset allocation decision is typically an important factor in determining the returns on a portfolio. Therefore, it is no surprise that the asset allocation decision is often contested in breach of fiduciary duty claims.

Generally, investment portfolios with thorough, well-defined investment objectives and constraints provide acceptable asset allocation ranges. For instance, an illustrative asset allocation range could be as follows:

- Cash and money market funds: 0-10 percent
- Fixed income securities: 40-50 percent
- Equity securities: 40-60 percent

In this simplified example, the damages analyst would likely create several "but-for" investment portfolios with different asset allocations within the specified bands. The analyst may use these alternative allocations to asses a range of reasonable investment returns.

In situations where there is (1) a lack of clarity in portfolio governing documents and/or (2) a broad investment mandate, the range of asset allocation and investment suitability is much broader. In these instances, the range of economic damages for the "but-for" investment portfolios can be substantial.

An additional consideration in the construction of the "but-for" investment portfolio is the fact that investment suitability and asset allocation may change over the economic damages period—as investment goals and risks change. This consideration may further complicate the construction of the "but-for" investment portfolio.

Income Tax Considerations

The income tax status of the trust needs to be considered over the entire economic damages period. The damages analyst may need to understand if there are any specific income tax considerations in the disputed portfolio and incorporate certain tax strategies in the "but-for" investment portfolio.

The tax profiles and characteristics of portfolios are generally in line with the tax profiles and characteristics of their trust beneficiaries. Therefore, the damages analyst may consider not only the tax profile and characteristics of the "but-for" investment portfolio, but also the tax profile and characteristics of the beneficiaries.

Some of the factors that make up a tax profile are income level, adjustments to taxable income, exemptions and tax deductions, tax credits, and filing status.

One consideration for a damages analyst is that the tax profile of the "but-for" investment portfolio may change over the economic damages period, similar to the changing tax profiles of the beneficiary over their lives.

Depending on the length of the economic damages period, the tax treatment for investment asset classes and tax environment for trust beneficiaries may change. This consideration may further complicate the "but-for" investment portfolio analysis.

Treatment of Investment Portfolio Cash Flow

During the life of the trust's investment portfolio, it will produce a level of cash flow from dividends, coupon payments, and distributions from its investments. The investment portfolio may distribute this income to beneficiaries, reinvest the income, or a combination of the two.

The trust investment portfolio may receive regular, periodic, or random contributions. And, the investment portfolio may be asked to make distributions on regular, periodic, or random intervals to its beneficiaries.

As part of the "but-for" investment portfolio, the damages analyst may need to make assumptions regarding the treatment of the various forms of investment portfolio cash flow. These assumptions will invariably influence the estimate of any economic damages and the overall complexity of the damages analysis.

Frequency of Rebalancing

Rebalancing is the process used by portfolio managers to realign asset allocation weights in an investment portfolio. There are typically three methods for determining when to rebalance a portfolio:

1. Time only
2. Threshold only
3. A combination of time and threshold

Time only rebalancing is the procedure where a fiduciary rebalances a trust portfolio at predetermined intervals to maintain the ascribed asset allocation. Time only rebalances typically occur on a monthly, quarterly, semiannual, or annual basis.

Threshold only is a procedure that considers the actual asset weights as a percent of the entire portfolio as they drift from the ascribed allocation based on market values. The threshold only rebalance occurs when the asset allocation crosses a predetermined threshold for the allocation.

For example, if the ascribed asset allocation for the portfolio is to be 60 percent equity and 40 percent fixed income with a threshold of 10 percent, then a rebalance would be triggered at any time the equities account for more than 70 percent or less than 50 percent of the portfolio.

The third rebalancing procedure is a combination of the threshold rebalancing procure and the timing rebalancing procedure. This procedure takes into account the predetermined times to rebalance and any allocation-triggered rebalances. The combination rebalance is triggered by either the time since the last rebalance or by exceeding the threshold.

If the IPS describes a clear procedure for rebalancing the portfolio, then that procedure, generally, is most applicable for the "but-for" investment portfolio. However, in the case that the IPS does not describe a well-defined procedure for rebalancing, then the damages analyst may consider the factors above and how they relate to the profile of the trust and the "but-for" investment portfolio.

Application of Fees/Expenses

The "but-for" investment portfolio will typically be adjusted for fees and expenses. The damages analyst may look at the fees and expenses stated in the IPS, or the damages analyst may need to consider market-based fee and expense rates.

If the portfolio management fees and expenses are well defined in the IPS, then it may make sense

for the damages analyst to use the fees and expenses as stated in the IPS. However, if the fees and expenses are not well defined in the IPS, then the damages analyst may consider using market rates for the fees and expenses.

The actual trust portfolio may be subject to AUM fees, performance fees, account fees, redemption fees, purchasing fees, transaction fees, and other fees/expenses. It is up to the damages analyst to understand whether the actual trust portfolio fees are applicable to the "but-for" investment portfolio.

If the fee structure is disputed, it may be beneficial for the damages analyst to incorporate a sensitivity analysis for the range of appropriate fees and expenses charged on the "but-for" investment portfolio.

Complex fee structures are not uncommon for trust investment portfolios, especially among actively managed funds and alternative investments. Complex fee structures add complexity to the construction of the "but-for" investment portfolio.

Let's consider the case of a hurdle rate performance fee, one of the more common complex fee structures. If the disputed portfolio contains a hurdle rate performance fee, the analyst's model should consider the possibility of the "but-for" investment portfolio clearing a hurdle rate. Upon clearing the hurdle rate, the manager of the fund is rewarded for surpassing expectations.

Therefore, the damages analyst may consider including the hurdle rate expense calculation in the damages model to avoid overstating economic damages. While the hurdle rate example is fairly straightforward, the fees and expenses are based on piece-wise structures, which can be more difficult to model.

Conclusion

The "but-for" test and its product (i.e., the "but-for" investment portfolio) are generally accepted methods for calculating economic damages. The "but-for" investment portfolio method may be particularly applicable in cases involving the allegation of a trustee breach of fiduciary duty with respect to investment portfolios.

While other methods for estimating economic damages in these cases exist, many of those alternative methods fail to properly account for opportunity costs.

The "but-for" investment portfolio in conjunction with the actual trust portfolio may be a useful method for measuring trustee breach of fiduciary duty damages and other damages. Due to the aforementioned complexities associated with the construction of the "but-for" investment portfolio, an experienced damages analyst should be involved in this process.

Damages analysts should have the following skills:

1. Thorough knowledge of financial markets to interpret investment suitability
2. Expertise in financial modeling
3. The ability to interpret results in a cohesive manner for finders of fact

Notes:

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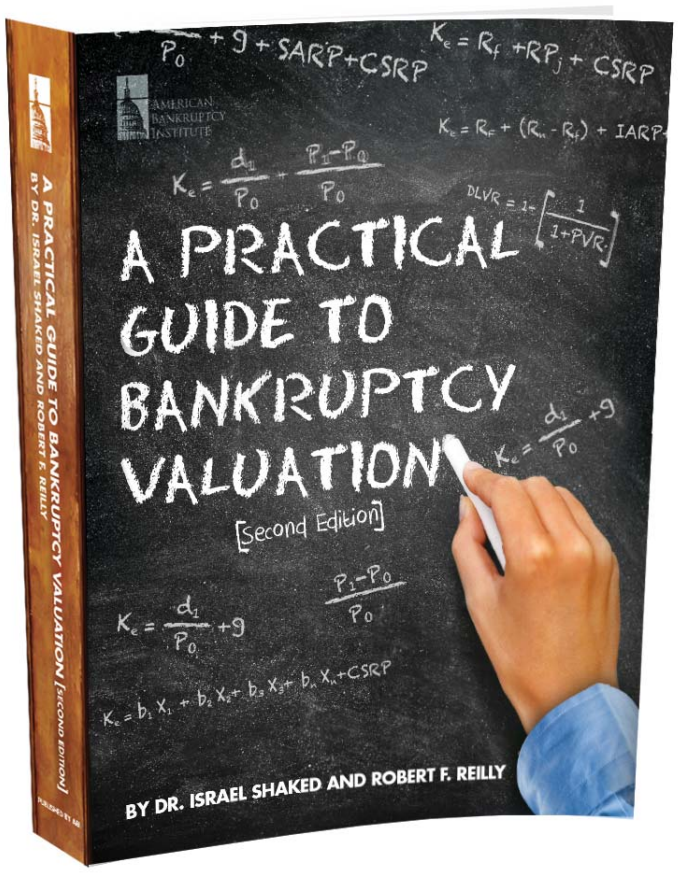

Published by the American Bankruptcy Institute, the revised and expanded second edition of *A Practical Guide to Bankruptcy Valuation* contains a wealth of information on how solvency and capital adequacy analyses, creditor-protection issues, debtor-in-possession financing, fraudulent conveyance and preference claims, restructuring of debtor securities, sale of bankruptcy estate assets, plans of reorganization, bankruptcy taxation issues and fresh-start accounting issues, among others, are factored into properly valuing a bankrupt company.

Interspersed with helpful charts and hypothetical examples, this manual describes the generally accepted approaches for valuing the assets and securities of a financially troubled business. It also provides professional guidance to troubled-company managers, debt-holders and other creditors, equity-holders and investors, bankruptcy counsel, juridical finders of fact and other parties to a bankruptcy proceeding, including those called upon to be expert witnesses in bankruptcy cases.

Based on the authors' combined 75 years of experience in the valuation field, *A Practical Guide to Bankruptcy Valuation,* second edition, lays a solid foundation for those seeking a better understanding of valuation within the bankruptcy context.

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A PRACTICAL GUIDE TO BANKRUPTCY VALUATION

Dr. Israel Shaked and Robert F. Reilly

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Willamette Management Associates

Application of the Sales Projection Method in Measuring Trustee Breach of Fiduciary Duty Damages

Justin M. Nielsen

The prudent investment of trust assets can minimize the potential for trustee fiduciary litigation risk, in addition to maximizing the trust beneficiaries' economic interest in the trust. However, trust beneficiaries may initiate a breach of fiduciary duty tort claim when they feel that the trustee has breached any investment management fiduciary duties to the trust. For trust beneficiaries, and their legal counsel, who have brought breach of fiduciary duty tort claims against a trustee, one of the issues is how to measure the "damage" to the beneficiaries as a result of the breach. This discussion addresses the role of the investment management trustee as a fiduciary to the trust beneficiaries. This discussion then presents an analysis that legal counsel, in collaboration with a damages analyst, can use in attempting to quantify the "damage" to the trust beneficiary as a result of the investment management trustee breach of fiduciary duty.

Introduction

When investing trust assets, a trustee has a fiduciary relationship to the beneficiaries of that trust. As presented in *Paul v. North*:

> A fiduciary relation exists between two persons when one of them is under a duty to act or to give advice for the benefit of another upon matters within the scope of the relation.[1]

Most business relationships/partnerships are not fiduciary relationships/partnerships. While most business relationships/partnerships have a degree of trust and confidence, a fiduciary relationship exists when:

1. one party is accustomed to being guided by the judgment and advice of another party or
2. one party otherwise believes that another party is acting in his or her best interest.

Potential fiduciary liabilities (i.e., breach of fiduciary duty tort claims) are possible when an investment management trustee does not adequately perform the required fiduciary duties.

These fiduciary liabilities generally arise from a breach of the "standard of care," as defined by the "prudent investor rule" ("PIR"). This means that the trustee standard of care and investment management fiduciary duties require a prudent investment of the trust assets. This duty typically includes both (1) competent initial investment and (2) continued monitoring of the performance of the trust assets.

It is common in breach of trustee fiduciary duty tort matters for the court to award economic damages in an amount necessary to make the beneficiary whole. However, quantifying the damages caused by the trustee breach of fiduciary duty can prove problematic. While there are several generally accepted methods available to measure economic damages, the sales projection method is one method to measure economic damages in a trustee breach of fiduciary duty tort matter.

While the sales projection method is commonly used to quantify lost profits economic damages for business operations, it can also be tailored to effectively analyze and quantify investment management economic damages as a result of a trustee breach of fiduciary duty.

This discussion:

1. provides a summary of investment management trustee fiduciary duties to beneficiaries, as well as some examples of a breach of those fiduciary duty;
2. discusses and addresses how the damages analyst can assist legal counsel in estimating the tort "damages" attributable to a breach of fiduciary duty by the trustee; and
3. includes an illustrative example of the sales projection method, which we simply call the "projection" method.

Trustee Fiduciary Duties

Common-law trusts separate legal and beneficial ownership, with the trustees holding legal title to trust property, which they in turn manage on behalf of the beneficiaries. The person who establishes a trust is referred to as the "trust settlor," "grantor," or "trustor."

Trustee fiduciary duties originate from the responsibility of having fiduciary powers—that is, the investment management fiduciary power to select the investments of a particular trust on behalf of the trust settlor, grantor, or trustor.[2]

As presented in the American Bar Association article "Trustee Bank's Breach of Investment Management Fiduciary Duties":

> The investment management fiduciary power, in conjunction with the duty of undivided loyalty, creates the standard of care and scope of the investment management fiduciary duties.[3]

As a result of these fiduciary powers, trustees are held to a high standard of care. As presented in the judicial decision *Meinhard v. Salmon*:

> [A fiduciary] is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.[4]

In selecting the investments of a particular trust, and considering the requirement of the trustee to continually monitor the performance of the selected trust investment assets, trustees should choose the extent to which the trust returns (and ultimately the beneficiaries' trust distributions) are subject to market risks and volatility. This is because trustees are required to provide a standard of care and act prudently in selecting and monitoring trust investments for the beneficiaries.

The PIR provides guidance to trustees with regard to fiduciary duties that are required by a trustee in managing trust investment assets. As presented in the *Restatement (Third) of Trusts (1992)* and the *Uniform Prudent Investor Act (1994)*, the PIR requires a trustee to utilize an overall investment strategy. Such a strategy should have risk and return objectives that are "reasonably suited" to the trust.

Further, the PIR requires that a fiduciary (i.e., trustee) invest trust assets as if they were his or her own assets. The fiduciary (i.e., trustee) should consider the needs of the trust's beneficiaries, the provision of regular trust income or distributions to the beneficiaries, and the preservation of trust assets.

The PIR also requires the trustee to:

1. diversify the investments of the trust,
2. avoid investments that are excessively risky, and
3. monitor investments and make portfolio adjustments on an ongoing basis.[5]

Fiduciary liabilities, that is, breach of fiduciary duty tort claims, are typically initiated as a result of the trustee not adequately performing his or her fiduciary duties. However, it's important to note that fiduciary liabilities, or breach of fiduciary duty tort claims, are not always dependent on the relative change in value of the trust assets. Rather, breach of fiduciary duty tort claims may be brought against a trustee as a result of a failure to prudently represent the beneficiaries of a particular trust.

For example, let's assume there is a $2 million trust that had been set up for two 20-year-old beneficiaries. The 20-year-old beneficiaries are:

1. unable to work,
2. expected to live approximately 50 years, and
3. anticipating the receipt of annual distributions from the trust of $100,000 (in aggregate) over the next 50 years based on the initial goal of the trust.

Further, let's assume that it is also the goal of the trust to ensure that the $2 million initial principal balance is available for the beneficiaries at the end of 50-year term.

Next, let's assume that the initial trust assets were comprised of dividend-paying common stocks. However, shortly after engaging the trustee to manage the trust, the trustee sold all of the dividend-paying common stocks and invested the entire proceeds in non-dividend-paying, growth-oriented common stocks.

If over the next three years there is insufficient income from the trust investment assets to meet the $100,000 annual distribution to the 20-year-old beneficiaries, then it may be inferred that the trustee has not prudently represented the beneficiaries of the trust.

Should legal counsel determine that the trustee has breached his or her fiduciary duty to the beneficiaries, the next step is to utilize a damages analyst to quantify any potential damages associated with the breach. It is important to note that the damages analyst should be consulted early on in the process.

This is because it may be advantageous to legal counsel for the damages analyst to:

1. assist with assessing the merits of the case (including providing some initial analysis to determine the scale of the potential economic damages associated with a breach of fiduciary duty),
2. assist with weighing the merits and risks of going to trial, and
3. assist with reviewing and critiquing other damages analyst's work that may be transmitted during the engagement.

Measuring Economic Damages in a Trustee Breach of Fiduciary Duty Tort Claim

There are several generally accepted methods to measure economic damages in a trustee breach of fiduciary duty tort claim. While the application of these methods are more commonly used to quantify lost profits economic damages for business operations, they can also be tailored to effectively analyze and quantify investment management economic damages as a result of a trustee breach of fiduciary duty.

The underlying theory of lost profits damages, as it relates to business operations, is that "but-for" the actions of the defendant (or "but-for" the damaging event) the plaintiff would have experienced a higher level of revenue and profits. Considering the example presented in the previous section, this method can be applied to trustee breach of fiduciary duty tort claims where, "but-for" the actions of the trustee, the beneficiary would have experienced (received) an appropriate level of trust distributions.

In addition to the sales projection method (referred to herein as the "projection" method), the following list presents the three other generally accepted methods to quantify lost profits and lost revenue for business operations:

1. Before-and-after method
2. Yardstick method
3. Market model method

As mentioned, while initially constructed to analyze lost profits and lost revenue for business operations, the above methods, in addition to the projection method, may be used to quantify economic damages attributable to trustee breach of fiduciary duty.

Before-and-After Method

As presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, the before-and-after method is described as follows:

> The "before-and-after" method determines economic revenues for the damages period by comparing the performance of the business before the event occurred and after the effects of the damaging event are over. The underlying theory is that, "but for" the event, the plaintiff would have experienced the similar revenues and anticipated lost profits during the damages period before the event occurred and/or after the event has subsided.[6]

Many damages analysts refer to the "before-and-after" method as the "book ends" method. This reference is due to the fact that this damages measurement method uses historical financial information (before and after the damaging act) as proxies to quantify what would have happened during the wrongful act time period.

In order to correctly apply the "before-and-after" method, the damages analyst should identify and quantify any other factors that may have affected profitability or revenue during the damages period, as well as before and after the damages period (i.e., the "book ends" period).

For example, if the damages analyst is attempting to quantify damages for a real estate development company over a 2009 to 2010 damages period, the effects of the industry performance, as well as the performance of the regional, national, and global economy, should also be considered in measuring damages attributable to the wrongful act.

Yardstick Method

As presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, the yardstick method is described as follows:

> The yardstick method utilizes guideline company or industry measures to serve as proxy for what the revenues and profits of the affected business would have been but for the damaging event.[7]

One component of the yardstick method is for the damages analyst to identify guideline companies (namely guideline publicly traded companies) that are reasonably comparable to the subject business.

The damages analyst should also appropriately consider any changes, other than the wrongful act, that may have affected the subject company performance over the damages period (such as changes in management, changes in product design, unrelated litigation, etc.).

Market Method

As presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, the market method is described as follows:

> The fourth methodology for determining lost profits, the market model, is not used as often as the first three models already discussed. According to this methodology, the expert considers the plaintiff's market share prior to the defendant's alleged act to determine lost revenues/sales. For example, in a market in which the plaintiff and defendant are sole competitors, the plaintiff needs only to show "evidence defining the market, demonstrating what share of the market would have been but for the defendant's breach, and establishing the profit he would have earned on the increased sales."[8]

While this method is sometimes applied in patent infringement matters, it may be applied in other damages scenarios, if appropriate data are available.

As mentioned above, each of these methods can be tailored to measure trustee breach of fiduciary duty economic damages. For purposes of the following illustrative example, it is more appropriate to apply the projection method.

Projection Method

As presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, the projection method is described as follows:

> The sales projection method utilizes company-specific forecasts for certain items, preferably by using forecasts that the company has prepared in the ordinary course of business or for some purpose other than the litigation. Some businesses are more sophisticated than others, and their projections (formatted like a typical income or operating statement) may specify revenues by product lines, detailed expenses, income taxes, and miscellaneous income/expenses.[9]

Many courts have concluded that the projection method for calculating commercial economic damages is reliable. However, as presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*:

> [T]he challenge for the financial expert remains how to make the appropriate estimates and analyses and then relate them to the performance that the specific event impacted so the conclusions are reliable.[10]

Based, in part, on the court's view that the projection method is generally reliable, it is a common method used to estimate commercial economic damages. And, the projection method can be easily tailored to quantify other damages, such as trustee breach of fiduciary duty economic damages.

The following illustrative example presents the application of the projection method in measuring economic damages attributable to a trustee breach of fiduciary duty.

Illustrative Example

Let's consider an example of a trustee damaging act involving a $2 million trust that had been set up for two 20-year-old beneficiaries. Specifically, the example encompasses the following information:

- The beneficiaries are two 20-year-olds who are unable to work.
- The two 20-year-old beneficiaries are required to receive an annual $100,000 (in aggregate) distribution from the trust.
- The term of the trust was 50 years.
- A further goal of the trust was to ensure that the $2 million principal balance is available for the beneficiaries at the end of the 50-year term.
- The trust was initially invested in dividend-paying common stocks.
- The trustee, upon appointment, sold all of the dividend-paying common stocks and subsequently invested the entire proceeds in non-dividend-paying, growth-oriented common stocks.
- The trust was unable to distribute the required $100,000 in each year over the three years subsequent to the trustee appointment.

In tailoring the projection method to measure the trustee breach of fiduciary duty economic damages, the damages analyst should attempt to quantify the amount of income generated by the trust assets "but-for" the trustee damaging act. This analysis would entail:

1. holding the trust portfolio of assets at a "standstill" over the three years subsequent to the trustee appointment and
2. subtracting all income generated by the "new" trust portfolio investments (initiated by the trustee) over the three years subsequent to the trustee appointment.

The annual difference between the income generated by the "standstill" trust portfolio of assets and the income generated by the "new" trust portfolio assets would represent the damages attributable to the trustee breach of fiduciary duty.

Mathematically, this procedure would be:

(Year 1 Standstill Assets Income – Year 1 New Assets Income)
\+ (Year 2 Standstill Assets Income – Year 2 New Assets Income)
\+ (Year 3 Standstill Assets Income – Year 3 New Assets Income)
= Breach of Fiduciary Duty Damages

For purposes of the example, let's also assume that the three-year damages period is January 1, 2013, through January 1, 2016. Further, let's assume that the trust assets prior to the appointment of the trustee were investments in the common stock of (1) Ford and (2) AT&T.

Finally, let's assume that the investments made by the trustee (i.e., the new trust portfolio assets) resulted in zero dividends/income over the three-year damages period.

Based on these assumptions, the measurement of the trustee breach of fiduciary duty economic damages is summarized below.

As presented in Exhibit 1, let's assume the following:

1. The initial purchase amount for each dividend-paying stock was $1 million.
2. The initial share prices of Ford and AT&T on January 1, 2013, were $15 per share and $35 per share, respectively.
3. The annual dividend per share for Ford and AT&T was $1 and $2, respectively.

Based on the application of the projection method, as presented in Exhibit 1, the trustee breach of fiduciary duty economic damages are measured

Exhibit 1
Illustrative Economic Damages Analysis

Standstill Assets	Initial Amount	Initial Share Price	Number of Shares	Dividend per Share	Year 1 ($)	Year 2 ($)	Year 3 ($)
Ford	$1,000,000	$15.00	66,666.67	$1.00	66,667	66,667	66,667
AT&T	$1,000,000	$35.00	28,571.43	$2.00	57,143	57,143	57,143
				Total Standstill Assets Income	123,810	123,810	123,810
				Total New Assets Income	-	-	-
				Total Annual Indicated Economic Damages	123,810	123,810	123,810
				Total Economic Damages	371,429		

at $371,429. This simplified example is one of the many ways the projection method can be applied to measure economic damages based on a trustee breach of fiduciary duty.

Conclusion

This discussion presented an overview of investment management trustee fiduciary duties including how and when a damages analyst can be utilized to measure potential economic damages as a result of a trustee breach of fiduciary duty.

Legal counsel should consult the damages analyst early on in the process of reviewing a potential trustee breach of fiduciary duty claim. This early consultation is recommended because the damages analyst can:

1. assist with assessing the merits of the case (including providing some initial analysis to determine the scale of the potential economic damages associated with a breach of fiduciary duty),
2. assist with weighing the merits and risks of going to trial, and
3. assist with reviewing and critiquing other valuation analyst's work that may be transmitted during the engagement.

There are several generally accepted methods that can be used to measure economic damages, including:

1. the "before-and-after" method,
2. the yardstick method, and
3. the market model method.

The sales projection method may be the most common method to measure economic damages.

However, with appropriate considerations, all four measurement methods may be tailored to measure potential economic damages as a result of a trustee breach of fiduciary duty.

Notes:

1. Paul v. North, 191 Kan. 163, 380 P.2d 421, 426 (1963).
2. The trustee fiduciary duties are based on the rights conferred by (1) the purpose of the subject trust, (2) the subject trust terms, and (3) relevant state laws.
3. O.A. Ishmael, "Trustee Bank's Breach of Investment Management Fiduciary Duties," *Commercial and Business Litigation Articles*, americanbar.org.
4. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).
5. Ultimately, investment management trustees are expected to continually analyze investments that differ in their risk and return characteristics, with the optimal risk selection reflecting the financial resources, life situations, and risk tolerance of the beneficiaries who will ultimately receive the trust income and distributions.
6. Nancy J. Fannon and Jonathan M. Dunitz, *The Comprehensive Guide to Lost Profits and Other Commercial Damages* (Portland, OR: Business Valuation Resources, 2014), 219.
7. Ibid., 220.
8. Ibid., 226.
9. Ibid., 223.
10. Ibid., 225.

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Best Practices Discussion

Measuring and Defending Economic Damages in Breach of Fiduciary Duty Tort Claims

Casey D. Karlsen and Jacob Jackson, Esq.

Breach of fiduciary duty tort claims often incorporate complex legal topics and damages analyses. Some of these legal and damages-related topics are summarized in this discussion. From a legal perspective, this discussion summarizes the law under which a plaintiff may seek to recover economic damages, the circumstances where lost profits may be awarded, and the effect on damages of a heightened standard of care placed on fiduciaries. This discussion then presents three methods that analysts commonly use to measure economic damages—the before-and-after method, the yardstick (or comparable) method, and the sales projections "but for" method.

Introduction

A fiduciary relationship is one in which one party holds a legal or ethical relationship of trust with another party (or group). Asset managers, trustees, and banks are a few of the common fiduciaries. Fiduciaries usually have power over the assets of beneficiaries, who may or may not hold legal title to those assets.

The trust fiduciary is under significant obligations to:

1. put the beneficiary's interest first,
2. avoid conflicts of interest, and
3. not profit without the beneficiary's knowledge and consent.

When the fiduciary's actions cause a break in this trust (a "bad act"), the beneficiary may bring a legal cause of action and may pursue lost profits. The path to recovering lost profits is somewhat unique to a breach of fiduciary duty.

This discussion summarizes the law under which a plaintiff may seek to recover economic damages, the circumstances in which lost profits may be awarded, and the effect on damages of a heightened standard of care placed on fiduciaries.

This discussion also summarizes three methods for measuring economic damages:

1. The before-and-after method
2. The yardstick method
3. The sales projections method

This discussion summarizes the variables that damages analysts may consider when measuring lost profits in breach of fiduciary duty tort claims.

Finally, this discussion integrates these topics into an illustrative example.

Legal Liability Background

Sources of Law

To understand legal liability in the context of a breach of fiduciary duty, legal liability and standards of care should first be understood. Broadly, legal liability arises from one of two bodies of law: tort law or contract law.

Contract law provides forward-looking remedies with the intent of placing the wronged party in the position in which they would have been, had the other party not breached the deal.

On the other hand, tort law is restorative and attempts to place a wronged party back to where they were before the harm. In this way, contract law is forward looking and tort law is rearward looking.

To know which body of law to apply to a situation, legal counsel typically looks to whether or not there is a contract. If there is a contract that has been breached, contract law applies. Where someone has been harmed in a way that was not a breach of contract, tort law applies.

As with most legal matters, exceptions abound. In the case of fiduciary relationships, many states have adopted laws allowing for tort claims even when a contract exists. States have also adopted laws providing for certain duties and obligations, whether or not these items actually appeared in the disputed contract or were even agreed to by the parties of the complaint.

States commonly have laws that provide specific guidelines for damages in a breach of fiduciary duty case.

To sum up the three types of applicable law: contract law applies when a contract exists, tort law applies when a contract does not exist, and state laws can modify or define those contracts and tort claims.

Elements of a Cause of Action

At their cores, both contract law and tort law generally require four basic elements to be shown by the party bringing a lawsuit:

1. A duty owed by the defendant to the plaintiff
2. A breach of that duty
3. Damage to the plaintiff (whether monetary or otherwise)
4. A causal link between the breach of duty and the damage

These four basic elements are the building blocks of nearly every civil lawsuit.

Of these four basic elements of contract law and tort law, duty reigns king. Plaintiffs want the duty to be broad and expansive—while defendants want the duty to be defined very narrowly to show their actions were not in violation of any duty.

In a contract claim, the concept of duty is replaced with the existence of a contract. The terms of a contract are essentially the duty of each party. The concept of duty is commonly used in the tort law context.

Determining the Duty of a Defendant

The process of defining a duty depends on the type of legal action. A defendant's duty in a contract is typically easier to ascertain than in a tort dispute, assuming a well-written contract. What a potential defendant needs to do to avoid liability can literally be in black and white.

The duty in tort law is sometimes fluid and guided by vague standards. A common, and the lowest, duty is to act as a reasonable person. That is, generally, everyone in every situation has a duty to exercise reasonable caution against every reasonably foreseeable plaintiff. Understandably, many lawsuits have revolved around the concept of reasonableness to identify what the defendant's duty actually was.

Where states have created tort causes of action, the duty element is often written into state statutes. The courts will interpret these statutes, but usually duty is more precisely defined in these circumstances.

Generally, the process to determine legal duty in a breach of fiduciary duty is summarized as follows. First, legal counsel may look to state statutes for specific duties. Second, legal counsel may then look to whether or not a contract existed between fiduciary and beneficiary. If so, the duty owed could be one or a combination of these two sources. Finally, if neither state statutes nor contracts apply, then legal counsel may analyze whether or not the fiduciary dropped below a reasonable standard of care, as defined by the local courts.

Statutory Duties Owed by a Fiduciary in Washington and Oregon

A fiduciary relationship is sacred to many states. The concept of reasonableness is replaced by a duty of loyalty and other duties depending on the exact relationship.

A trustee-beneficiary relationship is a good example of a fiduciary relationship. A trustee has a duty to keep beneficiaries reasonably informed about the status of the trust, avoid personal conflicts, and other specific requirements. Because states may have differing laws on fiduciary duties and damages, this discussion focuses on Washington and Oregon.

Washington imposes duties on trustees which specifically include a duty to inform the beneficiaries of "facts necessary for them to protect their interests" and to "administer the trust solely in

the interests of the beneficiaries" amongst many other specific guidelines (RCW 11.98.072(1) and RCW 11.98.078(1)). Oregon has statutes with nearly identical language (ORS 130.710(1) and ORS 130.655(1)).

Washington and Oregon similarly provide guidelines for damages in the trustee-beneficiary context. They both state, in similar words, that a trustee who breaches their duties related to a trust is liable for the greater of the cost to restore the trust to the pre-breach condition or the profit the trustee made through breaching the trust.[1]

In this way, both states take a traditional torts approach to damages, but also give the beneficiary the profit of the bad act, if that profit was greater than the actual damages.

Breaches of fiduciary duties take many forms and result from several types of fiduciary relationships. As a result, legal counsel may analyze state statutes for heightened duties owed by fiduciaries and for increased damages when a breach of fiduciary duty occurs.

Lost Profits Considerations

In most civil cases, a plaintiff only needs to prove the facts by a preponderance of the evidence. Whether an issue is being decided by a judge or jury, the finder of fact need only to conclude that the plaintiff's allegations are more likely than not correct. This legal standard may generally be quantified as a 51 percent certainty that the plaintiff's allegations are correct.

Lost profits may be more judgment-based by nature. Accordingly, courts have not uniformly accepted this generous standard. A "reasonable certainty" standard is more common for the award of lost profits in either contract or tort cases. This standard is comparable to a "beyond a reasonable doubt" legal standard, which is only found in criminal court cases.

By either legal standard, a judge may want to see a pattern of profits that the plaintiff experienced beginning before the defendant performed the wrongful act. And, a judge may want to see reduced or lost profits after the defendant did the bad act.[2]

The length of time the judge may require may be as subjective as either standard of proof may be vague. In any event, a plaintiff will be standing on more solid ground with consistent profit and loss statements, pay stubs, tax returns, or similar financial data.

Lost profits without a consistent prior history, or without any history at all, are not necessarily barred so long as the evidence is based on sufficient facts. The Washington Supreme Court stated in the *Larsen v. Walton Plywood Co*. case, "lost profits will not be denied merely because a business is new if factual data is available to furnish a basis for computation of probable losses."[3]

The sort of lost profits data discussed in the *Larsen* decision was expert testimony based on speculative sales numbers which assumed the plaintiff had sales volumes disproportionate to competitors. The court found that this was not sufficient factual data as a result of the underlying speculations.

In *Gillespie v. Seattle-First National Bank*, another Washington case, the court stated the degree of proof required for lost profit recovery. "[L]ost profits must be proven with reasonable certainty, or conversely, damages which are remote and speculative cannot be recovered."[4]

In the *Gillespie* case, the court recognized the difficult balance between this heightened standard and the difficulty of proving lost profits. It stated that a "[p]laintiff must produce the best evidence available and if it is sufficient to afford a reasonable basis for estimating his loss, he is not to be denied a substantial recovery because the amount of the damage is incapable of exact ascertainment."

In the *Gillespie* decision, the court also went on to discuss expert testimony. The court discussed both:

1. how reliance on expert testimony is a sufficient basis to reach a finding of lost profits and
2. how "experts in the area" or qualified damages analysts ("analysts") are competent to pass judgment.

The *Gillespie* decision did not go on to further define "experts in the area."

From *Gillespie* and *Larsen*, one can deduce that, while the courts may put a blanket "reasonable certainty" instruction on lost profits, the emphasis on certainty goes to the existence of damages, and the emphasis on reasonableness seems to go to the method of damages measurement.

Effect of Heightened Duty of Care on Measurement of Lost Profits

Lost profits are recoverable in many tort claims. A plaintiff bringing a breach of fiduciary relationship is given a "leg up" through state law specifying the duties of a fiduciary or perhaps establishing profit to the breaching party as a floor for damages.

As a result, state law has the ability to widen the circumstances in which a breach of fiduciary duty may lead to a plaintiff's successful recovery. State law may also potentially increase the recovery amount. A state-by-state analysis of the particular type of fiduciary relationship is necessary.

Considerations in Lost Profits Awards

When analyzing a specific case, it would be prudent to first look to the applicable statutes to find a heightened duty. While the above statutes cannot be relied on in every type of fiduciary relationship, these principals of loyalty sum up the duties in most circumstances.

Next, with the duties of the fiduciary in mind, legal counsel may compare the wrongful act performed against this standard. If the defendant's actions fall below this standard, then there may be a breach. If a breach exists, legal counsel may look to whether actual damage resulted. Or, depending on the circumstances, counsel may look to whether a profit was made by the breaching party.

Finally, for proving the dollar measurement of lost profits, legal counsel and analysts should use factual data as a basis for calculations and avoid speculation.

Retaining a Qualified Damages Analyst

As discussed in the *Gillespie* decision, retaining a damages analyst may be advantageous for parties engaged in breach of fiduciary duty tort claims. The services performed by an analyst (1) may assist the parties in obtaining a favorable settlement or judgment and (2) may reduce the total litigation-related expenses.

The parties in a lawsuit and their legal counsel ("counsel") may have relevant insights into the estimation of economic damages. However, economic analysis typically is not counsel's area of expertise—their area of expertise is legal defense. Conversely, an analyst's area of expertise is economic analysis.

Analysts, therefore, typically are expected to simply have more financial analysis experience and relevant qualifications than legal counsel and other parties in tort claims. In addition to measuring economic damages, analysts often add value by:

1. assessing the merits of a case,
2. weighing the risks of going to court, and
3. reviewing and critiquing materials prepared by opposing damages experts.

Through the above-listed services, the odds of obtaining a favorable settlement or judgment may increase substantially.

The parties in tort claims understandably often seek to minimize total legal expenses. Therefore, these clients may have reservations with regard to retaining an analyst to estimate economic damages.

However, hesitancy to retain an analyst actually may result in higher total legal expenses. If an analyst is not retained, legal defense teams or other parties may expend considerable resources preparing economic damage analyses, which may include educating themselves on unfamiliar topics.

By contrast, an analyst is often able to efficiently prepare analyses relying on past experience, knowledge, and operational systems already in place. Retaining an analyst also may lower the total costs by simply allowing the retained parties to focus on areas in which they are proficient—the legal representatives can efficiently manage the legal strategy while analysts focus on the economic damage analysis.

However, when an independent analyst is retained in a legal dispute, the analyst is obligated by professional and ethical standards to advocate for his or her position only. That is, the analyst should present an impartial and unbiased position rather than advocating for the client's position.

Measuring Economic Damages

The methods to measure economic damages may vary in form or fundamental methodology based on the cause of the economic damages. However, most economic damages claims may be measured based on the following three methods:

1. The before-and-after method
2. The yardstick method (also referred to as the "comparable method")
3. The sales projections method (also referred to as the "but for" method)

Analysts may use these three methods to measure lost profits. There is no legal requirement to use more than one method to measure damages. However, analysts may use more than one method to support the reasonableness of the damages conclusion.

The Before-and-After Method

In the before-and-after method, analysts compare:

1. economic income from the time period in which profitability was affected by the alleged damaging acts (the "damage period") to
2. results attained prior to or after the damage period (the "comparison period").

If performed accurately, this comparison allows the analyst to identify lost profits resulting from the alleged wrongful acts.

In order to apply this method, the analyst should identify and quantify the effects of all other factors that may affect profitability in either the damage period or the comparison period.

For example, if the analyst measures damages for a real estate development company by comparing income from the 2009 to 2010 damage period with income from the 2005 to 2008 comparison period, the analyst should also consider the impact of the severe decline in real estate activity during the damage period.

The reliability of the before-and-after method may be compromised to the extent that significant adjustments have to be made for the results of additional external factors.

Another potential limitation of the before-and-after method may be the availability of data. The before-and-after method requires sufficient operating data for the analyst to identify meaningful profits from the damage period and the comparison period. These data may not always be available due to factors such as a limited operating history, challenges identifying or clarifying a distinct damage period, and other factors.

The Yardstick (or Comparable) Method

In the yardstick method, analysts compare the performance of the subject company to benchmark data from the same time period. The benchmark data may be the operating results of guideline companies, relevant industries, or the subject company branches or divisions that were unaffected by the alleged wrongful acts.

In order to correctly apply this method, the analyst should select benchmark data that are sufficiently similar to the subject company. The credibility of results from the yardstick method may be reduced to the extent that benchmark data are dissimilar to the subject company.

Analysts may consider qualitative and quantitative similarities between the subject company and the benchmark data. Regression analysis is a useful tool to analyze quantitative similarities. For example, an analyst could perform a regression analysis to compare the subject company's sales to total industry sales over a certain number of years.

Analysts also should consider any other changes in the subject company operations that may have affected the performance of the subject company relative to the benchmark data over the period reviewed (e.g., changes in management, product redesign).

The Sales Projections (or But-For) Method

In the sales projections method, also called the "but-for" method, analysts compare (1) economic profits from the damage period with (2) projected economic profits if the alleged wrongful acts had not occurred.

The sales projections method is a common economic damages measurement method.[5] The availability of data may be a contributing factor to the relatively high application of this method. Many businesses regularly prepare projected operating results, which, if prepared prior to—and without consideration of—the alleged damaging acts, may be used as reasonable projected economic profits, absent, or "but for," the impact of the alleged wrongful acts.

Additionally, financial projections by industry are available for many industries from a variety of private and public data sources. These industry projections may often be used in the sales projections method. However, courts often prefer projections prepared specifically for the subject company rather than general industry projections.

The reliability of the results derived from the sales projections method depends on the reliability of the projected results. Therefore, analysts should carefully consider the reasonableness and accuracy of projections.

As part of the analysis, analysts may consider the historically demonstrated ability of the subject company to achieve projected goals. Analysts may also consider the reasonableness of the projected results and key underlying assumptions such as capital expenditures, cash requirements, resulting market share, and other factors.

Measuring Damages

After identifying lost profits in each period using one or more of the previously discussed measurement methods, the total damages may be measured using either:

1. ex-ante damages measurement methods or
2. ex-post damages measurement methods.

In an ex-ante damages measurement, lost profits are discounted at a risk-adjusted rate from the terminal date to the date of the alleged wrongful acts. The analyst may then add interest damages from the date of the alleged wrongful acts to the date of the trial based on the prejudgment interest rate.[6]

Ex-ante damages measurements typically consider only information that was known or knowable as of the date of the breach.[7]

In an ex-post damages measurement, the analyst discounts future lost profits (from the current date to the terminal date) back to the current date based on a risk-adjusted rate. For historical lost profits, the analyst does not apply a discount rate and instead totals the undiscounted lost profits from the date of breach through the current date. Ex-post damages measurements rely on all information available as of the date of trial.

If the damages award is taxable to the plaintiff, it may be appropriate to recommend to the court that the total damages award include both the (after-tax) damages measurement and the income tax expense related to the damages measurement.[8]

Damages Measurement Illustrative Example

A hypothetical example of the application of the sales projections method is presented next.

Jim Cheatum, a shareholder-elected manager at Clean Grocery, has a key role in business management decisions. At a Christmas party in 2011, Cheatum learns that earlier that day there was a toxic waste spill next to the onion farm from which Clean Grocery routinely purchases produce.

Unhappy with his current salary at Clean Grocery, Cheatum decides not to voice this news to other members of management or act on this information for the betterment of Clean Grocery. Instead, he approaches a competing grocery store and offers to keep this information secret if they offer him a better job. Cheatum is offered—and he accepts—a new job.

Two weeks later, the local newspaper publishes an article about Clean Grocery's poisonous onions. Sales at the grocery store plummet and remain depressed for years afterwards. Additionally, Clean Grocery incurs significant expenses associated with recalling damaged produce as well as ongoing marketing campaigns to rebuild its image to the public.

When Cheatum's knowledge of the toxic waste spill and subsequent lack of action are exposed in 2016 through Cheatum's social media account, Clean Grocery shareholders elect to pursue economic damages from Cheatum.

An analyst is retained in this dispute to measure the economic damages resulting from Cheatum's breach of fiduciary duty. The analyst elects to use the sales projections method based on consideration of a five-year projection prepared on December 15, 2011, before Cheatum's breach of fiduciary duty. After reviewing the historical and projected financial data, the analyst compiles the Clean Grocery financial fundamentals presented in Exhibit 1.

After the toxic waste spill and resulting negative media coverage, Clean Grocery was not able to achieve the projected results. Clean Grocery lost considerable sales not only of onions, but of all its groceries. Additionally, Clean Grocery incurred significant recall and marketing costs associated with the wrongful acts.

After an analysis of the financial projections, the analyst concludes that the projections reasonably represented the expected operating performance of Clean Grocery "but for" Cheatum's alleged breach of fiduciary duty.

The projected and actual financial performance of Clean Grocery is summarized in Exhibit 2.

The analyst then reviews the Clean Grocery operating environment to identify any other factors that may have affected its ability to achieve its projected earnings. The analyst estimates that other changes in the operating environment—including the employment termination of an additional key member of management and increased competition—accounted for approximately 40 percent of the identified lost profits.

The analyst concludes that the remaining 60 percent of the lost profits was a direct result of the damaging acts. The calculated lost profits resulting from the wrongful acts are presented in Exhibit 3. A graphical representation of this analysis is presented in Figure 1.

The analyst selects the ex-post damages measurement method because much of the risk of achieving the projection was accounted for in the reduction of lost profits for other changes in the operating environment. Because this particular damages award would be taxable, the analyst concludes that pretax income represents the appropriate level of income to restore the plaintiff to its economic position before the wrongful event.

Based on the data presented in Exhibit 3, the analyst measures lost profits attributable to the wrongful acts from 2012 through 2016 of $6.2 million.

Exhibit 1
Clean Grocery Financial Fundamentals Summary
As of December 15, 2011

	For the Fiscal Year Ended December 31,											
	Historical					Projected					*CAGR*	*CAGR*
	2007	2008	2009	2010	2011 [a]	2012	2013	2014	2015	2016	*2007-2011*	*2012-2016*
	$000	$000	$000	$000	$000	$000	$000	$000	$000	$000	*%*	*%*
Revenue	50,120	52,110	53,988	55,001	56,205	57,891	59,570	61,476	63,198	65,093	*2.9*	*3.0*
Annual Change	*NA*	*4.0%*	*3.6%*	*1.9%*	*2.2%*	*3.0%*	*2.9%*	*3.2%*	*2.8%*	*3.0%*		
Pretax Income	5,012	5,207	5,400	5,508	5,624	5,736	5,937	6,115	6,280	6,456	*2.9*	*3.0*
Annual Change	*NA*	*3.9%*	*3.7%*	*2.0%*	*2.1%*	*2.0%*	*3.5%*	*3.0%*	*2.7%*	*2.8%*		

CAGR = Compound annual growth rate
NA = Not applicable
[a] Estimated based on annualized financial data as of December 15, 2011.

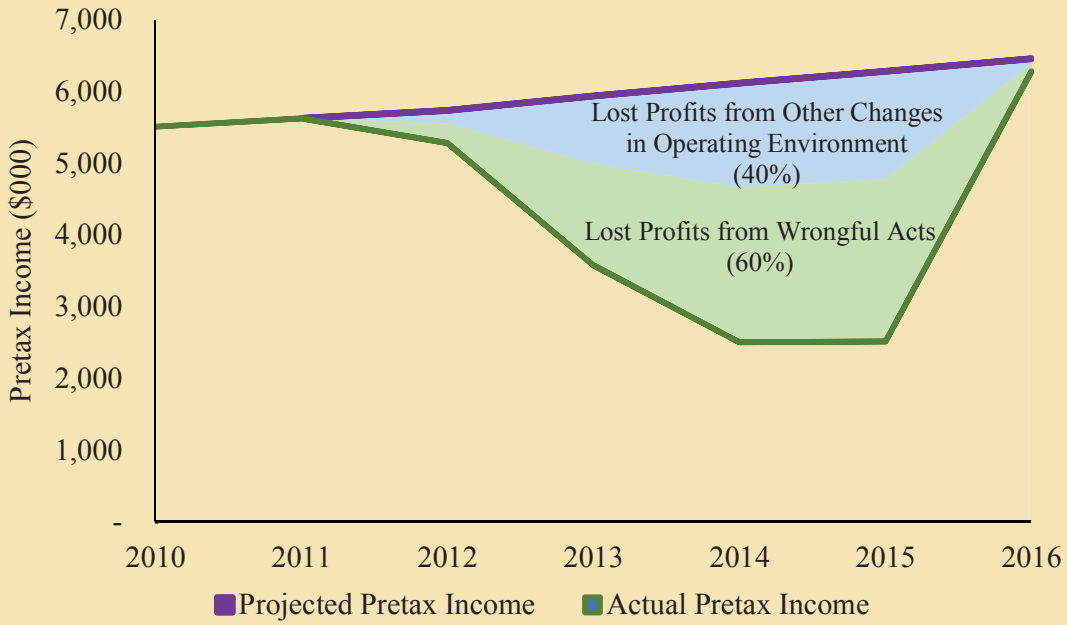
Exhibit 2
Clean Grocery Projected and Actual Financial Performance
As of December 15, 2011

	For the Fiscal Year Ended December 31,				
	2012	2013	2014	2015	2016
	$000	$000	$000	$000	$000
Projected Pretax Income	5,736	5,937	6,115	6,280	6,456
Actual Pretax Income	5,279	3,575	2,502	2,515	6,280
Difference	457	2,362	3,613	3,765	176

Exhibit 3
Clean Grocery Measurement of Lost Profits from the Wrongful Acts
As of December 15, 2011

	For the Fiscal Year Ended December 31,				
	2012	2013	2014	2015	2016
	$000	$000	$000	$000	$000
Difference between Projected Income and Actual Pretax Income	457	2,362	3,613	3,765	176
Less: Lost Profits from Changes in Operating Environment (40%)	(183)	(945)	(1,445)	(1,506)	(70)
Equals: Lost Profits Attributable to the Alleged Wrongful Acts	274	1,417	2,168	2,259	106

Figure 1
Clean Grocery Graphical Representation of Sales Projection Method Lost Profits Analysis



Summary and Conclusion

The measurement of lost profits often presents a challenge associated with the heightened standard of proof. However, damages from breaches of fiduciary duties are often more generously awarded than in other tort claims. These two seemingly opposite forces do not cancel each other out, but rather lead to a unique legal analysis.

If a fiduciary has breached a legal duty, and if profits have been lost, then a plaintiff may still establish these lost profits and their measurement with fact-based evidence rather than speculation. An economic damages analyst may give an opinion on lost profits using one or more of the methods in this discussion to satisfy this requirement.

Retaining a qualified damages analyst (1) often assists parties in obtaining a favorable settlement or judgment and (2) may minimize total litigation-related expenses.

This discussion was intended to be general legal information, not legal advice. Every legal claim is unique and there is no substitute for advice from legal counsel with knowledge of the specific circumstances of a case.

Notes:

1. See RCW 11.98.085 and ORS 130.805.
2. See Farm Crop, 109 Wn.2d at 928.
3. Larsen v. Walton Plywood Co., 65 Wash.2d 1, 390 P.2d 677 (1964).
4. Gillespie v. Seattle-First National Bank, 70 Wash. App. 150, 855 P.2d 680 (Div. 1 1993).
5. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 4th ed. (New York: McGraw-Hill, 2008), 1025.
6. John R. Phillips and Michael Joseph Wagner, "Economic Damages: Use and Abuse of Business Valuation Concepts" (Chapter 14) in *The Handbook of Advanced Business Valuation,* Robert F. Reilly and Robert P. Schweihs, eds. (New York, McGraw-Hill, 2000), 286.
7. Robert F. Reilly, "Measuring Damages to Intangible Assets," *Valuation Strategies* (November/December 2015): 30.
8. Phillips and Wagner, "Economic Damages: Use an Abuse of Business Valuation Concepts," 279.

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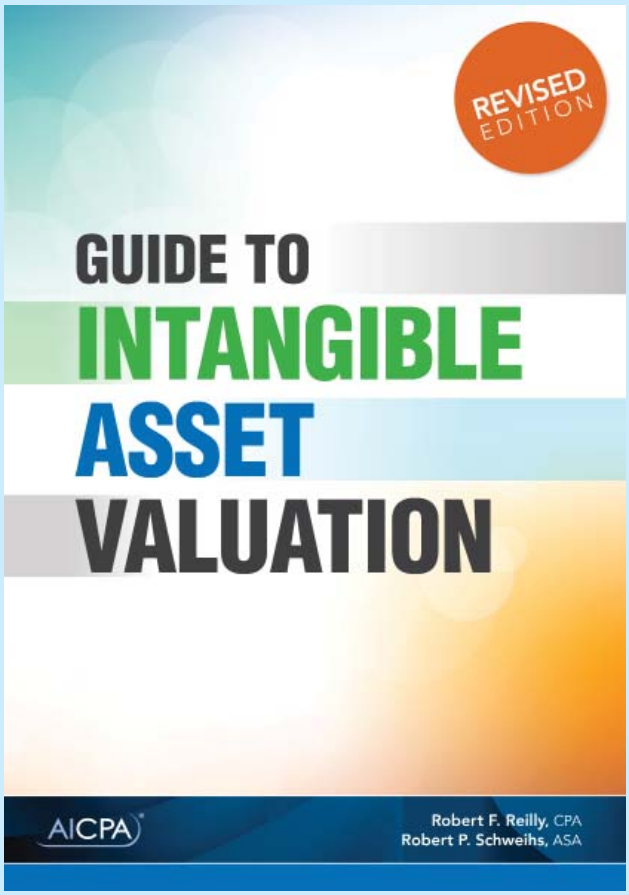
Guide to Intangible Asset Valuation

by Robert F. Reilly and Robert P. Schweihs



This 745-page book, originally published in 2013 by the American Institute of Certified Public Accountants, has been improved! The book, now in hardback, explores the disciplines of intangible asset valuation, economic damages, and transfer price analysis. *Guide to Intangible Asset Valuation* examines the economic attributes and the economic influences that create, monetize, and transfer the value of intangible assets.

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Guide to Intangible Asset Valuation

Table of Contents

ESOP Fiduciaries and the Asset Management Role of an Institutional Trustee

Charles A. Wilhoite, CPA

ESOP fiduciaries serving in a specific trustee role typically have numerous responsibilities with regard to the successful operation of an ESOP and the related trust. In addition to the administrative and legal aspects of the ESOP that should be managed, institutional trustees are also responsible for managing trust assets. The effectiveness of such management generally is measured pursuant to the legal standard of prudence, or exercising the level of "care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[1]

Introduction

Recently published statistics indicate that more than 6,700 employee stock ownership plans ("ESOPs"), covering over 14 million participants, currently operate in the country.[2]

Roughly 5,500, or 82 percent, of the identified ESOPs represent stand-alone ESOPs, with the remaining 1,200 being represented by KSOPs, or ESOPs with a 401(k) plan feature.

While the number of ESOPs has declined from approximately 8,900 in 2002 to approximately 6,700 currently, or at an annual rate approximating 2.3 percent, the number of ESOP participants has increased from 10.2 million to 14.1 million over the same period, or at an annual rate approximating 2.7 percent.[3]

Further, data indicate that approximately 229 new ESOPs were created annually between 2010 and 2014.

The estimated total value of the ESOP assets exceeds $1.3 trillion, with employer securities representing approximately $270 million, or slightly less than 21 percent of total ESOP assets. Based on these statistics, ESOP trustees—whether internal or institutional—are responsible for the management of over $1 trillion of plan assets on behalf of ESOP participants that are independent of the employer securities owned. As a result, ESOP trustees make recurring, responsible decisions with regard to the management of ESOP assets—in order to protect and advance the economic interests of over 14 million individuals.

The following discussion identifies several of the responsibilities of parties who serve as ESOP trustees, with particular emphasis on an institutional trustee's responsibility to manage trust assets in a manner that produces reasonable returns for the ESOP participants.

ESOP Fiduciary versus ESOP Trustee versus ESOP Administrator

The successful management and operation of an ESOP and related trust typically requires the skills and expertise of numerous individuals and professionals, including executive management, attorneys, financial advisers, ESOP administrators, and institutional trustees.

This fact is due to the general complexity of ESOPs, and is particularly the case with regard to larger ESOPs that operate in a circumstance in which there are a number of shareholders in the sponsor company (i.e., the entity in which the ESOP trust owns equity) in addition to the ESOP trust, and other structural specifics with regard to the ESOP trust and sponsoring company.

It is beyond the scope of this discussion to identify and explore the various structural and operating circumstances under which an ESOP can operate. Examples of complicating, structural specifics that add to the complexity of an ESOP circumstance include the following:

1. A capital structure that includes multiple equity owners and potential owners (e.g., outstanding options and warrants, and convertible debt) in addition to the ESOP owner
2. A pass-through tax structure (e.g., S corporation status) for the sponsor company
3. A trustee, or a trustee group or committee, comprised of members of management at the sponsor company

Based on the fact that numerous individuals may be involved in the ultimate formation and operation of an ESOP, it is important to understand some of the broad terms that are used to describe these individuals and their specific roles. Three ESOP terms relevant to this discussion—and to the roles that individuals perform with regard to an ESOP—are (1) fiduciary, (2) trustee, and (3) administrator.

ESOP Fiduciary

Generally, any individual or entity that makes decisions for the ESOP, or authorizes or causes someone else to make decisions for the ESOP, is a fiduciary to the ESOP. Within the ESOP arena, this definition is widely recognized regardless of the title or position an individual or entity maintains.

Specifically, the Employee Retirement Income Security Act of 1974 ("ERISA") defines a *fiduciary* as any person who, with respect to an employee benefit plan:

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 with respect to plan funds or property, or
4. has any discretionary authority or responsibility regarding the administration of the plan.[4]

Based on this definition, it is clear that numerous parties potentially could find themselves fulfilling the role of ESOP fiduciary. Parties typically encompassed in the ESOP fiduciary category include executive management of the sponsor company, internal trustees and ESOP advisory or administrative committee members, institutional trustees, ESOP administrators, or any individual responsible for identifying and appointing other fiduciaries.

ESOP Trustee

By definition, a *trustee* of an ESOP will always be viewed under ERISA as a fiduciary. This is based on the fact that a trustee can exercise authority and control over plan assets.

As required by ERISA, every ESOP should have one or more trustees. The trustees of an ESOP are named in the plan document or are appointed by another named fiduciary.[5]

Unless one of the following two circumstances exists, trustees should have exclusive authority and discretion over the management and control of the assets of the ESOP:

1. When the trustee operates as a directed trustee, subject to the proper directions of another named fiduciary that are made in accordance with the terms of the plan and are not contrary to the provisions of ERISA
2. When the trustee, or another fiduciary, delegates the authority to manage, acquire, or dispose of the assets of the plan to an investment manager

ESOP Administrator

As suggested by the title, an ESOP administrator is responsible for the day-to-day administration, or management, of the plan. Based on the discretionary authority typically granted to the role, a plan administrator is generally considered to be a fiduciary as defined by ERISA.

The plan typically designates both the administrator and the specific authority granted to an administrator, which may include the following responsibilities:

1. Hiring qualified professionals, such as accountants, actuaries, appraisers, and attorneys
2. Determining the rights of plan participants

3. Preparing and issuing required reports to governmental agencies and plan participants
4. Maintaining plan records

Institutional Trustee Management

Published sources indicate that slightly more than 8 of 10 closely held ESOP companies operate with inside fiduciaries as trustees. These fiduciaries typically are officers of the sponsor company.

However, most publicly traded companies, and roughly 2 of 10 closely held ESOP companies, operate with outside fiduciaries, most of which are independent. The use of an independent trustee to fulfill certain fiduciary roles and responsibilities typically adds to the overall administrative cost of operating an ESOP.

Such practice, however, serves to help avoid conflicts inherent in executive management of the sponsor company fulfilling fiduciary responsibilities, thereby providing a higher level of assurance that the ESOP is being managed in the best interests of plan participants.

The remaining focus of this discussion addresses the fiduciary duties fulfilled by institutional trustees with regard to the management of ESOP trust assets. As previously discussed, the effectiveness of such management typically is evaluated based on the "prudent man" standard.

With regard to the management of ESOP trust assets, such a standard requires that the trustee exercises the level of care and judgment that a similarly qualified, prudent expert, rather than a prudent layperson, would exercise when making financial investment decisions for a similar entity in similar circumstances.

In many instances, institutional trustees providing their services to an ESOP in a corporate capacity through a trust company or division of a bank often are staffed with a wide range of business and legal professionals. These professionals typically include financial advisers.

In such instances, institutional trustees can rely on internal experts, or the advice of independent financial advisers to fulfill the responsibility of managing ESOP trust assets. However, even if the investment advice required to manage ESOP trust assets is delegated by an institutional trustee to an independent investment adviser, the ultimate fiduciary responsibility with regard to the effective management of the ESOP trust assets rests with the institutional trustee.

One of the most significant asset management decisions a trustee will play a role in is the decision of the ESOP trust to either purchase or sell sponsor company shares. Once again, while an institutional trustee may employ professionals fully capable of providing the requisite financial advisory services, such trustees typically rely on the advice and counsel of independent financial advisers to make stock purchase and sale decisions.

"One of the most significant asset management decisions a trustee will play a role in is the decision of the ESOP trust to either purchase or sell sponsor company shares."

And while an institutional trustee may rely on the advice and counsel of independent financial advisers to assist in rendering such decisions, the trustee is still expected to verify the following:

1. Qualifications of the independent adviser
2. Reasonableness of the independent adviser's analytical process and key assumptions
3. That the independent adviser relied on sufficient and appropriate information and data
4. Reasonableness of the independent adviser's conclusions based on the facts and circumstances existing at the time the conclusions were rendered

In addition to purchase and sale decisions regarding sponsor company shares, institutional trustees typically manage ESOP trust assets in a manner that addresses both reasonable return considerations and liquidity considerations. In essence, while managing ESOP trust assets to generate a reasonable annual return to participants, trustees should also maintain the liquidity necessary for the trust to address any diversification needs.

To be clear, the original intent of ESOP legislation was to provide a tax-advantaged mechanism to motivate investments *primarily* in stock of sponsoring companies. Through an ESOP, shareholders are afforded the opportunity to sell shares to an ESOP, thereby transferring ownership to employees. In effect, the motivating factors of ownership, including involvement in decision making and wealth creation, are transferred to employees.

The above factors are widely credited with creating an environment that often results in better performance for ESOP companies relative to non-ESOP companies.

Further, the tax-advantaged nature of ESOPs, including the tax deductibility of ESOP contributions and the ability of the ESOP to borrow to acquire the stock of sponsoring companies, generally provides potential for higher cash flow generation. This increased cash flow can be directed toward acquisitions and capital investments that spur growth.

While ESOPs are designed to invest primarily in the qualifying stock of sponsor companies, the assets of an ESOP trust can be represented by substantial investments in other assets, including cash and securities.

In order to reduce the risk to ESOP participants, particularly in circumstances in which the sponsor company stock reflects a declining value trend, trustees often consider diversifying plan investments by selling sponsor company stock and purchasing other assets. While not prescribed, alternative investments can include mortgages, bonds, and the stock of other corporations.

In order to achieve reasonable returns for plan participants, trustees typically adhere to a defined, rational investment process—consistent with professional standards—that generally includes the following:

1. A statement of investment objectives and policies
2. An investment strategy that includes relevant guidelines regarding allowable investments, investment horizons, acceptable risk levels, targeted asset allocations, and liquidity needs
3. Investment performance measurement—including appropriate benchmarking—and regular reporting periods

Of course, significant detail can, and typically is, reflected in a formal statement of investment objectives and policies. Such detail is beyond the scope of this discussion, which now focuses on trustee management of the ESOP trust assets based on the prudent man standard and consideration of the general process delineated above.

Trustee Management of the ESOP Trust Assets

Published statistics indicate that the DJIA, the S&P 500, and the Nasdaq increased approximately 25 percent, 19 percent, and 28 percent, respectively, in 2017. While each of these equity-based indexes reflects significant growth in the most recent year, it would be unreasonable for a trustee to assume that such high returns could be achievable over a long-term investment horizon.

However, ESOP participants aware of the performance levels achieved by the major indexes in 2017 may measure the performance of the trust, generally, against the performance of the major indexes. Such a comparison, though clearly unreasonable from a long-term performance perspective, demonstrates the need for a defined, rational investment process that clearly explains investment objectives and strategies that will be employed to achieve reasonable, long-term returns.

Statement of Investment Objectives and Policies

By their nature—that is, assets represented primarily by investments in sponsor company securities—ESOP trust assets generally are recognized to represent investments with inherently higher risk than a pool of diversified investments serving as the foundation for a pension fund.

As a result, a general statement of investment objectives and policies provides clarity regarding:

1. the desired or targeted performance level for trust assets and
2. the guidelines and practices that will be followed to achieve the targeted performance level.

Based on the prudent man principle, it likely would not be considered unreasonable for a trustee to establish return objectives for ESOP participants consistent with the historical rates of return represented by the combined dividend and stock appreciation returns realized by investors in the sponsor company stock. This, of course, can be readily determined if the sponsor company stock is publicly traded, but is more challenging if the sponsor company is privately owned.

Other foundations for establishing reasonable return objectives can include published rates of return for:

1. the relevant, broad industry category in which the sponsor company operates or
2. selected guideline publicly traded companies operating within the relevant sponsor company industry.

Investment policies serve as the investment guidelines that will be followed to ensure that established investment objectives are pursued strategically and consistently, and monitored appropriately. Common investment policies address the following:

1. Investment strategy
2. Investment performance measurement and reporting

Investment Strategy

An investment strategy is a defined process through which investment objectives are pursued. While an ESOP trust may be comprised primarily of sponsor company securities, the trust may also include substantial investments in other assets, including cash and nonsponsor company investments.

As previously discussed, an investment strategy typically addresses the following:

1. Guidelines regarding allowable investments—potential investments are defined by categories, often with restrictions on certain investment types (e.g., adult entertainment, tobacco and alcohol products, guns and munitions).
2. Investment horizons—targeted holding periods may be identified for certain investment types.
3. Acceptable risk levels—investment concentrations and/or certain investment exposures may be limited (e.g., hedge funds, derivatives, development-stage companies, or emerging markets).
4. Targeted asset allocations—asset allocations are intended to balance risk among different asset investment categories, producing a targeted, "weighted" investment risk level commensurate with the targeted overall investment return level.
5. Liquidity needs—cash or near-cash investment levels must be maintained to meet trust liquidity needs in a timely fashion, thereby avoiding untimely investment liquidations.

Investment Performance Measurement

Investment performance measurement requires periodic review of the investment portfolio and related reporting. Such reviews include evaluating the actual performance of the portfolio—often on a quarterly basis—in relation to established performance objectives.

Further, it is not unusual to establish both long-term and interim measurement periods (e.g., analyzing performance based on three-year or five-year measurement periods with interim evaluations based on quarterly or year-to-date measurements).

Investment performance measurement also typically includes evaluating asset performance categories, based on asset allocations employed, in relation to relevant capital market benchmarks. For example, the portion of the total portfolio allocated to domestic equities can be evaluated based on comparison with certain domestic equity indexes (e.g., the BlackRock Russell 1000 or Fidelity Investments funds).

Similarly, the portion of the total portfolio allocated to domestic fixed income investments can be evaluated based on comparison with certain domestic fixed income indexes (e.g., Fidelity Fixed Income & Bond Funds or Vanguard Bond Funds).

Figure 1 provides data regarding historical returns on U.S. Treasury bills, U.S. Treasury bonds, and stocks (as measured by the S&P 500 Index) for 2003 through 2017. The return on U.S. Treasury bills, U.S. Treasury bonds, and stocks averaged 1.25 percent, 4.19 percent and 11.18 percent, respectively, between 2003 and 2017.

However, between 2013 and 2017, the average returns averaged 0.45 percent, 1.28 percent, and 16.09 percent for U.S. Treasury bills, U.S. Treasury bonds, and stocks, respectively.

As indicated, average U.S. Treasury bill and U.S. Treasury bond returns declined in the most recent 5-year period through 2017 relative to average U.S. Treasury bill and U.S. Treasury bond returns based on the most recent 15-year period through 2017.

However, average stock returns have increased over the same comparative periods. Both U.S. Treasury bond returns and stock returns experienced significant volatility over the 15-year period presented.

Exhibit 1 provides additional data regarding historical stock and bond returns and inflation statistics covering the 1926 through 2016 period, as published by Duff & Phelps in the *2017 Valuation Handbook*.

Consistent with the data previously discussed, equity returns have increased considerably and bond returns have remained relatively flat in the most recent years (i.e., 2010 through 2016) in comparison to return periods from 2000 forward, which include the impact of the Great Recession in 2008.

Further, the inflation rate in the most recent years is down relative to all other periods presented.

Figure 2 presents the data summarized in Exhibit 1 graphically, once again demonstrating the significant volatility in stock returns relative to inflation and bond returns.

The data presented in Exhibit 1 and the graphs presented in Figure 1 and Figure 2 present inflation, bond return, and stock return information that may be considered by trustees for the purposes of:

1. establishing target returns for ESOP trust assets and
2. evaluating actual returns realized on ESOP trust assets.

Figure 1
Annual Returns on Treasury Bills, Treasury Bonds, and Common Stocks
2003 through 2017

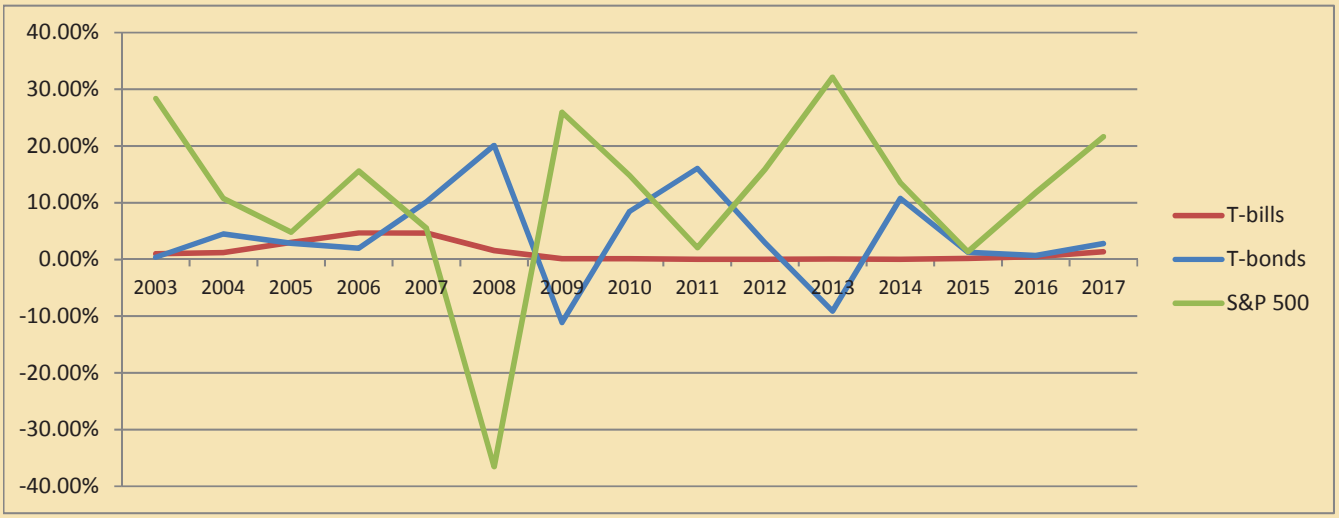


Exhibit 1
SBBI Series: Large-Cap Stocks, Small-Cap Stocks, LT Corporate Bonds, LT Government Bonds, Inflation
Average Annual Compound Rates of Return: 1926 through 2016

	1926 - 2016	2007 - 2016	2000s	2010s
Inflation (U.S. Consumer Price Index)	2.90%	1.80%	2.50%	1.60%
LT Gov't Bonds (20-year maturity yield)	5.50%	6.50%	7.70%	6.90%
LT Corp Bonds (20-year maturity yield)	6.00%	6.90%	7.60%	7.80%
Large-Cap Stocks (S&P 500 Total Return Index)	10.00%	6.90%	-0.90%	12.80%
Small-Cap Stocks	12.10%	7.60%	6.30%	15.30%

Source: *2017 Valuation Handbook: U.S. Guide to Cost of Capital* (New York: Johy Wiley & Sons, 2017).

However, it is important to note that the data presented represent broad index measures that likely require deeper analysis and possible adjustment to render them reliable comparatives for the purpose of evaluating the performance of ESOP trust assets.

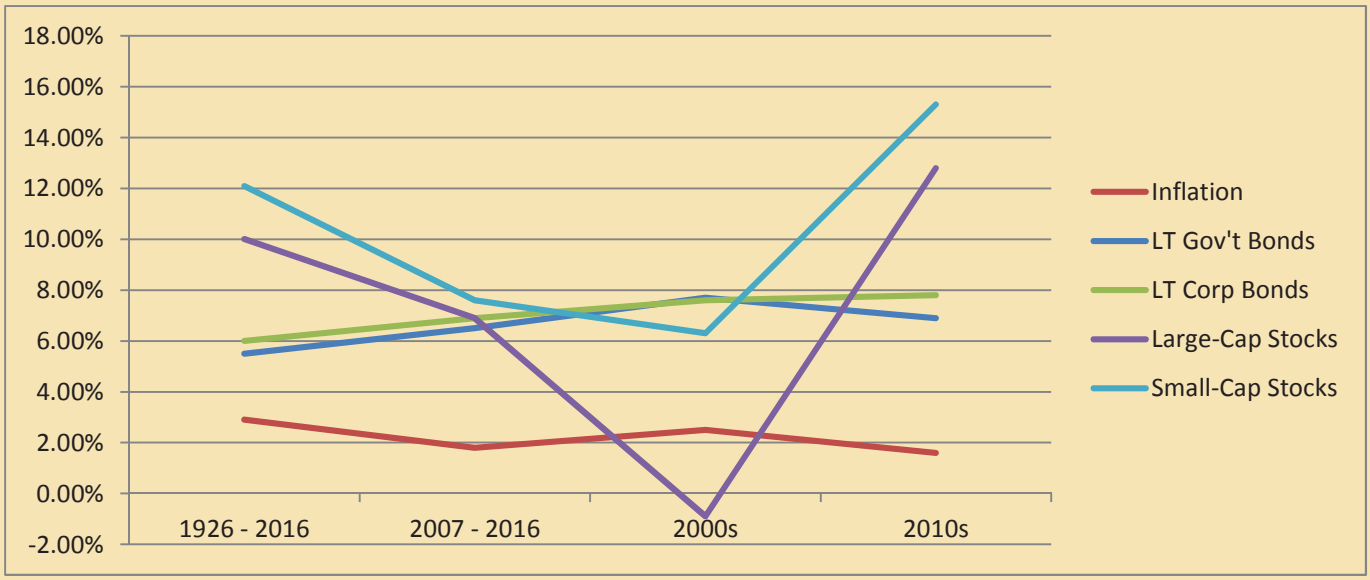
Further, the composition of the ESOP trust asset base should be considered in order to develop a reasonable, weighted expected return. That expected return should be based on the investment allocation structure of the trust.

The weighted expected return can then be analyzed based on the application of trust investment allocation weights to comparable, market-based investment returns.

Summary and Conclusion

ESOP fiduciaries serving as trustees and responsible for the management of trust asserts are held to the prudent man standard. This standard requires a

Figure 2
SBBI Series: Large-Cap Stocks, Small-Cap Stocks, LT Corporate Bonds, LT Government Bonds, Inflation Average Annual Compound Rates of Return: 1926 through 2016



trustee to act as a prudent expert would act under similar circumstances.

The objective, of course, is for the trustee to manage trust assets in a manner that safeguards trust assets and provides reasonable returns to ESOP participants.

Because ESOPs are not intended to guarantee retirement benefits, and investments primarily in sponsor company securities necessarily expose ESOP participants to greater risk than more diversified investments, trustees typically rely on defined processes to fulfill their fiduciary responsibilities.

Such processes typically include developing the following:

1. A statement of investment objectives and policies
2. An investment strategy that includes relevant guidelines regarding allowable investments, investment horizons, acceptable risk levels, targeted asset allocations, and liquidity needs
3. Investment performance measurement—including appropriate benchmarking—and regular reporting periods

Generally, judicial precedent indicate that the reasonableness of investment decisions made by fiduciaries based on the circumstances, rather than the ultimate results of investment decisions, is of primary concern.

Notes:

1. ERISA Section 404(a)(1)(B).
2. National Center for Employee Ownership "ESOPs by the Numbers," updated March 2017, https://www.nceo.org/articles/esops-by-the-numbers. The statistics are based on data maintained by the U.S. Department of Labor, effective as of 2014.
3. Ibid.
4. ERISA, Public Law 93-406.
5. ERISA Section 403(a)
6. U.S. Treasury bills are based on the 3-month Treasury bill rate; U.S. Treasury bonds are based on the 10-year Treasury bond rate; and stocks are represented by the S&P 500 Index, and include both price appreciation and dividends. Source: http://pages.stern.nye.edu/~adamodar/New_Home_Page/datafile/histretSP.html.

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The Perils of the "Power of Substitution" for "Intentionally Defective" Grantor Trusts

Samuel S. Nicholls

The power of substitution is held by the settlor of a grantor trust if this power is provided by the trust instrument. This power allows the settlor, at any time, to remove an asset or assets from the grantor trust in exchange for an asset or assets of equivalent value. Such a transfer can be problematic and vulnerable to challenge if the equivalent value is questionable. One such example is when a promissory note bearing a below-market interest rate is the substituted property. First, this discussion presents an analysis of the dispute, In re the Matter of The Mark Vance Condiotti Irrevocable GDT Trust*, which involved the trustees' refusal to honor the settlor's request to exercise his power of substitution. Second, this discussion presents an illustrative example, with quantitative exhibits, of how complex such transactions can be and how equivalent value may be determined.*

Introduction

The dispute styled *In re the Matter of The Mark Vance Condiotti Irrevocable GDT Trust* ("*Condiotti*")[1] was first tried before a Colorado probate court, and on appeal was decided by the Colorado Court of Appeals on July 9, 2015.

The case involved whether or not the trustees of an intentionally defective grantor trust had the ability, consistent with their fiduciary duties, to reject the grantor's request to exercise his power of substitution. A defective grantor trust is not included in the grantor's estate due to certain features, such as providing the grantor the power of substitution to remove certain assets held by the grantor trust in exchange for an asset or assets of supposedly equivalent value.

In *Condiotti*, the grantor (or "settlor") attempted to exercise his power of substitution, but the trustees refused to execute the transaction. The trustees refused because the asset proposed to be swapped into the trust was a promissory note owed by the grantor that the trustee determined to be less than equivalent value.

The trustees reached this conclusion because the note bore a low interest rate (the Applicable Federal Rate or "AFR") that did not adequately reflect the risks of the obligor and lack of marketability of the note.

A second contention of the trustees was that the proposed substitution constituted a loan. Such a loan was forbidden by the trust indenture.

Both the probate court and the Colorado Court of Appeals (the "Court of Appeals") ruled in favor of the trustees. The trustees were deemed to have properly executed their fiduciary duties. The probate court had ruled that the proposed substitution both constituted a loan and the substituted property was not of equivalent value.

The Court of Appeals did not address the issue of equivalency of value. Rather, the Court of Appeals ruled on the basis that the transaction was effectively a loan, in violation of a provision in the trust instrument forbidding such.

With respect to determining the equivalency of value by the fair market value standard, this dispute may serve as a simple lesson for trust substitution transactions that can be more complex. Such complex transactions occur when the trust corpus consists of an ownership interest in a privately held operating company, limited partnership units of a

private equity fund, or otherwise nonmarketable assets.

At the conclusion of this discussion, a more complex example, with exhibits, is presented whereby the substituted property is not of equivalent value.

Background on the Power of Substitution for Grantor Trusts

For purposes of federal estate tax, a grantor trust is a separate entity that is excluded from the grantor's estate. The grantor pays any income, gift, and capital gains taxes incurred by the trust.

Another feature of grantor trusts is a privilege conferred to the grantor called "the power of substitution." This power allows the grantor, in their discretion, to remove any asset or assets from the trust corpus in exchange for another asset or assets of equivalent value. The reason why many grantor trusts contain this provision is that it is one condition by which the Internal Revenue Service ("the Service") recognizes a trust as a grantor trust.

The exact language of Internal Revenue Code Section 675(4) is as follows:

> "A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity"[2] and which includes any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.[3]

In other words, when a grantor exercises its power of substitution, it does so in a nonfiduciary capacity, and a fiduciary (the trustee) cannot have this power. Also interesting, in the context of *Condiotti*, is that the power of substitution can be exercised without the approval or consent of the trustee (the fiduciary). This language did not address and forestall situations when a grantor may abuse this discretionary ability and substitute assets that were not of equivalent value.

However, the Service did address this issue in Revenue Ruling 2008-22. That Revenue Ruling recognized that a trustee has a fiduciary duty to prevent the substitution of assets that are not of equivalent value.[4]

The *Condiotti* Case

In *Condiotti*, the grantor trust (the "Condiotti Trust") settlor, Mark Vance Condiotti, appealed the probate court's order that had been found in favor of the defendant co-trustees, Patricia G. Condiotti and MidFirst Bank. Defendant Patricia G. Condiotti was the wife of plaintiff Mark Vance Condiotti.

The dispute arose out of the trustees' refusal to honor the grantor's election to substitute a promissory note to be owed to the trust by the grantor for the value of the entire trust corpus,[5] which equaled $9,500,000.

When the settlor first made this request, the trustees responded that:

1. the settlor was not actually invoking his substitution power; rather, he was attempting to obtain a loan and
2. the promissory note was not of equivalent value.

The Colorado Court of Appeals focused on the following two provisions of the Condiotti Trust instrument:

1. The power of substitution
2. The forbidding of the settlor from obtaining a loan from the trust's corpus without adequate interest or security[6]

The Court of Appeals' focus was on the original intent of the settlor when the trust was created, rather than his intent when he later attempted to exercise his power of substitution. One such intent, as expressed in the language and provisions of the trust instrument, was the prohibition from obtaining a loan from the trust's corpus.

The trustees, in their capacity as fiduciaries, acted properly when they considered whether or not the proposed substitution was effectively a loan.

The Court of Appeals cited *Love v. Olson* and the following conditions observed by that court under which any particular transaction may be considered to be a loan:[7]

1. Do the parties "stand in the relationship of debtor and creditor?"

"Also important is that each beneficiary, . . . be given longer than a few days or weeks to review and potentially challenge the determination of fair market values."

2. Was a promissory note executed?
3. Was interest "agreed to or paid?"
4. Did the parties agree that the recipient would repay the money received?

The Court of Appeals also considered Revenue Ruling 85-13, which held that a grantor's "receipt of the entire corpus of the trust in exchange for [the grantor's] unsecured promissory note constituted an indirect borrowing of the trust corpus."[8]

The Court of Appeals decision hinged entirely on the whether or not the proposed transaction was a loan, rather than the issue of equivalent value. The Court of Appeals determined that the proposed transaction did indeed violate a provision of the trust indenture because it constituted a loan.

In *Condiotti*, was the Court of Appeals' emphasis on the transaction's status as a loan, and decision not to rule on equivalent value of substituted property, necessarily a blueprint for such transactions? *Benson v. Rosenthal*[9] suggests not.

The *Benson* case involved trusts that owned interests in the New Orleans Saints and Pelicans franchises, a television affiliate, and other businesses and investments. The trust instruments contained the power of substitution. That power was similarly challenged by the trustee when promissory notes were proposed to be substituted for property of equivalent value.

In the *Benson* case, the U.S. District Court of Appeals for the Eastern District of Louisiana ruled in favor of the grantor. The court concluded that the promissory notes were considered to be assets and of equivalent value.

Considering that in *Condiotti*, the probate court, unlike the Court of Appeals, did rule on the issue of equivalent value, as did the *Benson court,* it stands to reason that any exercise of the power of substitution should include an independent determination of fair market value for each property involved.

Also important is that each beneficiary, by way of terms in the trust instrument related to the power of substitution, be given longer than a few days or weeks to review and potentially challenge the determination of fair market values. It may also be advisable for the trust instrument to provide a remedy for any impasse, such as the selection of a third appraiser to be selected by the first two appraisers, not by any party to a dispute.[10]

Sometimes these substitution transactions can be circuitous or involve nonmarketable assets. The following are some examples of pitfalls to avoid—or factors to consider—when the power of substitution is exercised.

The Texas Four-Step

In the following example, a grantor trust is initially funded with assets in exchange for a promissory note ("Note #1") of equivalent value owed by the trust to the grantor. Subsequently, the grantor exercises its power of substitution to remove an asset in exchange for a promissory note owed by the grantor to the trust ("Note #2"), which the grantor pays down with cash two weeks later.

The trust then uses that cash to pay down the original note—Note #1— that it owed to the grantor when the trust was seeded.

Effectively, the end result is that the asset is removed from the trust in exchange for the forgiveness of the debt owed since seeding. Technically, was Note #1 or Note #2 the substituted property, and was it equivalent value? Or was the cash exchanged technically the substituted property, even though it was remitted two weeks later to pay down Note #2?

Step One—The Seeding

These assets—consisting of marketable securities, real estate investment properties, ownership interests in privately held operating and holding companies, and limited partnership interests in hedge funds and leveraged buyout funds—are valued by an independent appraiser at a fair market value of $100 million.

The valuation considered appropriate discounts for lack of control and lack of marketability.

These assets were paid for by the trust in exchange for Note #1 with a principal amount of $100 million, bearing interest at the AFR. This note was owed by the trust to the grantor, and was secured not by all of its assets, but rather by one of its largest assets—a 40 percent ownership interest in a holding company called XYZ Holdings, LLC, that contained various private equity investments.

Step Two—The Substitution with a Promissory Note

Several years later, on December 31, 2017, the grantor executes its power of substitution to swap an asset held by the trust (not the 40 percent

membership interest in XYZ Holdings, LLC). The asset fair market value was determined by an independent valuation analyst to be $150 million.

The asset was exchanged for Note #2 with a face value of $150 million and with interest at the AFR. The valuation analyst was not asked to estimate the fair market value of Note #2.

The recorded value of the trust's total assets did not change because an asset worth $150 million (assuming its recorded value was $150 million on December 31, 2017) was swapped for another asset of equivalent value—the promissory note owed by the grantor.

Step Three—Obligor Pays Down Promissory Note Owed to the Trust

The grantor initially paid for the $150 million asset with a promissory note. This payment form was because the grantor did not have sufficient cash on the date of the transaction.

However, after two weeks, the grantor freed up $150 million in cash, which was remitted to the trustees of the trust to extinguish Note #2—$150 million promissory note.

Step Four—Trust Then Pays Down Promissory Note Owed to the Grantor

The trustees then use $100 million of the $150 million cash received to pay down Note #1, the principal of which was $100 million owed to the grantor.

Which Was the Substituted Property—Note #1, Note #2, or $150 Million in Cash?

The ultimate result of this series of transactions was that the trust had one asset worth $150 million removed and replaced with $50 million in cash as an asset, and $100 million fewer liabilities because Note #1 was paid down.

The trust first received Note #2, which was paid down two weeks later with $150 million in cash. The trust was left with $50 million in cash after paying down Note #1 owed to the grantor.

A clue to solving the question as to which note (or cash) was the property substituted for the $150 million asset was that the trust also held other liabilities owed to third-party creditors.

However, the trust elected to pay down Note #1 owed to the grantor, a related party, rather than pay any other creditors. It appears that the grantor desired to have Note #1 (owed to them by the trust) paid down as the upshot of these transactions.

The net effect of these transactions was that the power of substitution resulted in the grantor receiving an asset worth $150 million in exchange for extinguishment of Note #1 plus $50 million in cash to the trust.

It is evident that the substituted property was Note #1, much as it is evident through generally accepted accounting principles that the values of both sides of a transaction are equal to each other. Therefore, a case could be made that the paydown of Note #1 plus the residual $50 million in cash were the substituted property.

If one were to contend that the actual cash of $150 million was the substituted property, one would have to somehow debunk the fact that when the transaction was effected, the consideration was Note #2, despite how long it took for the obligor to pay down that note.

Further, Note #2 bore interest at the AFR, well below what a typical market rate of interest would have been. Therefore, Note #2, even if completely secured, would have had a fair market value below its principal amount, and would not have met the standards of being an asset of equivalent value to the $150 million asset.

As for the contention that Note #1 plus $50 million of cash was the substituted property, were they of equivalent value, worth $150 million? Exhibits 1 through 5 present the calculations for estimating the fair market value of Note #1.

Applying an Appropriate Market-Based Interest Rate to Note #1

Note #1 had a principal amount outstanding on the date of the substitution of $100 million, and was secured by one of its largest assets—a 40 percent membership interest in XYZ Holdings, LLC.

After analyzing the assets held by XYZ Holdings, LLC, and estimating the fair market value of the 40 percent noncontrolling, nonmarketable membership interest, it is determined that the security interest is less than the $100 million principal amount of Note #1. Therefore, it is partly secured.

Exhibit 1 presents the appropriate risk-adjusted yields for two scenarios:

1. If the note were completely secured ("Scenario 1")
2. If it were completely unsecured ("Scenario 2")

Upon analysis of XYZ Holdings, LLC, the valuation analyst determines that for Scenario 1, an

Exhibit 1
Fair Market Value of $100 Million Promissory Note
Market Yield Analysis
As of December 31, 2017

Straight Bond Yield Analysis

Value Line Rating	Equivalent S&P Rating	10-Year Straight Bond Yields	
A	AAA	3.74%	Investment Grade
B	AA+ or -	3.83%	
C	A	4.00%	
D	**BBB+ or -**	**4.72%**	
E	**BB+ or -**	**6.21%**	Speculative
F	B+	6.72%	
G	B	7.48%	
H	B-	7.74%	
I	CCC	8.76%	
J	CC	15.30%	> Highest Risk of Default
K	C	19.55%	> Default
L	D	28.90%	> Bankruptcy

Asset-Backed Loans	1st Quartile	Median	3rd Quartile
Yield	4.34%	4.68%	8.16%

Unsecured Corporate Bonds	BBB+/-	**BB+/-**	B+/-
7-Year Yield (median)	5.31%	**6.43%**	6.73%

Risk Adjusted Yield Calculation	Scenario 1 Secured Note	Scenario 2 Unsecured Note	
Risk-Free Rate	2.58%	2.58%	[a]
Market-Based Risk Adjustment	2.14%	3.85%	[b]
Market Yield	4.72%	6.43%	[b,c]
Company-Specific Risk Factor Adjustment	0.50%	0.50%	[d]
Risk Adjusted Yield	**5.22%**	**6.93%**	

S&P = Standard & Poor's

[a] *Federal Reserve Statistical Release* average of the seven-year nominal U.S. Treasury note yield to maturity rate as of December 31, 2017.

[b] The market-based risk adjustment is equal to the difference between the market yield-to-maturity rate for straight bond securities with an equivalent S&P rating and the risk-free rate, which we determined as the seven-year U.S. Treasury bill yield to maturity rate. The yield-to-maturity rates for straight bond securities are based on the *Value Line Survey*, the Pepperdine University study, and an analysis of publicly traded corporate bonds with a seven-year duration to maturity, as summarized above.

[c] The "BBB" rating indicates that an obligor has adequate capacity to meet financial commitments. However, the obligor is susceptible to adverse economic conditions and changes in circumstances. The "BB" rating indicates an obligor is less vulnerable to adverse business, financial, and economic conditions in the near term, and currently has capacity to meet financial commitments. However, the obligor faces significant ongoing uncertainties. See www.standardandpoors.com/ratings/definitions.

[d] Based on other risk factors associated with the obligor.

Sources: As cited and analyst calculations.

appropriate S&P rating is BBB+/-, or 4.72 percent. This is in line with the median yield for asset-based loans, which was 4.68 percent.

For Scenario 2, based on the time to maturity of Note #1, it is determined that an appropriate S&P rating is BB+/-, whose yield for a seven-year maturity date was 6.43 percent.

For each scenario, an additional 0.5 percent was added to reflect additional risk factors for XYZ Holdings, LLC, relative to the guideline company obligors. This resulted in a risk-adjusted yield for Scenario 1 and Scenario 2 of 5.22 percent and 6.93 percent, respectively.

Fair Market Value of $100 Million Promissory Note—Scenario 1

As presented on Exhibit 2, the note had a principal amount of $100 million and bore interest at a rate of 3.5 percent. Under Scenario 1, the note is assumed to be completely secured by the 40 percent membership interest in XYZ Holdings, LLC.

In other words, the fair market value of this ownership interest was equal to $100 million, and the security interest was not only attached, but also perfected. However, the market-based interest rate for Scenario 1 was 5.22 percent.

This resulted in a fair market value of Note #1 under Scenario 1 of $90.1 million, or 9.9 percent less than its face value.

Fair Market Value of $100 Million Promissory Note—Scenario 2

As presented on Exhibit 3, under Scenario 2, the note is assumed to be completely unsecured. Although it bore interest at a rate of 3.5 percent, the market-based interest rate for Scenario 2 was 6.93 percent.

This resulted in a fair market value of Note #1 under Scenario 2 of $81.5 million, or 18.5 percent less than its face value.

Fair Market Value of Security Interest

As presented on Exhibit 4, the security interest consisting of the 40 percent membership interest in XYZ Holdings, LLC, was meaningfully less than the $100 million principal balance of Note #1.

The first step was to ascertain whether the recorded values of the assets held by XYZ Holdings, LLC, were at fair market value and were appropriately discounted for lack of control and lack of marketability. In this example, let's assume that they were not. Furthermore, there is an entity level discount due to the ownership interest being a 40 percent membership interest.

As presented on Exhibit 4, appropriate discounts for lack of control and lack of marketability are applied to each class of assets in succession. This assumes the entity level discount is included in each discount.

The sum of the discounted asset values is then compared to the undiscounted total value to arrive at a combined discount for lack of control and lack of marketability equal to 26 percent.

After subtracting this discount ($77.2 million) from the indicated value of total assets ($300 million), subtracting total liabilities ($50 million), and multiplying by the membership interest (40 percent), we arrive at a fair market value of the 40 percent membership interest equal to $69 million.

Because Note #1 had an outstanding principal balance of $100 million, it was only partly secured. It may have seemed initially that Note #1 was entirely secured because, as presented on Exhibit 5, the indicated value of total assets, less liabilities, multiplied by 40 percent was equal to $100 million. However, that figure is not based on fair market value.

The next step was to reconcile the fact that the Note #1 was somewhat secured, but not entirely.

Concluded Fair Market Value of Note #1—Weighted Average of Scenario 1 and Scenario 2

As presented on Exhibit 5, the fair market value of Note #1 was based on a weighted average of the fair market values under Scenario 1 and Scenario 2.

To arrive at the percentage weights, the fair market value of the security interest, or $69 million, was subtracted from the principal outstanding, or $100 million. The unsecured amount of the principal was, therefore, $31 million, or 31 percent of the outstanding principal.

The next step was to multiply the fair market value of Note #1 by each of the two weights—a 69 percent weight to Scenario 1 as if it were fully secured and a 31 percent weight to Scenario 2 as if it were entirely unsecured.

Adding these two values resulted in a fair market value of Note #1 equal to $87.4 million, or 12.6 percent less than face value.

The substituted property had been determined to have a fair market value of $125 million, and

Exhibit 2
$100 Million Promissory Note Substituted for Asset with Fair Market Value of $100 Million
Scenario 1—Note Fully Collateralized and Perfected
Fair Market Value of Promissory Note
As of December 31, 2017

Scenario 1:
(1) Security Interest Perfected
(2) Note Fully Collateralized

Outstanding Principal on Valuation Date	$100,000,000	
Maker/Debtor (obligor)	Grantor Trust	
Note Holder (obligee)	Grantor	
Valuation Date	12/31/2017	
Interest Rate	3.50%	
Type	Interest Only	
Payment	Annually	
Maturity Date	12/31/2024	
Selected Risk-Adjusted Rate	5.22%	[a]

Payment Date	Beginning Principal	Annual Interest Payment 3.50%	Partial Period	Adjusted Interest Payment 3.50%	Principal Payment	Ending Principal	Total Payment	Discounting Period	Present Value Factor 5.22%	Present Value of Total Payment
12/31/2018	$100,000,000	$ 3,500,000	1.00	$ 3,500,000	$ -	100,000,000	$ 3,500,000	1.0000	0.9504	$ 3,326,400
12/31/2019	100,000,000	3,500,000	1.00	3,500,000	-	100,000,000	3,500,000	2.0000	0.9032	3,161,200
12/31/2020	100,000,000	3,500,000	1.00	3,500,000	-	100,000,000	3,500,000	3.0000	0.8584	3,004,400
12/31/2021	100,000,000	3,500,000	1.00	3,500,000	-	100,000,000	3,500,000	4.0000	0.8158	2,855,300
12/31/2022	100,000,000	3,500,000	1.00	3,500,000	-	100,000,000	3,500,000	5.0000	0.7754	2,713,900
12/31/2023	100,000,000	3,500,000	1.00	3,500,000	-	100,000,000	3,500,000	6.0000	0.7369	2,579,150
12/31/2024	100,000,000	3,500,000	1.00	3,500,000	100,000,000	-	103,500,000	7.0000	0.7003	72,481,050

Indicated Fair Market Value	**$ 90,121,400**
Dollar Difference from Face Value	$ 9,878,600
Discount from Face Value	-9.9%

Sensitivity Analysis

Market Rate	Indicated Value	Discount from Face Value
4.4%	$ 95,873,127	-4.1%
4.6%	$ 95,776,744	-4.2%
4.8%	$ 95,663,575	-4.3%
5.0%	$ 95,557,048	-4.4%
5.2%	$ 90,121,400	-9.9%
5.4%	$ 95,335,598	-4.7%
5.6%	$ 95,220,675	-4.8%
5.8%	$ 95,088,265	-4.9%
6.0%	$ 94,963,548	-5.0%

[a] As presented in Exhibit 1 (Scenario 1).
Sources: As cited and analyst calculations.

Exhibit 3
$100 Million Promissory Note Substituted for Asset with Fair Market Value of $100 Million
Scenario 2—Unsecured Note
Fair Market Value of Promissory Note
As of December 31, 2017

Scenario 2:
(1) Unsecured Note

Outstanding Principal on Valuation Date	$100,000,000	
Maker/Debtor (obligor)	Grantor Trust	
Note Holder (obligee)	Grantor	
Valuation Date	12/31/2017	
Interest Rate	3.50%	
Type	Interest Only	
Payment	Annually	
Maturity Date	12/31/2024	
Collateralization	None	
Selected Risk-Adjusted Rate	6.93%	[a]

Payment Date	Beginning Principal	Annual Interest Payment 3.50%	Partial Period	Adjusted Interest Payment 3.50%	Principal Payment	Ending Principal	Total Payment	Discounting Period	Present Value Factor 6.93%	Present Value of Total Payment
12/31/2018	$100,000,000	$ 3,500,000	1.00	$ 3,500,000	$ -	100,000,000	$ 3,500,000	1.0000	0.9352	$ 3,273,200
12/31/2019	100,000,000	3,500,000	1.00	3,500,000	-	100,000,000	3,500,000	2.0000	0.8745	3,060,750
12/31/2020	100,000,000	3,500,000	1.00	3,500,000	-	100,000,000	3,500,000	3.0000	0.8178	2,862,300
12/31/2021	100,000,000	3,500,000	1.00	3,500,000	-	100,000,000	3,500,000	4.0000	0.7648	2,676,800
12/31/2022	100,000,000	3,500,000	1.00	3,500,000	-	100,000,000	3,500,000	5.0000	0.7152	2,503,200
12/31/2023	100,000,000	3,500,000	1.00	3,500,000	-	100,000,000	3,500,000	6.0000	0.6688	2,340,800
12/31/2024	100,000,000	3,500,000	1.00	3,500,000	100,000,000	-	103,500,000	7.0000	0.6255	64,739,250

Indicated Fair Market Value	**$ 81,456,300**
Dollar Difference from Face Value:	$ 18,543,700
Discount from Face Value:	-18.5%

Sensitivity Analysis

Market Rate	Indicated Value	Discount from Face Value
6.1%	$ 94,891,461	-5.1%
6.3%	$ 94,761,006	-5.2%
6.5%	$ 94,624,814	-5.4%
6.7%	$ 94,476,593	-5.5%
6.9%	$ 81,456,300	-18.5%
7.1%	$ 94,186,648	-5.8%
7.3%	$ 94,024,923	-6.0%
7.5%	$ 93,869,841	-6.1%
7.7%	$ 93,711,400	-6.3%

[a] As presented in Exhibit 1 (Scenario 2).
Sources: As cited and analyst calculations.

Exhibit 4
$100 Million Promissory Note Substituted for Asset with Fair Market Value of $100 Million
Fair Market Value of Security Interest Attached to Promissory Note
Security Interest: A 40 Percent Membership Interest in XYZ Holdings, LLC
Asset-Based Approach
Adjusted Net Asset Value Method
As of December 31, 2017

	Accounting Book Value as of 12/31/2017 $000 [a]	Selected DLOC Adjustment %	Selected DLOC Adjustment $	Indicated Noncontrolling, Marketable Value $	Selected DLOM Adjustment %	Selected DLOM Adjustment $	Indicated Noncontrolling, Nonmarketable Value $	Total Discount for DLOM and DLOC % [b]
XYZ Holdings, LLC, Assets:								
Cash and Cash Equivalents	10,000	-5.0%	(500)	9,500	-5.0%	(475)	9,025	-9.8%
Marketable Securities	60,000	-5.0%	(3,000)	57,000	-5.0%	(2,850)	54,150	-9.8%
Notes Receivable	14,000	-10.0%	(1,400)	12,600	-40.0%	(5,040)	7,560	-46.0%
Real Estate Investments	50,000	-10.0%	(5,000)	45,000	-15.0%	(6,750)	38,250	-23.5%
Direct Private Equities	130,000	-15.0%	(19,500)	110,500	-20.0%	(22,100)	88,400	-32.0%
Indirect Private Equities	25,000	-15.0%	(3,750)	21,250	-20.0%	(4,250)	17,000	-32.0%
Other	11,000	-10.0%	(1,100)	9,900	-15.0%	(1,485)	8,415	-23.5%
Total:	300,000						222,800	-26%
Less: XYZ Holdings, LLC, Total Liabilities	(50,000)							
Equals: XYZ Holdings, LLC, Members' Equity	250,000							
Multiplied by: 40 Percent Membership Interest	40%							
Equals: Undiscounted Value of Membership Interest	100,000							

Asset-Based Approach – ANAV Method		$000
Indicated Value of Total Assets (controlling, marketable) [a]		300,000
Less: DLOC and DLOM [b]	-26%	(77,200)
Indicated Value of Total Assets (noncontrolling, nonmarketable) [c]		222,800
Less: Total Liabilities		(50,000)
Equals: Indicated Value of Total Membership Interests (noncontrolling, nonmarketable) [c]		172,800
Multiplied by: 40 Percent Ownership Security Interest	40%	69,120
Equals: Fair Market Value of Security Interest for $100 Million Promissory Note [rounded] [c]		**69,000**

ANAV = Adjusted net asset value
DLOC = Discount for lack of control
DLOM = Discount for lack of marketability
[a] On a controlling, marketable ownership interest level of value basis.
[b] The DLOC and DLOM for each asset is applied in succession. The combined DLOC and DLOM is calculated as the total fair market value of assets on a noncontrolling, nonmarketable ownership interest level of value basis, divided by the indicated value of total assets on a controlling, marketable ownership interest level of value basis, less 1.
[c] On a noncontrolling, nonmarketable ownership interest level of value basis.
Sources: As cited and analyst calculations.

the upshot of the transactions was that Note #1 was extinguished and the trust was left with $25 million in cash remaining ($125 million less an eliminated liability of $100 million plus $25 million in cash).

Therefore, the actual consideration for the substituted property, based on the fair market value standard of value, was not $125 million, but rather $87.4 million plus $25 million, or $112.4 million. Accordingly, the consideration for the substituted property was deficient by the amount of $12.6 million.

Conclusion

In *Condiotti*, the finder of fact gave consideration to the intent of the grantor when the trust was established. Therefore, heavy emphasis was placed on the language of the trust instrument—which forbade the grantor from obtaining any loan from the trust corpus.

Similarly, in the "Texas Four-Step" example presented above, if "intent" is the operative word for determining which note (or cash) was the substituted property, the intent appeared to be the ultimate paydown of Note #1 by way of first Note #2

Exhibit 5
$100 Million Promissory Note Substituted for Asset with Fair Market Value of $100 Million
Fair Market Value of Promissory Note
As of December 31, 2017

Calculation of Weighting Factor as Percentage of Principal Outstanding:

		As of 12/31/17 $	Percentage of Principal (Weight)
Principal Outstanding	[a]	$100,000,000	100%
Less: FMV of Security Interest	[b]	69,000,000	69%
Equals: Unsecured Amount of Principal		31,000,000	31%

Calculation of Fair Market Value of Promissory Note:

		Indicated FMV $	Weight	Weighted Average $
Scenario 1—FMV of Promissory Note	[c]	90,121,400	69%	62,183,766
Scenario 2—FMV of Promissory Note	[d]	81,456,300	31%	25,251,453
			100%	87,435,219

Fair Market Value of $100 Million Promissory Note [rounded]	**$87,435,000**

Dollar Difference from Face Value	**$12,565,000**
Discount from Face Value	**-12.6%**

FMV = Fair market value
[a] As of the valuation date.
[b] As presented in Exhibit 4.
[c] As presented in Exhibit 2.
[d] As presented in Exhibit 3.
Sources: As cited and analyst calculations.

and then cash to retire Note #2, which was used to retire Note #1.

When a transaction is based on the fair market value standard of value and involves a promissory note, the promissory note at fair market value may not necessarily be worth its face value even on the date of the transaction.

This phenomenon also occurs when a bond that trades publicly may be worth less than its face value, if current, market-based interest rates paid by companies of similar levels of risk are higher than the stated interest rate of the bond. This conclusion is relevant to estate planning whereby promissory notes often bear interest rates at the AFR.

Notes:

1. In re Matter of Condiotti, No. 14CA0969 (Col. App. July 9, 2015).
2. IRC Section 675(4).
3. Ibid.
4. Rev. Rul. 2008-22.
5. A trust's corpus is akin to a corporation's shareholders' equity—assets minus liabilities.
6. In re Matter of Condiotti, No. 14CA0969 at 5.
7. Love v. Olson, 645 P.2d 861, 863 (Colo. App. 1982).
8. Rev. Rul. 1985-13, 1985-7 I.R.B. 28.
9. Thomas Benson v. Robert Rosenthal, No. 15-782, 2016 WL 2855456 (E.D. La. 2016).
10. In President George Washington's will, he wrote a similar provision to resolve any challenges.

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ESOP Trustee Considerations in Multistage Stock Purchase Transactions

Scott R. Miller

One of the most ambiguous issues in multistage employee stock ownership plan ("ESOP") stock purchase transactions is the level of control to apply in the valuation of the sponsor company shares being purchased. An ESOP trustee should carefully address this issue to ensure that the ESOP does not pay more than fair market value for the sponsor company shares being purchased. At the same time, an ESOP trustee should have a reasonable understanding of the selling party's perspective, to allow for the best chance of completing a stock purchase transaction that is beneficial to the ESOP. Further, the ESOP trustee should ensure that the ESOP participant shares are redeemed appropriately—before and after a secondary securities purchase or sale transaction.

Introduction

It is common that the initial stock purchase in the formation of an ESOP ("initial ESOP transaction") involves less than 100 percent of the sponsor company's equity. The non-ESOP owners of the sponsor company may not be ready to sell their entire ownership interest. Also, the sponsor company management may not want to take on the leverage required for a single 100 percent ESOP stock ownership transaction.

Although multistage ESOP stock purchase transactions are common, they may involve a number of additional considerations.

When an ESOP makes a secondary purchase of sponsor company shares ("secondary transaction" or "secondary purchase"), the ESOP trustee may not be sure what level of value (control versus noncontrol) is appropriate for the shares being acquired. This issue can be mitigated with careful planning prior to the initial ESOP transaction.

The ESOP trustee may indicate that the ESOP has no future intention to acquire control of the sponsor company. Alternatively, the ESOP trustee may indicate the ESOP's intention to gain control of the sponsor company over time—and to structure the initial ESOP transaction with a binding purchase option to guarantee that such an intention may be realized.

However, multistage ESOP stock purchase transactions are not always mapped out from the start. The non-ESOP owners of the sponsor company may not have made their future ownership intentions clear at the time of the initial ESOP stock purchase transaction.

The ESOP trustee may be unexpectedly presented with a sponsor company stock acquisition opportunity—having had no plan to gain control of the sponsor company over time when the initial ESOP stock purchase transaction occurred. In these cases, an ESOP trustee should take special care in the treatment of secondary stock purchase transactions.

First, this discussion addresses how structuring the initial ESOP stock purchase transaction can affect control pricing considerations in a secondary stock purchase transaction down the road.

Second, this discussion addresses three different scenarios that an ESOP trustee may encounter when the ESOP makes a secondary stock purchase of an ownership interest in a sponsor company.

These three scenarios include the following:

1. An ESOP owns a controlling interest position in a sponsor company and makes a

secondary stock purchase of a noncontrolling ownership interest.

2. An ESOP owns a noncontrolling interest in a sponsor company and makes a secondary stock purchase of a controlling ownership interest.
3. An ESOP owns a noncontrolling interest in a sponsor company and makes a secondary purchase of a noncontrolling ownership interest swing block of shares, resulting in the ESOP owning control after the secondary stock purchase transaction.

Finally, this discussion addresses additional issues that an ESOP trustee may encounter regarding ESOP participant share redemptions before and after secondary stock purchase transactions.

These issues include the following questions:

1. At what level of value should the sponsor company redeem an ESOP participant's shares?
2. What is the effect on the value of the ESOP-owned sponsor company stock if the ESOP loses its ownership control position over time?

There are many issues that an ESOP trustee should address when considering a secondary stock purchase transaction. This discussion attempts to bring some clarity to one of the more ambiguous valuation issues: the level of ownership control.

Initial Structuring of a Multistage ESOP Stock Purchase Transaction

When the result of an initial ESOP sponsor company stock purchase transaction is 100 percent ownership and control in fact, then a control level of value is often appropriate and easily justifiable. When the result of the initial ESOP stock purchase transaction is less than 100 percent ESOP ownership, then the issue becomes more complicated.

If structured with intention and clarity regarding current and future aspects of ownership control, even an initial ESOP transaction involving a noncontrolling ownership interest may justify some level of control price premium.

This section addresses a wish list of provisions that can be structured into an initial ESOP stock purchase transaction to increase the level of ESOP ownership control. Each additional provision that is included will add to the appropriateness of an ownership control level of value.

First, an initial ESOP stock purchase transaction may include an ESOP option to purchase a controlling ownership interest in the sponsor company at a later date. The "later date" should be within a reasonable period of time, and at a minimum, shortly after the initial ESOP stock acquisition loan is repaid.

If this provision is included to support the use of a control level stock purchase price, then (1) the purchase option should be binding and (2) the ESOP should not have to pay any additional consideration for the stock purchase option.

Additionally, the ESOP should have realistic financing options to facilitate the implementation of the stock purchase option. The sponsor company selling shareholders may either guarantee seller financing or agree to facilitate third-party financing.

Second, an initial ESOP stock purchase transaction may be structured in a way that results in voting control for the ESOP trustee. This voting control result may be achieved:

1. through an initial ESOP stock purchase transaction involving a control block of sponsor company voting shares or
2. through the grant of a proxy to the ESOP trustee giving voting control over a control block of sponsor company voting shares.

Third, if not given outright voting control, the plan document may grant an ESOP trustee voting control over third-party acquisition offers. The ESOP trustee is then able to accept or veto any future stock purchase/sale transactions based on the best interests of the ESOP participants. Without this right, it is difficult to justify that the ESOP trustee has any significant level of ownership control.

Fourth, a plan document may require that the ESOP participant shares receive at least as favorable a purchase price and purchase terms as the non-ESOP shares in the event of a third-party acquisition. This provision should also include an ESOP trustee right to veto any third-party transaction that does not include the ESOP shares.

That is, if the non-ESOP controlling shareholders decide to sell their sponsor company shares to a third party, then the buyer may also need to agree to purchase the ESOP shares at the same price and terms.

Finally, if an initial ESOP stock purchase transaction occurs at a control level of value, the plan documents should specify that ESOP participant shares be valued at a control level of value for future stock redemption purposes.

These provisions range from strong support for a controlling level of value (i.e., the ESOP trustee voting control immediately following the initial ESOP stock purchase transaction) to a minimum requirement for any level of control price premium (i.e., a guarantee that the ESOP participant shares will be redeemed at the same level of value). The circumstances of each initial ESOP stock purchase transaction will be different.

However, these provisions address important aspects of control, and each aspect should be considered when purchasing sponsor company shares at a control level of value.

The proposed Department of Labor regulations[1] provide that a control price premium is only justified:

1. if actual voting control and control in fact are passed to the purchaser with the initial ESOP stock purchase transaction or
2. if such control will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the stock sale.

Therefore, if each of the control provisions mentioned here are included in an initial ESOP stock purchase transaction, specifically a binding agreement to allow the ESOP to acquire ownership control in a reasonable period of time, then an ESOP trustee may be justified in paying a control level of value throughout a multistage ESOP stock purchase transaction.

However, if control provisions were not implemented in the initial stock purchase ESOP transaction, then an ESOP trustee should tread carefully in secondary stock purchase transactions. The following three transaction scenarios present situations where the level of control may be in question.

Scenario 1: An ESOP Owns a Controlling Interest in a Sponsor Company and Makes a Secondary Purchase of a Noncontrolling Ownership Interest

For scenario 1, let's consider an ESOP that purchases a 70 percent ownership interest in a sponsor company in the initial ESOP stock purchase transaction. At a later date, the ESOP then purchases the remaining 30 percent ownership interest, resulting in 100 percent ESOP ownership of the sponsor company.

In scenario 1, the level of control at which the secondary, noncontrolling ownership interest transaction takes place can depend on the terms of the initial ESOP stock purchase transaction. One way to justify a control level of value throughout a multistage ESOP transaction is for the selling shareholders to grant the ESOP a binding option to purchase the remaining shares at a later date.

Typically, a binding option to purchase additional sponsor company shares benefits an ESOP. This is because it guarantees to the ESOP the option to gain control in the future. However, in scenario 1, when the secondary stock purchase is a noncontrolling interest, this ESOP purchase option may also benefit the selling shareholders.

An initial ESOP stock purchase transaction may be structured as a multistage purchase, with a control level of value throughout. This can be thought of as a single control transaction, with the addition of an ESOP trustee's option not to proceed.

A control level of value may be justified here if the secondary purchase option is (1) binding and (2) structured to realistically occur within a reasonable period of time.

Allowing a multistage ESOP stock purchase transaction to be structured with a control level purchase price throughout may help facilitate the formation of an ESOP. If a control level purchase price is not guaranteed throughout the multistage ESOP stock purchase transaction, then the non-ESOP shareholders may decide to sell to a third party in order to receive a control price for their shares.

As long as the ESOP trustee is granted sufficient control rights, a binding purchase option, and other guarantees, a multistage ESOP stock purchase transaction at a control level purchase price may be beneficial for all parties involved.

If the secondary purchase in scenario 1 is a standalone transaction and not part of a multistage stock purchase transaction of a controlling ownership interest, then the ESOP should only purchase the block of shares at a noncontrolling ownership level of value. This is true even if the result of the secondary transaction is 100 percent ESOP ownership.

The price at which an ESOP trustee may purchase shares is based on the fair market value of those shares. The test of fair market value for any ESOP purchase is based on a hypothetical willing buyer and a hypothetical willing seller.

In scenario 1, although the ESOP owns a controlling interest in the sponsor company, the secondary purchase involves a noncontrolling ownership interest. A hypothetical buyer would not pay, and a hypothetical seller would not expect to receive, a control level of value for a noncontrolling ownership interest that did not change either party's level of control over the sponsor company.

Scenario 2: An ESOP Owns a Noncontrolling Interest in a Sponsor Company and Makes a Secondary Purchase of Controlling Ownership Interest

For scenario 2, let's consider an ESOP that purchases a 40 percent ownership interest in a sponsor company in the initial ESOP stock purchase transaction. At a later date, the ESOP then purchases the remaining 60 percent ownership interest, resulting in 100 percent ESOP ownership of the sponsor company.

In scenario 2, the secondary stock ownership transaction involves the purchase of a controlling ownership interest that results in 100 percent ESOP ownership of the sponsor company. Therefore, when this situation arises, an ESOP trustee can clearly pay a control level of value in the secondary stock ownership transaction.

However, the level of control at which the initial, noncontrolling ownership interest transaction may take place depends on the structure and circumstances of the initial ESOP stock ownership transaction. Much like scenario 1, in scenario 2 the initial ESOP transaction may be structured as a multistage purchase, with one controlling ownership interest purchase and one noncontrolling ownership interest purchase.

If an ESOP purchase option provision is present, both the scenarios appear to involve the same underlying principle, multiple stock purchase transactions and the guarantee of 100 percent ESOP ownership, if the ESOP trustee chooses.

However, when the initial ESOP stock purchase transaction involves a noncontrolling ownership interest, a multistage transaction may have to meet additional criteria in order to justify a control level of value throughout.

Even if an ESOP trustee has a binding option to purchase a controlling ownership interest at a later date, when the initial ESOP stock ownership transaction involves a noncontrolling ownership interest, the level of control that the transaction should take place at depends on the following factors:

1. The level of voting control that the ESOP trustee has immediately following the stock purchase transaction
2. The ESOP's ability to secure financing for the secondary stock purchase transaction
3. The ability of the ESOP trustee to cause the sale of the sponsor company
4. The rights and privileges of ESOP participant shares in the event of a sale to a third party.

In scenario 2, if there is no guarantee of ESOP control at a later date, the initial, noncontrolling ownership interest transaction should take place at a noncontrolling ownership interest level of value.

In scenario 2, it is most likely appropriate for an ESOP trustee to purchase the second controlling ownership interest block of shares at a control level purchase price. This is because the ESOP gains control in fact as a result of the second stock purchase transaction.

Scenario 3: An ESOP Owns a Noncontrolling Interest in a Sponsor Company and Makes a Secondary Purchase of a Noncontrolling Ownership Interest, Resulting in ESOP Control

For scenario 3, let's consider an ESOP that purchases a 40 percent ownership interest in a sponsor company in the initial ESOP stock purchase transaction. At a later date, the ESOP then purchases a 30 percent ownership interest resulting in 70 percent ownership in, and control of, the sponsor company.

This discussion has already presented the option of structuring a multistage stock purchase transaction at the outset. Therefore, in this section we will only consider a situation where no control considerations were made at the time of the initial ESOP stock purchase transaction.

In any transaction, we know that an ESOP trustee can pay no more than fair market value for the ownership interest that the ESOP acquires. We also know that the definition of fair market value considers both a hypothetical willing buyer and a hypothetical willing seller.

If only considering the block of shares changing hands in scenario 3, a noncontrolling block of shares, one may argue that a hypothetical seller would only expect to receive a noncontrolling ownership interest level of value for their shares.

However, a well-informed hypothetical buyer would know that the transaction will result in a change of control and a controlling ownership position.

According to guidance from the proposed Department of Labor regulations,[2] an ESOP may pay a control price premium only to the extent a third party would pay a control price premium. The guidance further suggests that the payment of a control premium is unwarranted unless the ESOP obtains both voting control and control in fact as a result of the stock purchase transaction.

Both of these criteria are met in the secondary stock purchase transaction in scenario 3. First, empirical evidence suggests that acquirers pay control premiums for noncontrolling blocks of stock that result in post-transaction controlling ownership interests. Second, in scenario 3, the ESOP gains both voting control and control in fact as a direct result of the secondary stock purchase transaction.

Even if an ESOP trustee purchases the swing block of shares at a control level of value, any additional purchases of noncontrolling ownership interests should take place at a noncontrolling ownership level of value.

The exception would be if the swing block purchase was part of a multistage stock purchase transaction of a controlling ownership interest, where a control level of value was negotiated at the outset and the ESOP has a binding option to acquire the remaining shares in a reasonable period of time.

At What Level of Value Should the Sponsor Company Redeem ESOP Participant Shares?

One of the most important considerations for an ESOP trustee is the consistent and fair treatment of ESOP participant shares.

If an ESOP owns a noncontrolling ownership interest in a sponsor company without control rights and with no plan in place to bring the ESOP ownership to an ownership control position, the sponsor company likely redeems ESOP participant shares at a noncontrolling ownership level of value.

However, if an ESOP ever pays a control level of value to acquire non-ESOP shares, the trustee should ensure that ESOP participant shares are also redeemed at a control level of value from that point forward. Even if the ESOP paid a control level of value to acquire a noncontrolling ownership position as part of a multistage transaction, ESOP participant shares should also be redeemed at a control level of value.

An ESOP trustee may encounter a conflict between (1) the consistent treatment ESOP participant shares over time and (2) the obligation to redeem ESOP participant shares at a control level of value (after the ESOP has acquired a control position or paid a control level of value for non-ESOP shares).

The following simplified example illustrates this conflict. Rusty Company ("Rusty") forms an ESOP with a 40 percent ownership interest in the company. Rusty ESOP does not have voting control or control in fact over the company.

The initial ESOP stock purchase transaction did not grant any binding purchase option for the Rusty ESOP to acquire a controlling ownership interest in the sponsor company. Over the next four years, Rusty ESOP participant shares are redeemed at a noncontrolling ownership level of value.

"One of the most important considerations for an ESOP trustee is the consistent and fair treatment of ESOP participant shares."

Four years later, the Rusty ESOP trustee is confronted with an unexpected opportunity to purchase an additional 30 percent ownership interest (swing block) in Rusty at a control level of value.

The Rusty ESOP trustee determines that the transaction is in the best interest of the ESOP participants and proceeds with the purchase. The resulting 70 percent ownership interest provides the Rusty ESOP with voting control and control in fact of the sponsor company.

The Rusty ESOP trustee is now confronted with the following problem. The Rusty ESOP now owns a control position and participant shares should be redeemed accordingly.

However, the Rusty ESOP trustee also wants to treat Rusty ESOP participant shares consistently over time, and specifically considers participant shares redeemed at a noncontrolling ownership level of value prior to the secondary stock purchase transaction.

Regardless, the Rusty ESOP trustee should act appropriately based on the information currently available, which is that the ESOP now owns a controlling interest in the sponsor company and ESOP participant shares should be redeemed at a control level of value.

Ideally, an ESOP trustee will have a clear long-term plan of control versus noncontrol ESOP ownership prior to the initial ESOP sponsor company stock purchase transaction. However, an unexpected change of control may still occur.

If an ESOP trustee is made aware of a possible future transaction resulting in ESOP control, they may consider informing the ESOP participants of the possibility so that the participants may make informed timing decisions regarding retirement, diversification, or other relevant choices.

Further, if the ESOP trustee enters into a binding agreement to acquire control of the sponsor company in the future, they may advocate for participant

share repurchases to occur at a control level of value beginning immediately, as opposed to after control is actually realized.

What If the ESOP Loses Its Controlling Ownership Position?

An ESOP's ownership position could decrease from a controlling interest to a noncontrolling interest (1) if the sponsor company continues to redeem ESOP shares over time without recycling those shares or (2) if the sponsor company issues additional non-ESOP shares as a means to raise capital.

The sponsor company may have legitimate business reasons to redeem shares rather than recirculating them through the ESOP. The sponsor company may also have legitimate business reasons to issue additional shares, such as an investment opportunity or financial distress.

However, an ESOP trustee should be careful if ceding a controlling ownership position. The proposed Department of Labor regulations[3] infer that it may be difficult to justify the ESOP ownership position as control in fact (and justify the ESOP purchasing an ownership interest at a control level of value) if an ESOP trustee could reasonably foresee that the ESOPs control position will be dissipated within a short period of time subsequent to the acquisition.

If the ESOP transition from a controlling ownership position to a noncontrolling ownership position is unavoidable or in the best interest of the ESOP participants, then the ESOP trustee should consider, at a minimum, securing a guarantee that future ESOP participant share redemptions will occur at a control level of value.

An ESOP trustee should consider securing this guarantee before approving any ESOP share redemptions, or non-ESOP share issuances, that would decrease the ESOP ownership position to below 50 percent or otherwise cause a loss of the ESOP control.

Conclusion

One of the most important duties of an ESOP trustee is to ensure that the ESOP does not pay more than fair market value to purchase a block of sponsor company shares. One of the important aspects of determining the fair market value of a block of sponsor company shares is the appropriate level of control. Although the Department of Labor has provided some guidance in this area, the appropriate level of control to apply may not always be clear.

In most cases, when the block of shares being acquired is a controlling ownership interest, with voting control and control in fact, an ESOP trustee may purchase the shares at a control level of value. This could be an initial ESOP stock purchase transaction involving a controlling ownership interest or a secondary stock purchase transaction involving a controlling ownership interest.

If an ESOP has a binding purchase option to acquire a controlling ownership interest in the sponsor company, then a control level of value may be permissible for transactions involving both controlling ownership interests and noncontrolling ownership interests.

However, before paying a control level of value, an ESOP trustee should analyze the likelihood that the ESOP will actually acquire control in fact in a reasonable period of time. Additionally, an ESOP trustee should consider the level of control that the trustee can exert prior to acquiring control in fact.

Before paying a control level of value to acquire any block of sponsor company shares, an ESOP trustee should consider if a hypothetical third party would also pay a control level of value for the same block of shares. If the block of shares is a swing block, and if the result of the transaction is ESOP control in fact, then a control level of value is likely to be appropriate.

When a transaction does not result in a change of control, a noncontrolling level of value is likely appropriate. This is true even if the ESOP already owns a controlling interest in the sponsor company.

Finally, an ESOP trustee should ensure that ESOP participant share redemptions occur at an appropriate level of value. If the ESOP either has control in fact of a sponsor company, or has previously purchased shares at a control level of value, then the ESOP participant share redemptions should occur at a control level of value.

Notes:

1. Prop. DOL Reg. Sec. 2510-3-18(b)(4)(ii)(I)(1).
2. Ibid.
3. Ibid.

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Adjustments to Financial Statements for ESOP Contribution Expense

Frank R. ("Chip") Brown

This article is reprinted, with permission from The Journal of Employee Ownership Law and Finance*, Volume 19/3.* *Determining any financial statement adjustments is a necessary procedure in an ESOP sponsor company appraisal. This discussion explains the common procedures for determining whether any financial statement adjustments are necessary for ESOP contribution expense. A practitioner may develop a basis for including ESOP contribution expense adjustments that best correspond with a particular set of facts and circumstances.*

An analyst is often faced with many decisions when performing a valuation. In an ESOP valuation analysis, a practitioner may need to consider potential financial statement adjustments related to ESOP contribution expense to develop appropriate indications of value. This article discusses normalizing- and control related adjustments to financial statements, the financial statement analysis of ESOP contribution expense, and the treatment of ESOP contribution expense.

ESOP Contribution Background

An ESOP is a defined contribution plan to which the sponsor company generally makes annual contributions. The annual contributions, in both the actual cash contributed and the expense recorded for financial reporting purposes, can vary from year to year. Participant accounts may receive such contributions in company stock or in cash.

The allocation of the shares and/or cash is generally based on the participant's compensation as a percentage of total covered payroll of all ESOP participants. Each participant has an account and additions are made to such an account from the sponsor company contributions, forfeitures from other participants, and income from the non-company stock investments held by the ESOP.

Contributions can be made for two basic kinds of ESOPs: leveraged and non-leveraged. For a non-leveraged ESOP, the annual contribution can be in the form of stock or cash. In a leveraged ESOP, the ESOP borrows money to purchase stock either from the sponsor company, from an outside lender (ESOP debt usually guaranteed by the sponsor company), or from existing shareholders. The purchased shares acquired by the ESOP with an ESOP loan are generally pledged as security for the loan and are held in a suspense account.

For a leveraged ESOP, the company makes annual deductible contributions to the ESOP for both principal and interest. The ESOP may use such cash to repay the ESOP loan. As the principal on the ESOP loan is amortized, a proportionate number of shares are released from the suspense account.[1] After releasing shares, the shares are allocated to participants' accounts. Shares allocated to participants' accounts no longer serve as collateral for the debt.

Normalizing- and Control-Related Adjustments to Financial Statements

One must understand normalizing and control adjustments to financial statements before attempting to apply such adjustments to an ESOP sponsor company, and specifically ESOP contribution expense. There are five primary types of financial statement adjustments:

1. Accounting or Generally Accepted Accounting Principles ("GAAP") adjustments
2. Nonrecurring adjustments
3. Non-arm's-length transactions adjustments
4. Financial control adjustments
5. Separation of operating and nonoperating items

While these adjustments appear somewhat similar at first, there are specific valuation impacts of each. The differences between the five types of adjustments can be significant from a fair market value perspective. The characteristics and distinctions of the five adjustment types are summarized below.

Accounting/GAAP Adjustments

Accounting-related adjustments are generally made because (1) the financial statements of the subject company and/or the guideline companies are inconsistent in accounting policies/reporting (e.g., aggressive or "low" quality vs. conservative or "high" quality) and (2) certain financial statement items prepared according to GAAP may need to be adjusted to something that better reflects economic reality. Some examples include:

- depreciation methods,
- inventory accounting,
- revenue recognition issues, and
- net operating losses.

Nonrecurring Item Adjustments

These adjustments relate to certain specific or isolated events that affected the subject company's past earnings performance. Some examples include:

- unusual gains or losses on sale of assets;
- lawsuit settlements;
- property loss due to fire, hurricane, flood, etc., not covered by insurance;
- expenses (not expected going forward) associated with the ESOP installation; and
- elimination of past items that might tend to distort the company's current and future earning power.

Non-Arm's-Length Transaction Adjustments

These adjustments relate to related-party transactions and often discretionary expenses. These items are more common in privately held companies. Some examples include:

- excess compensation paid to the owner(s) or to the family members of the owner(s),
- nonmarket rent paid to the owner(s), and
- personal travel and entertainment expenses of the owner(s).

For purposes of this article, non-arm's-length transactions are discussed separately from financial control adjustments. There is a difference of opinion among appraisers on whether adjusting non-arm's-length transactions, such as nonmarket owner compensation, represents "control" adjustments, and whether these adjustments should be made when valuing a noncontrolling interest. Further discussion on this disagreement is beyond the scope of this article.

Financial Control Adjustments

These adjustments relate to economies or efficiencies available to the typical financial buyer (which may or may not be present in the subject company at the time of appraisal), and not present on the as-if-freely-traded basis.[2] Prospective financial control buyers may consider adjustments that can improve the normalized earnings stream. These adjustments may also be a result of better management, which may also affect the expected growth rate of adjusted earnings.[3]

Separation of Operating and Nonoperating Items

Appraisers may adjust historical and/or projected financial statements of the ESOP sponsor company to exclude income or expense associated with a nonoperating asset or liability. For example, a practitioner may remove income associated with a rent property owned by a manufacturing company (i.e., renting properties not part of the core operations). If this income is removed from the historical and/or projected financial statements of

the subject company, the value of the real estate (less any debt associated with it) should be included in the total indicated value of the company (e.g., added to the indicated value of equity of the operating company).

ESOP Contribution Expense Financial Statement Analysis

Before an analyst can decide whether to make adjustments associated with ESOP contributions, he or she should first understand what is being adjusted. Specifically, the analyst should have a general understanding of the accounting associated with ESOP contribution expense, and ultimately the impact on the financial statements. For example, the analyst may make adjustments for financial statement items that may be in accordance with GAAP but do not make economic sense for valuation purposes.

As ESOP shares are committed to be released, unearned ESOP shares should be credited, and generally ESOP contribution expense should be debited or charged.[4] The amount of the entry should be based on the fair values of committed-to-be-released shares. Thus, as the sponsor company shares increase in value, the ESOP contribution expense increases as well.

Under AICPA Statement of Position 93-6, compensation/benefit expense is based on the fair value of the shares allocated, released, or committed to be released for any payments made on the ESOP debt that year. Hence, even if the company makes the same cash contribution amount each year, the expense on the income statement could fluctuate significantly if the share price has increased or decreased by a substantial amount.

The contribution expense could also vary significantly even if the share price has not. For example, if the sponsor company has made contributions to the ESOP greater than the required contribution for the principal and interest payments, the excess contribution amount is expensed in the current period. In future years, when that excess contribution is used to make debt payments, the difference between (1) the fair value of the shares released in the future period and (2) the expense amount already recognized in the previous period is recorded as an expense (if the share price has increased) or a credit to expense (if the share price has decreased).

Other Reasons for Variance in Contribution Expense

Significant variance in the contribution expense is not limited to leveraged ESOPs. Even after the debt has been repaid, contribution expense may be above or below a normal level of benefits due to repurchases of participants' shares.

The contribution expense associated with repurchased shares depends on whether the shares are "redeemed" (considered a capital transaction that does not affect the income statement) or "recycled" (expense recorded at the fair value of the shares times the number of shares recycled). If the shares are recycled, the associated contribution expense may be above a market/normal level of benefits if there is a significant number of recycled shares and/or there has been a significant increase in the share price.

Whatever the reason that contribution expense is higher than normal/market, a practitioner still faces the same decisions regarding the treatment of ESOP contribution expense in a valuation analysis.

"Leveraged ESOPs generally have more fluctuation and often higher levels of ESOP contribution expense."

Treatment of ESOP Contribution Expense in a Valuation Analysis

As described previously, ESOP contribution expense (on a GAAP basis) can vary significantly even if the ESOP sponsor company makes consistent cash contributions. In addition, some people question whether GAAP accounting for contribution expense reflects the true economic reality of the cost a hypothetical willing buyer or seller of the ESOP company shares would consider.

However, adjusting to a "market level" of benefit expense may not be appropriate. Unless there is a significant reduction in share price, the ESOP will eventually have to repurchase those participant shares at fair market value. Another issue arises regarding the use of a market level of benefits if ESOP contribution expense is expected to remain high going forward for the subject company and an acquisition of the company is unlikely.

Factors to Consider

There is not a definitive answer for how to always treat ESOP contribution expense in an analysis. It is an analyst's judgment based on the specific characteristics of the subject ESOP sponsor company. However, there are certain factors that should be considered in appropriate treatment of ESOP contribution expense in a valuation analysis. Some of the factors to consider are as follows:

- Leveraged ESOPs generally have more fluctuation and often higher levels of ESOP contribution expense. This is because the mandatory contribution amount (to cover the principal and interest) releases a portion of shares held in suspense. The fair market value of the shares released may be higher than a market level of benefits. Also, the sponsor company cannot reduce the cash contribution to offset the increase in share price, so as the stock price increases, so does the contribution expense.
- It is often common for a newly formed leveraged ESOP to make higher than the mandatory contribution in order to pay the debt down quicker. This compounds the issue of higher-than-normal contribution expense, because (1) it is a higher cash amount being contributed, which releases a greater number of sharers, and (2) it generally increases the equity price more quickly because the debt is paid down faster.
- A sponsor company with a new ESOP can have more fluctuation in stock price than a later-stage ESOP sponsor company, which directly affects the recognition amount of ESOP contribution expense on the income statement.
- A mature ESOP sponsor company may face a significant repurchase obligation. If the ESOP sponsor company decides to recycle a significant number of shares to minimize the cash flow impact, the ESOP contribution expense may be higher than normal.
- It is unlikely that ESOP contribution expense will be a consistent percentage of revenue over time for many ESOP sponsor companies, which might lead a hypothetical willing buyer and seller to negotiate a sale price on a normalized contribution/benefit level or the expectation of the ESOP contribution expense going forward.
- Participants could leave before they are fully vested and may not realize the full benefit that was recorded as an expense by the company in a previous period.
- A purchase study may help better understand the level of contribution expense going forward (e.g., if a significant number of shares are expected to be put back in the next few years, and the company plans on recycling such shares).

Discussions with ESOP Sponsor Company Management

Once an analyst has an understanding of the items above, he or she should interview management to learn the specifics of ESOP contributions for the sponsor company. Some interview questions may focus on the following:

1. *The company's method for accounting for ESOP contribution*. Is it consistent with GAAP? Where specifically on the income statement is the ESOP contribution expense being reported? If the company has audited financials, there should be a footnote that discusses this. If the ESOP was formed before 1992, the company does not have to use current accounting standards in recording ESOP contribution expense.

2. *Historical fluctuations in ESOP contribution expense*. Is it due to increases or decreases in the share price, increases or decreases in the actual cash contributed, or an increase in recycling of shares put back or forfeited by participants?
3. *Projected ESOP contribution*. What is the expected ESOP contribution going forward? What are the reasons for the projected contribution being inconsistent with historical amounts or for the fluctuations in the projected contributions?
4. *Debt payments*. If this is a leveraged ESOP, does the sponsor company anticipate only making the required contribution, or will the company pay down debt quicker than the amortization schedule?
5. *The company's total benefits*. What types of benefits are provided to employees? Is the ESOP replacing a prior benefit plan? What was the contribution made to the prior benefit plan?
6. *Potential for sale*. Are there any plans to sell the company? Any bona fide offers?

Analyst Decisions regarding ESOP Contribution Expense

After determining answers and information related to the items above and analyzing the company's financial statements, an analyst generally has three options for eating ESOP contribution expense in the valuation analysis:

1. Add back the entice ESOP contribution expense (and other benefit expenses) and then subtract a market level of benefits. The analyst would do this as an adjustment to the historical and projected income statements.
2. Use management's target or optimal ESOP contribution amount, based on discussions with management. The analyst would make this adjustment to the historical and projected income statements. Generally, one would expect this target/optimal ESOP contribution amount to be higher than a market level.
3. Make no or few adjustments and keep historical and projected income statements as-is or close to as-is.

An appraiser must use his or her judgment to determine which of the three options above to use. Which one to use depends on the specifics of the engagement There is no blanket right answer. There are reasons for using each of the three options, which in general are as follows:

Potential Reasons to Use a Market Level of Benefits

- If valuing on a financial control ownership basis
- If valuing for fair value for financial reporting purposes
- There is a planned sale or high potential for sale of company
- Management does not have a set contribution policy and is inconsistent year to year
- Elimination of past items that might tend to distort the company's current and future earning power
- Less subject to management's influence
- Above-market ESOP contribution expense is being separately incorporated into the repurchase obligation analysis
- Sponsor company would achieve the same/similar financial results/growth even if employees received a market level of benefits that is lower than the current level of benefits received from the sponsor company

"An appraiser's decisions on adjusting ESOP contribution expense have a directed and quantifiable impact on the valuation analysis of the ESOP sponsor company stock."

Potential Reasons to Use Management's Target or Optimal Level of ESOP Contributions

- Unusual or non-recurring events that caused ESOP contribution expense to be higher or lower than management's target or optimal amount
- If valuing assuming the company will continue having an ESOP (e.g., also calculating the ESOP tax benefit of the principal payments)
- The company contributed a higher-than-mandatory amount either to pay down debt quicker or to fund the ESOP for future year contributions
- Not as sensitive to changes in stock price
- Specific to the company and not a theoretical level based on limited market participant or industry data
- Elimination of past items that might tend to distort the company's current and future earning power
- Above-market ESOP contribution expense is being separately incorporated into the repurchase obligation analysis
- The sponsor company would not achieve the same historical and/or projected financial results and growth if employees received a market level of benefits that is lower than the current level of benefits received from the sponsor company

Potential Reasons to Use the Actual Level, with No or Few Adjustments

- Less subject to management's influence and to the analyst's subjective judgment
- If there are very few unusual or non-recurring items related to ESOP participants
- ESOP contribution expense has been relatively consistent
- Sale of company unlikely
- If valuing company assuming it will continue as an ESOP company (e.g., also calculating the ESOP tax benefit of the principal payments)

Summary and Conclusion

An appraiser's decisions on adjusting ESOP contribution expense have a directed and quantifiable impact on the valuation analysis of the ESOP sponsor company stock. An appraiser needs to understand not only the types of and reason for adjustments that may be made but also the basic accounting methods for ESOP contribution expense on the sponsor company financial statements.

There are many different factors that may influence a practitioner's decisions on whether to and how to adjust for ESOP contribution expense. Such decisions can be an extremely complex process. Adding to the complexity is the often volatile nature of ESOP contribution expense and the necessity to rely on certain assumptions. Despite this complexity, if necessary, there are ways to adjust ESOP contribution expense based on a particular set of facts and circumstances.

Notes:

1. Some ESOPs release shares based on a principal-and-interest formula.
2. Z. Christopher Mercer. *The Integrated Theory of Business Valuation* (Memphis, TN: Peabody Publishing, LP, 2004), 155.
3. Ibid.
4. There are other accounts that could be used, e.g., dividends payable or a compensation-related liability. For purpose of this discussion, we assume the entire amount is charged to ESOP contribution expense.

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Reasonableness of Shareholder/Employee Compensation Guidance for Closely Held Corporations

Robert F. Reilly, CPA

The Internal Revenue Service ("the Service") continues to challenge the tax deductibility of what it perceives to be excess compensation paid to closely held company shareholder/employees. The Service often alleges that these excess compensation amounts are disguised (and nondeductible) dividend payments. When these disputes reach the litigation stage, the courts often consider the so-called independent investor test to assess the reasonableness of closely held corporation shareholder/employee compensation. Essentially, the independent investor test determines whether the taxpayer company would earn a fair return on equity ("ROE")—after the recognition of the shareholder/employee compensation expense. Valuation analysts are particularly skilled at (1) measuring the taxpayer company ROE and (2) determining what should be considered a fair ROE for an investment in the taxpayer company. This discussion summarizes the professional guidance provided by the H.W. Johnson, Inc. v. Commissioner Tax Court *decision with regard to (1) the application of the independent investor test and (2) the assessment of the reasonableness of closely held corporation shareholder/employee compensation.*

Introduction

The Internal Revenue Service ("the Service") often challenges the reasonableness of the total amount of compensation that is paid to the shareholder/employees of closely held C corporations. The Service often claims that any alleged excess compensation amounts (particularly during the taxpayer corporation profitable years) are not tax deductible compensation payments at all. Rather, the Service often claims that such payments are disguised—and nondeductible—dividend payments.

Excess compensation amounts are typically measured as the amounts that the closely held corporation pays to the shareholder/employer in excess of what comparable employees would be paid to perform comparable work at comparable companies.

The United States Tax Court decision in *H.W. Johnson, Inc. v. Commissioner of Internal Revenue*[1] ("the *H.W. Johnson, Inc.*, decision"), provides recent guidance as to how the courts analyze this reasonableness of shareholder/employee compensation issue—particularly for closely held corporation taxpayers.

Although the *H.W. Johnson, Inc.*, decision is only a Tax Court memorandum decision, it is 32 pages in length. Accordingly, this published judicial decision does provide a fair amount of discussion regarding the court's rationale in this case.

In summary, the *H.W. Johnson, Inc.*, decision is very taxpayer friendly. As discussed below, the judicial decision was influenced by the testimony of competing forensic analyst ("analyst") testifying experts.

And, the forensic analyses of both litigant's forensic analysts—and the court's judicial decision—are heavily influenced by the specific facts

and circumstances of this particular construction industry taxpayer.

In particular, the Tax Court was heavily influenced by the application of the so-called independent investor test to assess the reasonableness of the H.W. Johnson, Inc., shareholder/employee compensation.

The independent investor measures whether the taxpayer corporation earns a fair rate of return on equity ("ROE") after allowing for the expense of the shareholder/employee compensation. The fair rate of ROE is based on the level of ROE that an independent investor would consider to be acceptable for an investment in the subject taxpayer company.

Valuation analysts are particularly skilled at measuring a subject closely held company ROE. In addition, valuation analysts are particularly skilled at measuring a benchmark (or required level) ROE metric. The appropriateness of the selected benchmark ROE measure is often based on the degree of comparability of the subject company to the selected benchmark data sources.

The Tax Issues in the Dispute

H.W. Johnson, Inc. (a C corporation), was the taxpayer in this matter and the petitioner in the U.S. Tax Court case. The Service determined deficiencies in the taxpayer's federal income tax for the taxable years ended June 30, 2003 and 2004 ("the years at issue"), of $877,440 and $2,087,678, respectively.

The particular income tax issues that the Tax Court decided were as follows:

1. Whether the amounts paid to shareholder/employees Bruce A. Johnson and Donald J. Johnson during the years at issue were considered reasonable compensation and deductible under Internal Revenue Code Section 162
2. Whether the taxpayer was entitled to deduct a $500,000 payment made in 2004 to DBJ Enterprises, LLC, an entity controlled by Bruce and Donald, as an ordinary and necessary business expense under Section 162

Background on H.W. Johnson, Inc.

During the years at issue, H.W. Johnson, Inc., operated a concrete contracting business. At that time, the taxpayer company was one of the largest curb, gutter, and sidewalk contractors in the State of Arizona. The taxpayer company had over 200 employees, and it earned contract revenue of $23,754,182 and $38,022,612 in 2003 and 2004, respectively.

The taxpayer company was incorporated in 1974 by H.W. Johnson and his wife Margaret Johnson. H.W. and Margaret had operated a predecessor sole proprietorship out of their home since 1968.

Since the company founding, H.W. managed all of the company operations, and Margaret managed all of the company financial and administrative matters.

Two of the Johnson sons, Bruce and Donald, began working part time for the company as teenagers in the 1970s. The sons worked full time for the company after they completed their education in 1977 and 1982, respectively.

Bruce and Donald gradually assumed increasing management responsibilities at the company. And, they took over daily operations of the taxpayer company in 1993.

H.W. and Margaret made gifts of shares of the company stock to Bruce and Donald. By 1996, when H.W. retired from H.W. Johnson, Inc., Bruce and Donald each owned 24.5 percent of the shares, with Margaret retaining the remaining 51 percent of the shares.

Upon the retirement of H.W., the two brothers became co-vice presidents and members (along with Margaret) of the company board of directors.

The taxpayer company revenue increased rapidly after Bruce and Donald assumed control of the H.W. Johnson, Inc., operations in 1993. In 1993, the taxpayer company reported revenue of approximately $4 million. Company revenue increased to over $11 million and over $13 million in 1994 and 1995, respectively.

The taxpayer company revenue remained steady at about $17 million between 1996 and 1999 and increased consistently every year thereafter, including in the years at issue. In fact, the taxpayer company revenue increased dramatically between 2003 and 2004.

H.W. Johnson, Inc., was profitable and experienced significant revenue and asset growth during 2003 and 2004, with gross profit margins (before payment of officer bonuses) of 38.3 percent and 38.2 percent, respectively.

During 2002 through 2004, the H.W. Johnson, Inc., assets, liabilities, equity, revenue, net income before taxes, and net income after taxes were reported as presented in Exhibit 1.

During the years at issue, shareholder/employees Bruce and Donald personally guaranteed the company loans. The taxpayer company used those loan proceeds to purchase materials and supplies.

The Tax Years at Issue: 2003 and 2004

During the years at issue, Margaret served as the company president and chairman of the board. Margaret managed the company payroll and finances, accounts receivable and delinquent account collections, employee hiring and terminations, and various other administrative functions, working around 40 hours a week. Together Bruce and Donald managed all operational aspects of the company business.

The taxpayer company operations were split into two geographical divisions: eastern and western. Each brother managed one division's operations, including the following functions: contract bidding and negotiation, project scheduling and management, equipment purchase and modification, personnel management, and customer relations.

Bruce and Donald each supervised over 100 employees in their respective divisions, including superintendents and foremen. The two brothers each worked 10 to 12 hours a day, 5 to 6 days a week.

The two brothers were at the job sites daily, and they regularly operated equipment while there. The two brothers were readily available if problems occurred at a job site. And, Bruce and Donald were known in the local construction industry for their responsive and hands-on management style.

During the years at issue, approximately 95 percent of H.W. Johnson, Inc., business was related to residential subdivision construction. The concrete work supervised by Bruce and Donald required both considerable technical skill and coordination. This is because fresh concrete is highly perishable.

That is, concrete "sets"—and becomes unusable—either (1) 90 minutes after it is mixed and loaded onto a truck or (2) if it reaches a temperature of 90 degrees.

H.W. Johnson, Inc., had to meet the varying specifications of different contractors, engineers, cities, towns, and counties on any given job. The company operating equipment was often modified or specially fabricated to meet the requirements of a given job.

Most of that equipment modification work was performed in-house—thereby reducing costs and improving efficiency—with Bruce or Donald often supplying the idea for a design that was then refined and implemented by the company fabrication foreman.

H.W. Johnson, Inc., enjoyed an excellent reputation with developers, inspectors, and other contractors, and it was known for its timely performance and equality product. As a result, the taxpayer company was routinely awarded contracts even where it was not the lowest bidder. H.W. Johnson, Inc., needed little marketing beyond its reputation in the local construction market.

Exhibit 1
H.W. Johnson, Inc.
Results of Operations
Years 2002 through 2004

Financial Fundamentals	2002	2003	2004
Assets	$6,814,399	$8,844,769	$13,424,705
Liabilities	3,228,649	5,058,551	9,536,121
Equity	3,585,750	3,786,218	3,888,584
Contract Revenue	23,239,207	23,754,182	38,022,612
Net Income before Taxes	210,967	387,706	348,579
Net Income after Taxes	132,545	250,468	202,366

D.B.J. Enterprises, LLC

A reliable supply of concrete was necessary to the company operations. H.W. Johnson, Inc., did not produce its own concrete, instead relying on local suppliers. Starting in late 2002

and throughout the years at issue, there were shortages of concrete in the company's market due to a housing boom in Arizona. In addition, large multinational and national construction companies were acquiring suppliers of concrete in Arizona, disrupting the locally based network.

Faced with the possibility of disruptions in the company's supply of concrete, Bruce and Donald suggested to Margaret that H.W. Johnson, Inc., invested in a concrete supplier (in order to have a reliable supply). As the controlling shareholder, Margaret refused to involve the taxpayer company in such a venture—because she considered it to be too risky.

On March 21, 2003, Bruce and Donald, acting through D.B.J. Enterprises, LLC ("DBJ"), partnered with other investors (including a former executive of a local concrete supplier that had been acquired by a large multinational company) to form Arizona Materials, LLC ("Arizona Materials").

Arizona Materials was formed to conduct a concrete supply business. DBJ owned a 52 percent equity interest in Arizona Materials. Through DBJ, Bruce and Donald invested substantial sums in, and guaranteed the indebtedness of, Arizona Materials.

There were occasional market shortages of cement—an essential ingredient of concrete—during the years at issue. However, Arizona Materials was able to obtain access to cement during that period because of its relationship with other cement suppliers.

H.W. Johnson, Inc., obtained a substantial amount of its concrete from Arizona Materials during 2004. And, H.W. Johnson, Inc., was able to procure its concrete even when other contractors could not (and were, therefore, forced to temporarily suspend operations).

H.W. Johnson, Inc., received bulk discounts for large concrete purchases from Arizona Materials, obtaining concrete at a price lower than it paid to other suppliers. DBJ exercised its influence as majority shareholder of Arizona Materials to ensure that H.W. Johnson, Inc., received a steady supply of concrete. (At that time, Arizona Materials had other customers that were willing to pay a higher price for its concrete.)

The Shareholder/Employee Compensation Issue

At the end of 2004, H.W. Johnson, Inc., made a $500,000 payment to related party DBJ. The H.W. Johnson, Inc., board meeting minutes state that the payment was for a "guaranteed supply of concrete at market prices for the year ended June 30, 2004. DBJ has negotiated with Arizona Materials L.L.C. on behalf of H.W. Johnson, Inc. to provide a continuous supply of concrete."

The Service noted that H.W. Johnson, Inc., and DBJ had no written agreement regarding the $500,000 payment.

During the years at issue, the H.W. Johnson, Inc., board held annual meetings in May to determine officer compensation, director's fees, and dividends. For those years, the taxpayer company compensated Bruce and Donald as presented in Exhibit 2.

The H.W. Johnson, Inc., officer bonus formula was adopted by the company board in 1991, and it was later amended in 1999. The total potential bonuses were calculated in proportion to the company's annual contract revenue, and the amounts were added to a "bonus pool."

At year end and upon the advice of the company accountant, the board of directors issued bonuses out of the bonus pool based on:

1. officer performance and
2. the company's ability to pay.

Any unpaid amounts remained in the company bonus pool for later payment, pending the board approval.

During the years at issue, H.W. Johnson, Inc., had a dividend plan, adopted in 1991 and later amended in 1999. That plan called for dividend payments when the company retained earnings balance exceeded $2 million. The company board determined the amount of the dividend on the basis of the company financial position, profitability, and capitalization, following the advice of the company accountant.

H.W. Johnson, Inc. paid modest dividends to its shareholders between 1996 and 2004. For most of those years, the dividend amount was $25,000. In 2002 and 2003, the dividend amount increased

Exhibit 2
H.W. Johnson, Inc.
Shareholder/Employee Total Compensation
For the Years 2003 and 2004

Company Officer	2003	2004
Bruce	$2,013,250	$3,651,177
Donald	2,011,789	3,649,739
Total	4,025,039	7,300,916

to $50,000. In 2004, the dividend amount was $100,000.

The Audit and the Tax Deficiency

On a timely filed Form 1120, U.S. Corporation Income Tax Return, for 2003 and 2004, H.W. Johnson, Inc., claimed income tax deductions for the salaries, bonuses, and director fees paid to Margaret, Bruce, and Donald.

The taxpayer company also claimed a deduction for 2004 for the $500,000 amount that it paid to DBJ, reporting the payment as an "administration fees" expense.

The Service issued a notice of deficiency to H.W. Johnson, Inc., determining that $2,607,517 and $5,616,771 of the amounts the company deducted for 2003 and 2004, respectively, as officer compensation exceeded so-called reasonable compensation.

The Service also disallowed in its entirety the $500,000 deduction that the taxpayer company claimed for 2004 as administration fees.

The Tax Court Analysis

At trial, the Service concluded that deductions of $3,214,000 and $6,532,000 for shareholder/employee compensation were reasonable, leaving $811,039 and $768,916 as the excess compensation amounts in dispute for 2003 and 2004, respectively.

The Tax Court noted that Section 162(a)(1) allows a taxpayer to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered" as an ordinary and necessary business expense. The taxpayer is entitled to a deduction for compensation payments if the payments:

1. are reasonable in amount and
2. are paid purely for services.

Though framed as a two-pronged test, courts considering the deductibility of shareholder/employee compensation under Section 162(a)(1) typically focus only on whether the compensation amount is reasonable.

In the *H.W. Johnson, Inc.*, case, the taxpayer had the burden of proving that the amounts paid to shareholder/employees Bruce and Donald in 2003 and 2004 were reasonable.

The Tax Court noted that the Court of Appeals for the Ninth Circuit (to which an appeal of this decision would be made) applies the following five factors to determine the reasonableness of compensation, with no one factor being determinative:

1. The employee's role in the company
2. A comparison of compensation paid by similar companies for similar services
3. The character and condition of the company
4. Potential conflicts of interest
5. The internal consistency of compensation arrangements

These are the so-called "five factors" described in the *Elliotts v. Commissioner* decision.[3]

In analyzing the fourth factor, the Court of Appeals emphasized evaluating the reasonableness of shareholder/employee compensation payments from the perspective of a hypothetical independent investor. That is, this fourth factor focuses on whether the independent investor would receive a reasonable return on equity after payment of the shareholder/employee compensation.

This so-called "independent investor test" is described both in the *Elliotts* decision and in the *Metro Leasing Dev. Corp. v. Commissioner* decision.[4]

At trial, both parties introduced expert witness reports and analyst testimony to support their respective positions.

The Service effectively conceded four of the five *Elliotts* factors that tended to support, or were at least neutral with respect to, the reasonableness of the shareholder/employee compensation paid by H.W. Johnson, Inc.

Nonetheless, the Service argued that the subject case hinged on the fourth *Elliotts* factor: namely, whether a hypothetical independent investor would receive an adequate ROE after accounting for the amount of shareholder/employee compensation paid to Bruce and Donald.

Accordingly, the Tax Court considered each of the *Elliotts* factors. However, the Tax Court focused on the independent investor test factor.

The Independent Investor Test

The Tax Court noted that the Ninth Circuit approached the fourth *Elliotts* factor by evaluating the compensation payments from the perspective of a hypothetical independent investor, focusing on the investor's rate of ROE.

If the subject company ROE (after payment of the shareholder/employee compensation) remains at a level that would satisfy an independent investor, there is strong evidence that:

1, the shareholder/employee is providing compensable services and
2. company profit-related dividends are not being disguised as salary.

In the subject case, both expert analysts agreed that H.W. Johnson, Inc., earned a pretax ROE of 10.2 percent and 9 percent for 2003 and 2004, respectively. The analysts differed, however, on what a required rate of ROE should be for the taxpayer company.

The Service's analyst used ROE data from four financial report empirical data sources. These four sources indicated an ROE ranging from 13.8 percent to 18.3 percent. The Tax Court concluded that the industry data on which the Service analyst relied were not as reliable as the industry data used by the company's analyst.

The Service analyst's first ROE indication was derived from seven selected "guideline companies." The Tax Court concluded that the selected guideline companies were not sufficiently comparable to H.W. Johnson, Inc. This was because "they were publicly traded, operated in industries different from petitioner's, and had gross sales substantially larger than petitioner's."

The Service analyst's second ROE indication was derived from industry data in an annual statement published by the Risk Management Association. The Tax Court noted that the publication itself states that its data should be used "only as general guidelines and not as absolute industry norms."

This is because the data "may not be fully representative of a given industry" for several reasons, including that:

1. the data are not randomly selected and
2. the data may include small sample sizes for certain industries.

The Service analyst's third ROE indication was derived from the Construction Financial Management Association annual financial survey. The Tax Court noted that "many of the companies in that data sample operated in industries dissimilar from petitioner's."

Finally, the Service analyst derived a "market required return on equity" from data published by Ibbotson Associates. The Tax Court was concerned because "that data is from companies engaged in the construction industry generally, not the concrete contracting sector of which petitioner is a part."

The taxpayer's analyst used ROE indications derived from Integra Information ("Integra") data. Integra is a data service that compiles financial information of privately held companies from government and other sources. The company's analyst used Integra data from 33 companies in SIC code 1771, construction—special trade contractors—concrete work, with revenue ranging from $25 million to $49,999,999.

The Tax Court noted: "We find the companies that petitioner's expert used to be more comparable to petitioner for purposes of a return on equity analysis than those used by respondent's expert."

The taxpayer's analyst calculated an average pretax ROE from these 33 companies of 10.5 percent and 10.9 percent for calendar years 2003 and 2004, respectively. Accordingly, the actual H.W. Johnson, Inc., pretax ROE was 0.3 percentage points less than the Integra companies' average ROE in 2003 and 1.9 percentage points less than the Integra companies' average ROE in 2004.

Of course, the parties disagreed about whether H.W. Johnson, Inc., had, in fact, "passed" the independent investor test—even based on the taxpayer analyst's ROE conclusions.

At trial, the Service argued that, because the taxpayer company ROE was slightly below the industry average ROE in 2003 and 2004, Bruce and Donald were unreasonably compensated in those years. An independent investor would have required a ROE that was more commensurate with the company's superior performance, the Service claimed.

The company maintained that its actual ROE was generally in line with the industry average and,

therefore, H.W. Johnson, Inc., had satisfied the independent investor test.

The Tax Court concluded: "We agree with petitioner." The Service produced no authority for its position that the required rate of ROE for purposes of the independent investor test must significantly exceed the industry average ROE, particularly when the taxpayer company has been financially successful.

The Tax Court's decision stated: "We consequently find that petitioner's returns on equity of 10.2 percent and 9 percent for 2003 and 2004, respectively, tend to show that the compensation paid to Donald and Bruce for those years was reasonable. As petitioner's expert points out, mere reductions in their collective compensation of $9,847 and $75,277 in 2003 and 2004, respectively—differences of approximately 1 percent—would have placed petitioner's return on equity at exactly the average for comparable companies in the concrete business. Consequently, this factor favors a finding that the compensation at issue was reasonable."

In summary, the *Elliotts* factors—particularly the independent investor test—supported the conclusion that the compensation the construction company paid to Bruce and Donald in 2003 and 2004 was reasonable. The two brothers were integral to the company's successful financial performance, a performance that included growth in revenue, assets, and gross profit margins during the disputed years.

Therefore, the Tax Court concluded: "The return on equity petitioner generated for each year after payment of Bruce's and Donald's compensation was in line with—indeed closely approximately—the return generated by the companies most comparable to it. We accordingly conclude that an independent investor would have been satisfied with the return. For these reasons, we hold that the $4,025,039 and $7,300,916 petitioner paid as officer compensation in 2003 and 2004, respectively, were reasonable and therefore deductible under Section 162(a)(1)."

The DBJ Payment

In addition, the Tax Court had to decide whether taxpayer H.W. Johnson, Inc., could deduct the $500,000 "administration fees" expense paid to DBJ and reported on its 2004 tax return as a business expense.

The taxpayer company argued that the $500,000 "administration fees" expense was an ordinary and necessary business expense. The company argued that the payment was made to DBJ for securing a guaranteed supply of concrete, discounted for bulk purchases, from Arizona Materials during 2004.

In contrast, the Service argued that the $500,000 payment was not an ordinary and necessary business expense and:

1. there was no written agreement or evidence of any oral agreement obligating petitioner to compensate DBJ, and, therefore, the $500,000 payment was voluntary;
2. DBJ performed no compensable services on behalf of petitioner; and
3. the $500,000 payment was made not for services that DBJ provided, but for services Bruce and Donald performed in their capacities as officers of H.W. Johnson, Inc.

The Tax Court concluded: "Respondent's arguments are unpersuasive."

The Tax Court noted that Bruce and Donald, acting through DBJ, used the DBJ controlling ownership position in Arizona Materials to cause Arizona Materials to supply concrete to H.W. Johnson, Inc., during times of shortage at favorable prices.

Bruce and Donald, acting in their individual capacities, when their more risk-adverse, controlling shareholder mother would not allow H.W. Johnson, Inc., to do so, made arrangements to form Arizona Materials to ensure the H.W. Johnson, Inc., concrete supply in the face of looming shortages.

The two brothers, again acting in their individual capacities and using DBJ as a vehicle, invested substantially in—and guaranteed the indebtedness of—Arizona Materials. The brothers assumed the risk associated with the Arizona Materials formation and operation in their individual capacities.

Therefore, the Tax Court concluded that Bruce and Donald could reasonably expect to be compensated by H.W. Johnson, Inc., for doing so when it substantially benefitted from the fruits of their efforts.

The Tax Court noted: "In view of the foregoing, respondent's contention that petitioner's payment to DBJ was voluntary, given the absence of a written agreement or evidence of an oral agreement to compensate DBJ, is unavailing."

And, the Tax Court concluded: "We are satisfied that petitioner's board, including majority shareholder Margaret, concluded at the close of 2004 that the $500,000 payment to DBJ was appropriate to compensate Bruce and Donald for the substantial

benefit they conferred on petitioner in their individual capacities."

The Tax Court decision states: "In the same vein, we do not agree with respondent that DBJ provided no compensable services to petitioner."

In summary with regard to the related party payment, the Tax Court concluded: "The $500,000 payment petitioner made in consideration of the resulting benefits was therefore earned and received by Bruce and Donald (through DBJ) in their individual capacities."

The Tax Court ruled that the $500,000 payment was an ordinary and necessary expense within the meaning of Section 162(a). This was because it was normal for a concrete contractor to expend funds in connection with ensuring a reliable supply of concrete in the face of shortages.

In addition, the expenditure was helpful to the H.W. Johnson, Inc., business, allowing it to meet customer demand when other contractors were hampered by the concrete shortage.

Summary and Conclusion

The *H.W. Johnson, Inc.*, decision is a taxpayer friendly judicial decision with regard to the reasonableness of closely held corporation shareholder/employee compensation. Of course, the specific facts and circumstances of the case were very favorable to the taxpayer's position.

First, the Tax Court relied on the *Elliott's* five factors in its reasonableness of shareholder/employee compensation analysis. In particular, the Tax Court relied heavily on the so-called independent investor test to assess the reasonableness of the closely held corporation's shareholder/employee compensation. The independent investor test is based on the reasonableness of the subject company's rate of ROE.

Second, both the Service analyst and the taxpayer analyst applied the independent investor test. The Tax Court seemed to be most influenced by the comparability of (or the lack of comparability of) the benchmark industry empirical data used by both analysts to calculate to required rate of ROE measurement.

Third, the Tax Court concluded that the taxpayer company did not have to exactly achieve the industry average rate of ROE. For a financially successful taxpayer company (like H.W. Johnson, Inc.), achieving a ROE sufficiently close to the industry average ROE calculation was sufficient to "pass" the independent investor test.

Fourth, the Tax Court was impressed with the measurable economic benefit to H.W. Johnson, Inc., associated with the DBJ relationship. Accordingly, the specific facts and circumstances of the case convinced the Tax Court of the tax deductibility of the DBJ payment.

For closely held taxpayer corporations, the documentation of the actual facts and circumstances help the taxpayer win the day with regard to the tax deductibility of (1) shareholder/employee compensation and (2) related party payments.

"[V]aluation analysts are uniquely qualified (1) to measure the closely held company rate of ROE and (2) to calculate an empirically based benchmark level of an independent investor required rate of ROE."

The Service continues to challenge what it perceives to be unreasonable shareholder/employee compensation or unsupportable related-party payments.

The closely held company taxpayer (and the taxpayer's legal counsel and forensic analyst) can prevail in a judicial challenge based on having the superior factual documentation and the superior empirical analysis.

Particularly with regard to the implementation of the independent investor test, valuation analysts are uniquely qualified (1) to measure the closely held company rate of ROE and (2) to calculate an empirically based benchmark level of an independent investor required rate of ROE.

Notes:

1. H.W. Johnson, Inc. v. Commissioner of Internal Revenue, T.C. Memo 2016-95 (May 11, 2016).
2. See Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1244 (9th Cir. 1983), *rev'g* T.C. Memo. 1980-282.
3. Elliotts v. Commissioner, 716 F.2d at 1245-1247.
4. Metro Leasing Dev. Corp. v. Commissioner, 376 F.3d 1015, 1019 (9th Cir. 2004), *aff'g* T.C. Memo. 2001-119.

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The Independent Investor Test and the Imposition of the Accuracy-Related Penalty

Robert F. Reilly, CPA

In income tax disputes, the federal courts often rely on the so-called independent investor test to assess the reasonableness of shareholder/employee compensation in the case of a C corporation taxpayer. In the case of Brinks Gilson & Lione v. Commissioner*, the Tax Court relied (in part) on the independent investor test—but not to determine if any claimed shareholder/employee compensation was a disguised dividend distribution. Before trial, the Internal Revenue Service and the taxpayer agreed that some of the corporation's year-end bonus payments were, in fact, nondeductible dividend distributions. In this case, the Tax Court had to decide on the application of the Section 6662 accuracy-related penalty related to the taxpayer's compensation tax deductions. This Tax Court decision provides judicial guidance to both taxpayers and practitioners as to the determination of (1) the accuracy-related penalty in a reasonableness of compensation tax dispute and (2) the application of the independent investor test to assess the reasonableness of close corporation shareholder/employee compensation.*

Introduction

This discussion involves the U.S. Tax Court decision in the matter of *Brinks Gilson & Lione v. Commissioner of Internal Revenue*.[1]

This case involves the imposition of the accuracy-related tax penalty. Brinks Gilson & Lione ("BGL"), an intellectual property law firm, was the C corporation taxpayer in this matter and the petitioner in the Tax Court case.

The imposition of the accuracy-related penalty related to the taxpayer's mischaracterization of nondeductible dividends paid to its shareholder/attorneys as tax deductible compensation expense. The shareholder/attorney distributions were made in the form of year-end bonus payments.

Internal Revenue Code Section 6662 imposes an accuracy-related penalty if any part of an underpayment of the tax required to be shown on a tax return is due to, among other things:

1. negligence or disregard of rules or regulations or
2. a substantial understatement of tax.

The term "understatement" is defined in Section 6662(d)(2)(A) as the excess of (1) the tax required to be shown on the tax return over (2) the amount actually shown on the tax return as filed.

In the case of a corporation, an understatement is "substantial" if, as was relevant in the *Brinks Gilson & Lione* case, it exceeds the lesser of:

1. 10 percent of the tax required to be shown on the tax return for the subject tax year or
2. $10 million.

In the *Brinks Gilson & Lione* case, the taxpayer argued that the Internal Revenue Service ("the Service") erred in the imposition of the Section 6662 accuracy-related penalty. The taxpayer argued that it had substantial authority for its treatment of the year-end bonus payments as deductible compensation expense.

In addition, the taxpayer argued that:

1. it had "reasonable cause" for the underpayment of the corporation's income tax and
2. it had acted "in good faith."

Therefore, the taxpayer claimed that it qualified for exceptions to the Section 6662 accuracy-related penalty.

In summary, the Tax Court disagreed with all of the taxpayer's arguments and imposed the Section 6662 penalty. In this case, the Tax Court did not have to determine the reasonableness of the amount of compensation paid to the BGL shareholder/attorneys.

The taxpayer and the Service agreed before the trial that certain amounts of the year-end bonuses were, in fact, excess compensation (and nondeductible dividend payments) for the tax years in dispute.

However, in deciding on the application of the Section 6662 penalty, the Tax Court did consider the application of the so-called independent investor test to assess the reasonableness of close corporation shareholder/employee compensation.

Based (in part) on its consideration of the independent investor test, the Tax Court concluded that taxpayer did not qualify for an exception to the Section 6662 accuracy-related penalty. Accordingly, this judicial decision illustrates yet another application of the independent investor test in the judicial determination of the reasonableness of a C corporation's shareholder/employee compensation.

The *Banks Gilson Lione* decision is only a Tax Court memorandum decision. Nonetheless, the published decision is 38 pages in length.

That is, the published decision does provide ample judicial guidance to both taxpayers and practitioners with regard to:

1. the application of the accuracy-related tax penalty,
2. the determination of the reasonableness of close corporation shareholder/employee compensation, and
3. the application of the independent investor test.

Description of the Subject Taxpayer

The taxpayer in this case is an intellectual property law firm organized as a regular C corporation. For the 2007 and 2008 tax years at issue in this case, BGL computed its federal taxable income on the basis of a calendar year, using the cash method of accounting. For the years in dispute, BGL also prepared its GAAP accounting financial statements using the cash method of accounting.

During the 2007 to 2008 period, BGL employed about 150 attorneys, of whom about 65 were shareholders. BGL also employed a nonattorney staff of about 270. The BGL business and affairs were managed by the firm's board of directors.

The BGL Shareholders

The BGL shareholders owned their shares in the corporation in connection with their employment with the firm as attorneys. Each shareholder/attorney acquired his or her shares at a price equal to the share's accounting book value. Upon a shareholder's employment termination, the shareholder was required to sell the shares back to BGL at a price determined under the same formula.

Subject to minor exceptions related to the firm "name partners," each shareholder's proportionate ownership of the BGL shares (i.e., the share-ownership percentage) equaled his/her proportionate share of the total compensation paid by the firm to its shareholder/attorneys.

For the 2007/2008 period, the BGL board set the annual compensation paid to the shareholder/attorneys. Then, the BGL board determined the necessary adjustments in each shareholder's share-ownership percentage necessary to reflect the proportionate compensation.

The BGL shareholder/attorneys were entitled to receive dividends as and when declared by the firm's board. However, it is noteworthy that BGL had not declared any dividends for at least a decade before the tax years in dispute.

Compensation Mechanics

For the tax years in dispute, the BGL board met to set compensation and shareholder-ownership percentages in late November or early December for the following year.

Based on the BGL annual budget, the board set each shareholder's expected compensation using a number of criteria including hours billed, collections,

business generated, and other contributions to the firm.

Because the board's compensation amounts were based on an annual budget, each shareholder only received a percentage of the expected total compensation (referred to as the "draw"). The remainder of the total compensation was received at year-end (referred to as the "year-end bonus").

It was the announced intention of the BGL board to distribute the amount of fiscal year-end bonus (referred to as the "bonus pool") that would result in the firm reporting a zero GAAP-basis net income for the year.

With very few exceptions for less active attorneys, the BGL shareholders shared in the bonus pool in proportion to their share ownership percentages. For each tax year in dispute, BGL calculated the year-end bonus pool—that is, $8,986,608 in 2007 and $13,736,331 in 2008—to be exactly equal to the firm's (pre-bonus) GAAP-basis net income.

Accordingly, the BGL reported (post-bonus) GAAP net income of zero for each year. That is, the BGL financial accounting reported that the firm revenue exactly equaled the firm expenses for 2007 and 2008.

For income tax purposes, BGL reported as employee compensation expense the total amount that it paid to its shareholder/attorneys, including the year-end bonus payments.

It is noteworthy that BGL withheld applicable income and employment axes, paid the employer's share of employment taxes, and filed the appropriate employer tax forms, including Forms W-2, Wage and Tax Statement, and Forms 941, Employer's Quarterly Federal Tax Return.

An independent payroll processing firm prepared the BGL Forms W-2 for 2007 and 2008 using records and information that BGL management reported to it. BGL management then provided the Forms W-2 to the firm's public accounting firm, McGladrey & Pullen ("McGladrey").

The BGL Invested Capital Balances

BGL reported shareholders' invested capital, measured by the accounting book value of its shareholders' equity, of approximately $8 million at the 2007 year-end and approximately $9.2 million at the 2008 year-end.

The BGL balance sheets for the years in dispute did not report any goodwill or other intangible asset values. This is only noteworthy because the Tax

Court noted that the BGL balance sheets may have understated the economic value of the firm shareholders' equity.

The BGL Reported Taxable Income

McGladrey prepared the BGL corporation income tax returns for the tax years in dispute. BGL timely filed its tax returns for 2007 and 2008. In each tax return, BGL included the year-end bonuses it paid to its shareholders as a deduction for officer compensation.

Before filing its federal income tax returns, BGL management did not ask McGladrey whether the full amount of the year-end bonuses paid to the firm shareholders was deductible as compensation expense. And, McGladrey did not opine to BGL management on the tax deductibility of the year-end bonuses.

The BGL 2007 tax return reported total income of $91,742,819, taxable income of $539,902, and a tax liability amount of $188,966. The BGL 2008 tax return reported total income of $107,019,812, taxable income of $561,075, and a tax liability amount of $196,376.

The GAAP basis net income that BGL reported for each year was zero. Accordingly, the taxable income that BGL reported on is federal income tax return was entirely due to book income versus tax income differences.

The Internal Revenue Service Audit

During the audit of the 2007 and 2008 tax years, the Service disallowed various deductions, including

the year-end bonuses that BGL had paid to its shareholder/attorneys.

After a negotiation, the Service and the taxpayer entered into a closing agreement that provided, among other things, that portions of the BGL officer compensation deductions for the years in dispute—$1,627,000 in 2007 and $1,859,000 in 2008—"should be disallowed and re-characterized as non-deductible dividends."

As a result of certain concessions that BGL made in settlement, the taxpayer's agreed upon income tax liability was $1,298,618 for 2007 and $1,212,152 for 2008. These tax liability amounts resulted in underpayments of $1,109,652 and $1,015,776 for the tax years 2007 and 2008, respectively.

The Issues before the Tax Court

Because the audit closing agreement provided that a portion of the BGL officer compensation deductions for the disputed years "should be disallowed and re-characterized as non-deductible dividends," the deductibility of the shareholder year-end bonuses was not an issue at the trial.

The sole issue before the Tax Court was whether the taxpayer was liable for accuracy-related penalties under Section 6662. The Service's proposed Section 6662 penalty related to the underpayment of tax regarding the BGL deduction of those portions of the year-end bonuses that the taxpayer agreed were nondeductible dividends.

Section 6662(a) and (b)(1) provides for an accuracy-related penalty of 20 percent of the portion of an underpayment of tax attributable to:

1. negligence or
2. the disregard of rules and regulations.

Section 6662(a) and (b)(2) provides for the same penalty on the portion of an underpayment of tax attributable to "[a]ny substantial understatement of income tax."

Section 6662(d)(2)(A) defines the term "understatement" as the excess of the tax required to be shown on the tax return over the amount actually shown on the tax return as filed. In the case of a corporation, according to Section 6662(d)(1)(B), an understatement is considered to be "substantial" if it exceeds the lesser of:

1. 10 percent of the tax required to be shown on the tax return for the tax year or
2. $10 million.

According to Section 6662(d)(2)(B)(i), an "understatement" is reduced by the amount attributable to the treatment of an item for which the taxpayer has "substantial authority."

In addition, Section 6664(c)(1) provides an exception to the imposition of the Section 6662(a) accuracy-related penalty if the taxpayer can demonstrate that:

1. there was reasonable cause for the underpayment and
2. the taxpayer acted in good faith.

In the *Brinks Gilson & Lione* matter, the taxpayer did not dispute that the deficiency to which BGL had agreed for each of the years in dispute exceeded 10 percent of the income tax it was required to show on its tax return for that year. Rather, the taxpayer claimed that it had substantial authority for deducting the full amount of the year-end bonuses it had paid to its shareholder/attorneys.

In particular, the BGL argued that, because it had relied on the services of a prominent accounting firm to prepare its tax returns, the taxpayer (1) had reasonable cause to deduct those amounts and (2) acted in good faith in doing so.

If the Tax Court found that BGL in fact had "substantial authority" for its position, then the disallowance of apportion of its claimed compensation deduction would not increase the "understatement" within the meaning of Section 6662(d)(2)(A).

If the Tax Court reached that conclusion, then the substantial understatement penalty would not apply to the portion of the underpayment attributable to the disallowance of those deductions, regardless of whether or not BGL had reasonable cause or acted in good faith.

In addition, the judicial determination that BGL had substantial authority for its position would also prevent imposition of the negligence penalty.

Accordingly, the Tax Court's first judicial consideration was whether BGL had substantial authority for its deduction of the year-end shareholder/attorney bonuses.

Consideration of Substantial Authority

According to the Tax Court's decision: "The determination of substantial authority requires a weighing of the authorities that support the taxpayer's treatment of an item against the contrary authorities. A taxpayer can have substantial authority for a position that is unlikely to prevail, as long as the

weight of the authorities in support of the taxpayer's position is substantial in relation to the weight of any contrary authorities."

The Taxpayer's Position

At trial, the taxpayer relied on the decision *Law Offices—Richard Ashare, P.C. v. Commissioner*[2] as its principal authority to support the deduction of year-end bonuses paid to the BGL shareholder/attorneys in 2007 and 2008.

In the *Ashare* decision, the Tax Court allowed a corporate law firm to deduct the amount that it paid to its sole shareholder as compensation—even though that compensation amount exceeded the firm's revenue for the year.

Also at trial, BGL claimed that Section 83 and the accompanying regulations (which deal with the transfer of property in connection with services) support the proposition that all of the amounts the taxpayer paid to its shareholder/attorneys should be treated as deductible compensation expense.

In addition, BGL cited authorities in other areas of the law to support the position that capital is not a material income-producing factor in a professional services business.[3]

As a final position, BGL argued that, under the so-called substance-over-form principle, the stock held by the BGL shareholders should be treated as debt. Based on this argument, the portion of the year-end shareholder/attorney bonuses determined to be nondeductible as compensation should nonetheless be deductible as interest expense.

In *Brinks Gilson & Lione*, the taxpayer devoted considerable effort to distinguishing the statutory and judicial authorities relied on by the Service.

The Service claimed that the amounts paid to the shareholder/employees of a corporation do not qualify as deductible compensation to the extent that the payments are funded by earnings attributable:

1. to the services of nonshareholder/employees or
2. to the use of the corporation's intangible assets or other capital.

The Service argued that the amounts paid to shareholder/employees attributable to those sources should be treated as nondeductible dividends.

In support of its position, at trial the Service relied primarily on the Tax Court opinion in *Pediatric Surgical Assocs., P.C. v. Commissioner*[4] and the U.S. Court of Appeals (Seventh Circuit) opinion in *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*.[5]

In the *Pediatric Surgical* decision, the Service determined that compensation payments to shareholder/employees attributable to the services of nonshareholders should be nondeductible dividends.

In the *Mulcahy* decision, the Seventh Circuit denied a corporation's deduction for consulting fees paid to entities owned by the taxpayer's founding shareholders That taxpayer sought to justify its deduction for the consulting fees based on the grounds that the payments were, in effect, additional compensation to its shareholders.

The Service emphasized the *Mulcahy* decision because any appeal of the *Brinks Gilson & Lione* decision would be filed with the Seventh Circuit.

At trial, the taxpayer argued that the subject fact set was distinguishable from the *Pediatric Surgical* decision fact set. This is because any "profit" that BGL made from the services of its nonshareholder/attorneys could justifiably be paid to its shareholder/attorneys in consideration for business generation and other nonbillable services.

Also at trial, the taxpayer distinguished the *Mulcahy* decision fact set based on the allegedly unique nature of the BGL shareholder/attorneys' interests. In particular, the taxpayer argued that, because (1) the BGL shareholder/attorneys received their stock in connection with their employment and (2) the BGL shareholders had to sell their shares back to the corporation at a price equal to the GAAP basis book value, the BGL shares did not represent "real" equity interests.

Therefore, the BGL shares did not entitle the corporation shareholders to a return on their invested capital.

Finally, at trial the taxpayer argued that, because the *Mulcahy* decision was published after BGL filed its tax returns for the tax years in dispute, the *Mulcahy* decision should not be taken into account in assessing the relative weight of authorities for and against the taxpayer's substantial authority positions.

The Application of the "Independent Investor Test"

According to the Tax Court decision in *Brinks Gilson & Lione*, "The principle applied in *Mulcahy* is well established in the law and grounded in basic economics: The owners of an enterprise with significant capital are entitled to a return on their investments."

That statement means that when a taxpayer pays salaries to shareholder/employees in amounts that

leave insufficient remaining profits to provide an adequate return on equity ("ROE") to shareholders, that inadequate ROE indicates that a portion of the amount paid as salaries is actually a distributions of earnings.

The Tax Court noted that an increasing number of Federal Courts of Appeal, including the Seventh Circuit, have been moving away from the so-called multifactor analysis in assessing the reasonableness of close corporation shareholder/employee compensation. Instead, the Appeals Courts were focusing on the independent investor test.

The independent investor test considers the reasonableness of close corporation shareholder /employee compensation from the perspective of whether the residual net income provides an ROE that would be acceptable to an independent (nonemployee) investor. The Tax Court specifically noted the following judicial authority: *Exacto Spring Corp. v. Commissioner*.[6]

Based on the relevance of the independent investor test as applied in the above-cited judicial decisions, the Tax Court noted that the fact that the *Mulcahy* decision itself was not "authority" was of little consequence for purposes of its decision in this matter.

The Tax Court noted that: "The Court of Appeals for the Seventh Circuit and the other courts that have assessed compensation paid to shareholder employees by its effect on the returns available to shareholders' capital refer to the governing inquiry as the "independent investor test."[7]

The independent investor test recognizes that shareholder/employees are economically indifferent to whether the total payments they receive from the taxpayer corporation are called compensation or dividends. From an income tax perspective, however, only compensation payments are deductible to the taxpayer corporation.

In contrast, dividend payments are not deductible to the taxpayer corporation. Therefore, the taxpayer corporation has a bias toward labeling any payments to shareholder employees as compensation rather than as dividends, without the arm's-length consideration of what a nonemployee investor would accept as a fair rate of ROE.[8]

The Tax Court noted that "the courts consider whether ostensible salary payments to shareholder/employees meet the standards for deductibility by taking the perspective of a hypothetical "independent investor" who is not also an employee."

Application of the Independent Investor Test to BGL

In the *Brinks Gilson & Lione* decision, it was easy for the Tax Court to decide: "Ostensible compensation payments made to shareholder/employees by a corporation with significant capital that zero out the corporation's income and leave no return on the shareholders' investments fail the independent investor test."

The trial record established that BGL had substantial capital even without considering the valuation of any off-balance-sheet intangible assets. At trial, the BGL expert witness admitted that a law firm's reputation and customer lists could be valuable intangible assets.

However, the Tax Court did not have to measure the value of any of the BGL intangible assets in its application of the independent investor test ROE. Regardless of such off-balance-sheet intangible assets, BGL reported a book value of shareholders' equity of about $8 million at the end of 2007 and about $9.3 million at the end of 2008.

The Tax Court concluded: "Invested capital of this magnitude cannot be disregarded in determining whether ostensible compensation paid to shareholder/employees is really a distribution of earnings."

The Tax Court did not believe that an independent investor would accept a zero percent ROE on an $8 or $9 million book value of equity. Such an independent investor would not allow the BGL board to pay out 100 percent of the firm's book-basis net income as shareholder/employee compensation—and leave no residual income as a return to the nonemployee/shareholder.

Accordingly, the Tax Court concluded: "petitioner's practice of paying out year-end bonuses to its shareholder/attorneys that eliminated its book income fails the independent investor test."

BGL Claimed an Exemption from the Independent Investor Test

At trial, BGL argued that its shareholder/attorneys held their stock in the corporation solely in connection with their employment. That is, the BGL shareholders acquired their stock at a price equal to its cash-basis book value. And, upon terminating their employment, the BGL shareholders had to sell their stock back to the corporation at a price determined under the same formula.

The taxpayer argued that, as a result of this arrangement, the BGL shareholder/attorneys lacked the normal rights of equity owners.

The Tax Court did not accept this BGL argument. Rather, in its decision, the Tax Court noted: "the use of book value as a proxy for market value for the issuance and redemption of shares in a closely held corporation to avoid the practical difficulties of more precise valuation hardly means that the shareholder/attorneys do not really own the corporation and are not entitled to a return on their invested capital."

The Tax Court concluded that any BGL shareholders who were not also an employee would generally demand such a return on investment.

The Tax Court concluded that the provisions of Section 83 and its associated regulations actually undermined the taxpayer's argument that its attorneys were not really equity holders. BGL cited regulations that determined when property is considered to be "transferred" by an employer to an employee.

The Tax Court noted that, under those regulations, a transfer did occur if, upon termination of his or her employment, an employee is required to return the property to the employer for a price that "does not approach the fair market value of the property at the time of surrender."[9]

BGL argued that the obligation that its shareholder/attorneys sell back their stock upon employment termination in exchange for book value meant that the stock was never actually "transferred" to the shareholder/employee. Accordingly, BGL argued that all of the amounts it paid to its shareholders—even any amounts actually designated as dividends—should be treated as compensation for services.

Again, the Tax Court rejected this BGL argument: "But petitioner is mistaken in its claim that the book value of one of its shares does not approach its fair market value."

The Tax Court noted that Regulation 1.83-5(a) provides that: "If stock in a corporation is subject to a nonlapse restriction which requires the transferee to sell such stock only at a formula price based on book value . . . , the price so determined will ordinarily be regarded as determinative of the fair market value of such property for purposes of Section 83."

The Tax Court concluded that the Regulation 1.83-3(a)(7) examples cited by the taxpayer were readily distinguishable from the actual BGL fact set. The examples in the regulations involved the requirement to resell stock upon termination of employment for amounts that were demonstrably below the stock's fair market value.

On the issue that the BGL attorneys were not really shareholders, the Tax Court concluded: "More generally, petitioner's argument that its shareholder/attorneys have no real equity interests in the corporation that would justify a return on invested capital proves too much. If petitioner's shareholder/attorneys are not its owners, who are? If the shareholder/attorneys do not bear the risk of loss from declines in the value of its assets, who does?"

The Tax Court noted that the use of share book value as a proxy for share fair market value deprived the BGL attorneys of the right to share in any unrealized appreciation upon the sale of their stock. However, the same attorneys were correspondingly not required to pay for any unrealized appreciation upon the purchase of their stock.

The BGL attorney acceptance of these concessions to avoid difficult valuation issues did not compel those attorneys to forgo any current return on their investment based on the taxpayer's profitable use of its assets in conducting its business. The BGL arrangement effectively provided its attorneys with an ROE through amounts designated as compensation.

The Tax Court concluded this issue as follows: "Were this not the case, we do not believe the shareholder/attorneys would be willing to forgo any return on their investments."

The Other Authorities Cited by BGL at Trial

The Tax Court concluded that the other judicial precedent that BGL cited did not refute the principle that shareholders with significant capital are economically entitled to a rate of ROE. BGL cited the decision in *Law Offices—Richard Ashare, P.C. v. Commissioner*.[10]

However, that case did not demonstrate that an incorporated law firm with significant capital can pay out compensation that eliminates all book-basis net income. Although the Tax Court allowed the Ashare taxpayer to deduct compensation that exceeded the firm revenue for the particular tax year at issue (1993), that taxpayer in that case did not consistently pay compensation amounts intended to eliminate its book-basis income.

In fact, the Ashare law firm had reported substantial income for 1990, three years before the tax year in dispute.

In contrast to BGL, the Ashare law firm reported minimal equity capital. The sole shareholder Richard Ashare had only invested $1,000 as equity in that taxpayer corporation. Therefore, a fair rate

of return on equity capital (i.e., the independent investor test) was not an issue in the Ashare decision.

BGL Argued That Its Stock Is Really Debt

The Tax Court disagreed with the BGL argument that the portion of the year-end bonus determined to be nondeductible as compensation should nonetheless be deductible as interest expense.

The Tax Court concluded "We have already rejected petitioner's argument that its stock is not real equity. Despite a departing shareholder's obligation to sell his stock back to petitioner at cash book value, shares of petitioner's stock lack the hallmark characteristics of debt."

The Section 6662 Penalty and the Weighing of Authority

Regulation 1..6662-4(d)(3)(ii) required the Tax Court to consider the relative weight of the legal authority presented by BGL and the legal authority presented by the Service.

The Tax Court concluded against the taxpayer on this issue, as follows:

> We conclude that the authorities that support petitioner's deduction of the full amount of the year-end bonuses it paid to shareholder/attorneys are not substantial when weighted against the contrary authorities. The independent investor test weights strongly against the claimed deductions. Petitioner's efforts to characterize its situation as unique do not persuade us. If the hypothetical independent investor had provided the capital demonstrated by the cash book value of petitioner's shares—even leaving aside the possibility of valuable firm-owned intangible assets—the investor would have demanded a return on that capital and would not have tolerated petitioner's consistent practice of paying compensation that zeroed out its income.

That is, the Tax Court concluded that the taxpayer did not have substantial authority for the deduction of shareholder/employee compensation that completely eliminated its income and left its shareholders with a zero rate of ROE.

Because the taxpayer did not have substantial authority for its treatment of the year-end bonuses it paid, the agreed disallowance of a portion of the deductions BGL claimed for those payments increased a "substantial understatement," within the meaning of Section 6662(d)(1)(B). That is, the accuracy-related penalties would apply to the taxpayer unless BGL had "reasonable cause" for its treatment of the year-end bonuses and acted in "good faith" in pursuing that treatment.

Reasonable Cause and Good Faith

At trial, BGL argued that it should not be subject to the imposition of the Section 6662(a) accuracy-related penalty. BGL presented the argument that it had reasonable cause and acted in good faith with regard to its claimed bonus payment deductions. Accordingly, BGL asserted that it qualified for the Section 6664(c)(1) exception to the accuracy-related penalty.

The BGL position was that its reliance on McGladrey to prepare its tax returns for the years in dispute qualified as "reasonable cause" and demonstrated "good faith."

The Tax Court disagreed with this "reliance on McGladrey" argument for two reasons. First, BGL could not demonstrate that McGladrey, in fact, actually advised the taxpayer regarding the deductibility of the year-end bonuses. Second, the Tax Court concluded that BGL failed to provide McGladrey with accurate information with regard to the subject year-end bonus payments.

Consistent with Regulation 1.6664-4(b)(1), the Tax Court recognized that "[a] taxpayer's reliance on the professional advice of an attorney or an accountant may constitute reasonable cause and good faith." The taxpayer argued that McGladrey's failure to apprise BGL of any issue concerning the tax deductibility of the year-end bonuses constituted "advice" on which it could reasonably rely.

However, the facts were that, before filing its tax return for each of the years in issue, BGL did not specifically ask McGladrey whether the full amount of the year-end bonuses it paid to shareholders was deductible as compensation for services. And, McGladrey had never commented to BGL regarding the tax deductibility of the year-end bonuses.

The Tax Court noted that the Section 6664 regulations allow flexibility regarding the form of advice to taxpayers. However, the regulations provide detailed requirements as to the content of advice that can constitute the taxpayer's reasonable cause and good faith.

However, the Tax Court concluded that the regulations necessarily contemplate that professional advice, in some form, involves an explicit communication to the taxpayer. Silence cannot qualify as professional advice because there is no way to know whether the tax adviser, in failing to raise an issue, considered all of the relevant facts and circumstances, including the taxpayer's subjective motivation.

The tax adviser's failure to raise an issue could not indicate whether the adviser even considered a certain tax issue, much less engaged in any analysis, or reached a conclusion.

Therefore, the Tax Court concluded that McGladrey's failure to raise concerns about the tax deductibility of the year-end bonuses did not constitute "advice" within the meaning of Regulation 1.6664-4(c).

In addition, the Tax Court noted that BGL could not have relied in good faith on McGladrey's preparation of its tax returns for the years in dispute. This was because BGL had provided McGladrey with inaccurate information.

The Tax Court noted that the error that led to the claim of the disallowed tax deduction was, in the first instance, the taxpayer's error.

As a general matter, in the fulfillment of professional responsibilities, an accountant signing a tax return is entitled to rely on information furnished to it by the taxpayer. An accountant only has a limited obligation to make inquiries in the case of manifest errors. In this case, BGL provided to McGladrey Forms W-2 that characterized the amounts paid to its shareholders as employee compensation.

On this issue, the Tax Court concluded: "Therefore, petitioner's reliance on McGladrey in preparing its returns for the years in issue does not constitute reasonable cause and good faith and does not relieve petitioner of liability for the accuracy-related penalty."

The Tax Court's Final Conclusion

The Tax Court concluded that BGL failed to show that:

1. it had reasonable cause for deducting in full the year-end bonuses it paid to its shareholder/attorneys in the years in dispute or
2. it acted in good faith in claiming such tax deductions.

Section 6664(c)(1) provided BGL with no defense to the imposition of the Section 6662 accuracy-related penalties. The Tax Court also determined that BGL did not have substantial authority for the tax deductions at issue in the case.

The Tax Court noted that the parties' agreed upon treatment of part of the bonus payments in each year as a nondeductible dividend resulted in a "substantial understatement" within the meaning of Section 6662(d)(1)(A).

Therefore, the Tax Court concluded that the accuracy-related penalty applied to the portion of the BGL underpayment attributable to the recharacterization of that part of the bonus payments for each year.

Notes:

1. Brinks Gilson & Lione v. Commissioner, T.C. Memo. 2016-20 (Feb. 10, 2016).
2. Law Offices—Richard Ashare, P.C. v. Commissioner, T.C. Memo. 1999-282 (Aug. 24, 1999).
3. See Hubbard-Ragsdale Co. v. Dean, 15 F.2d 410 (S.D. Ohio 1926), *aff'd per curiam*, 15 F.2d 1013 (6th Cir. 1926); Regulation 1.704-1(e)(1)(iv); Regulation 1.911-3(b)(3); Regulation 1.1348-3(a)(3)(ii); and Regulation 1.1361-2(e)(2).
4. Pediatric Surgical Assocs., P.C. v. Commissioner, T.C. Memo. 2001-81 (April 2, 2001).
5. Mulcahy, Pauritsch, Salvador & Co. v. Commissioner, 680 F.3d 867 (7th Cir. 2012), *aff'g* T.C. Memo. 2001-74.
6. Exacto Spring Corp. v. Commissioner, 196 F.3d 833, 838 (7th Cir. 1999), *rev'g* Heitz v. Commissioner, T.C. Memo. 1998-220; Rapco, Inc. v. Commissioner, 85 F.3d 950, 954-955 (2d Cir. 1996), *aff'g* T.C. Memo. 1995-128; Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1245 (9th Cir. 1983), *rev'g and remanding* T.C. Memo. 1980-282.
7. Exacto Spring Corp. v. Commissioner, 196 F.3d at 838; Dexsil Corp. v. Commissioner, 147 F.3d 96, 100-101 (2d Cir. 1998), *vacating and remanding* T.C. Memo. 1995-135.
8. Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1322-1323 (5th Cir. 1987), *aff'g* T.C. Memo. 1985-267 and Elliotts, Inc. v. Commissioner, 716 F.2d at 1243.
9. See Regulation 1.83-3(a)(3), (5).
10. Law Offices—Richard Ashare, P.C. v. Commissioner, T.C. Memo 1999-282.

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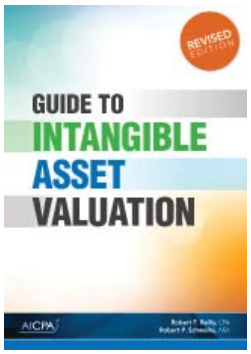

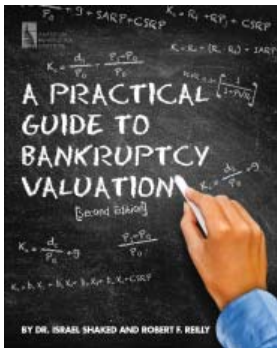

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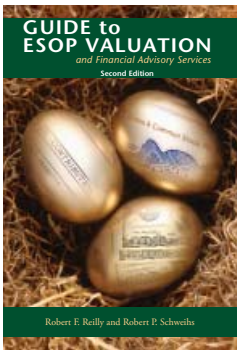

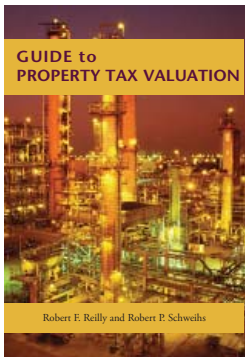

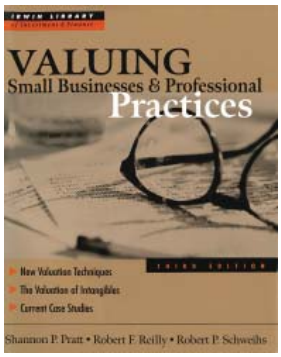

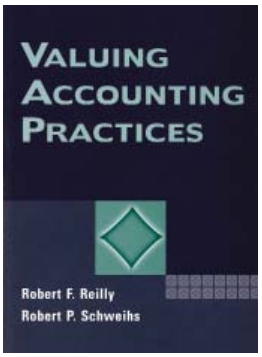

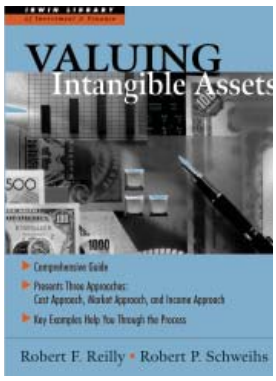

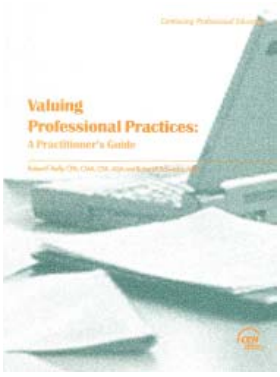

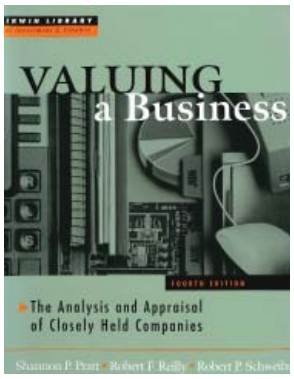

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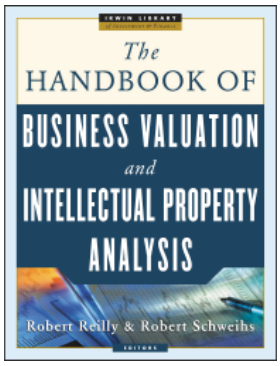

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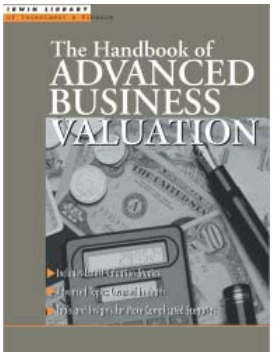

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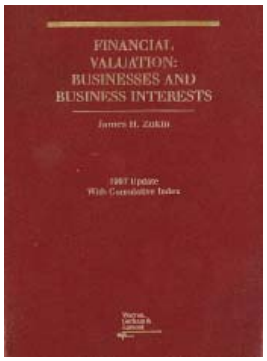

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Willamette Management Associates

The *SWS Group, Inc.*, Chancery Court Appraisal Decision—Fair Value Not Based on the Merger Price

Jeffrey A. Jensen and Kevin M. Zanni

In a matter that is similar to certain other recent fair value decisions, the Delaware Court of Chancery rejected a merger price indication in favor of its own discounted cash flow analysis. However, in the SWS Group, Inc., appraisal decision, instead of a decision supporting a higher fair value, the court ultimately found that the merger price was too high. This ruling highlights the risk of an arbitrage appraisal strategy and may give dissenting shareholders something to consider before invoking their appraisal rights. Also, this decision highlights how valuation analysts can sometimes arrive at significantly divergent opinions of value. The concern is that the court may view analysts as advocates for their clients—and not as advocates for their valuation opinion.

Introduction

In the matter of *In re Appraisal of SWS Group, Inc.* ("*SWS*"),[1] an appraisal arbitrage strategy resulted in the Delaware Court of Chancery ("Chancery Court") rejecting the merger price as a reliable fair value conclusion. The Chancery Court also rejected certain findings of the respondent analyst and petitioner analyst.

The Chancery Court noted that the "public sales process that develops market value is often the best evidence of statutory fair value."[2]

However, in the instant case, the respondent analyst, the petitioner analyst, and the Chancery Court agreed that the merger price was not a fair value indication. In *SWS*, the Chancery Court prepared its own discounted cash flow analysis to arrive at fair value.[3] As a result, the Court found the fair value of SWS Group, Inc., the company that is the subject of this litigation, to be lower than the merger price.

The Chancery Court, in the recent *In re Appraisal of Dell* ("*Dell I*") matter, determined a greater fair value than the merger price in the appraisal rights proceeding.[4]

In the *Dell I* matter, the Chancery Court found that the merger price was also not a fair value indication.

In *Dell I*, the Chancery Court rejected—in certain parts, just like in *SWS*—the findings of the respondent analyst and petitioner analyst. The Chancery Court decided to prepare its own discounted cash flow method analysis. The *Dell I* conclusion suggested a fair value price per share of the common stock of Dell at the time of its sale of a price 27 percent greater than the total merger consideration price per share.

In the even more recent matter, the Supreme Court of the State of Delaware ("Supreme Court") remanded the *Dell I* decision back to the Chancery Court on appeal ("*Dell II*").[5]

According to the Supreme Court, the Chancery Court erred in *Dell I* because "its reasons for giving [the merger price] no weight—and for relying instead exclusively on its own discounted cash flow . . . do[es] not follow from the court's key factual findings and from relevant, accepted financial principles."[6]

In *Dell II*, the Supreme Court found that the deal price should have been given weight. However, the Supreme Court did not mandate that the deal price should be the ultimate fair value conclusion. The Supreme Court stated, "despite the sound economic and policy reasons supporting the use of the deal price as the fair value on remand, we will not give in to the temptation to dictate that result."[7]

What is most interesting in *Dell I* is the Chancery Court finding that the merger price was less than the fair value of Dell, Inc., stock. Now that a ruling has been made in *Dell II*, it is clear that but for sound reasoning, specifically involving the process by which deal negotiations proceed, that the Delaware courts are partial to merger pricing as a measure of fair value. This more recent decision follows the decision in *In Re Appraisal of Petsmart, Inc.*

As discussed further herein, the facts and circumstances involving the SWS Group, Inc., merger suggested that the fair value is most likely not the same as the merger price. If *SWS* is appealed, it would be somewhat surprising if the Supreme Court overturned and remanded the Chancery Court ruling that the discounted cash flow method provided a better indication of fair value than the merger price.

This discussion of the *SWS* decision highlights key dissenting shareholder decision making and possible ramifications.

First, an investor should consider the decision to invoke appraisal rights. Dissenting from a proposed merger may result in a decrease in respective merger proceeds.

Second, an investor should consider that a merger price may be considered fair value, as it appears that the Delaware courts are partial to merger price as an indication of fair value—depending on the facts and circumstances.

And, finally, an analyst should consider how a subject analysis may be viewed by the court. Does the analysis advocate a position that overwhelmingly favors its client? Does the end result produce a value that is unreasonable?

Background of SWS Group, Inc.[8]

The target company, SWS Group, Inc. ("SWS Group"), was a small bank holding company that was publicly traded on the New York Stock Exchange. SWS Group had two general business segments:

1. traditional banking ("Bank") and
2. brokerage services ("Broker-Dealer").

The Broker-Dealer operations had significantly more locations and resources than the Bank. In fact, the Bank had a deficient amount of retail deposits. Nearly 90 percent of SWS Group deposits came from overnight sweep accounts that were held by SWS Group Broker-Dealer clients.

SWS Group provided loans to borrowers in North Texas that became past due as a result of the financial crisis in 2008 and 2009. From 2007 to 2011, the Bank's nonperforming assets increased from 2 percent of total assets to 6.6 percent. As a result, in July 2010, the Bank entered into a Memorandum of Understanding with Federal regulators that restricted certain business and required higher capital ratios.

The next year, in February 2011, federal regulators issued a cease and desist order to the Bank, which further restricted Banking activities.

SWS Group management searched for solutions to increase capital ratios of the banking business. First, the SWS Group management tried to increase bank-related capital by transferring capital from the Broker-Dealer to the Bank. This action resulted in a liquidation of Broker-Dealer assets.

Ultimately, this strategy only served to exacerbate the Bank's problem. The transfer of assets caused the capital of the Broker-Dealer segment to decline below the threshold capital levels acceptable to counterparties, creating the potential for an impairment of the Broker-Dealer business segment.

SWS Group tried to raise capital in December 2010 through a public offering of convertible unsecured debt. The debt offering failed due to a lack of investor demand. Consequently, SWS Group management investigated opportunities in the private marketplace.

Discussions between SWS Group and Hilltop Holdings, Inc. ("Hilltop"),[9] began in the early fall of 2010. At that time, both parties entered into a nondisclosure agreement allowing Hilltop to perform a due diligence review of SWS Group.

In March 2011, the terms of a Credit Agreement were finalized between SWS Group, Hilltop, and Oak Hill Capital Partners ("Oak Hill").[10]

According to the Credit Agreement, Hilltop and Oak Hill provided a $100 million senior unsecured loan to SWS Group at an interest rate of 8 percent. Also pursuant to the Credit Agreement, SWS Group issued an equity warrant to purchase 8,695,652 shares of SWS Group common stock to Hilltop and Oak Hill. The warrant had an exercise price of $5.75 per share.

Upon exercise of the warrants, the subject debt provided by Oak Hill and Hilltop is eliminated. If the warrants were not exercised, the subject loan would mature in five years.

At the same time that SWS Group entered into the Credit Agreement, it also entered into an Investor Rights Agreement ("IRA") with Hilltop and Oak Hill. The IRA provided Hilltop and Oak Hill the right to appoint a board member and a board observer to the SWS Group board of directors.

The Credit Agreement contained anti-takeover clauses, which would place the loan in default if the board no longer consisted of a majority of continuing directors, or if any other stockholder acquired more than 24.9 percent of SWS Group stock.

In addition, a clause in the Credit Agreement included a covenant prohibiting the SWS Group from undergoing a fundamental change, which was defined to include a sale of SWS Group ("Merger Covenant").

After the Credit Agreement was finalized, SWS Group implemented a plan to improve the business. From 2011 through 2014, SWS Group management prepared annual budgets. In order to prepare the annual budget, management asked its business leaders for aspirational goals/projections.

The annual budget was then presented to the SWS Group board of directors for approval. Single year projections are extrapolated to produce three-year strategic plans.

However, SWS Group never met its budget during the period from 2011 to 2014. Rather, SWS Group suffered declining revenue throughout the period and failed to earn a profit in every year except for 2012. In 2012, SWS Group recorded a small profit.

SWS Group hired a new CEO in 2012, who implemented changes and improved capital levels at the Bank. The CEO's efforts resulted in the termination of the cease and desist order in 2013.

However, the Bank still struggled to maintain profitability. Disappointing financial performance of SWS Group led management to write down approximately $30 million of the deferred tax asset.

The deferred tax asset was comprised of accumulated net operating losses. SWS Group management did not believe that it would be able to generate sufficient income to realize the full benefit of the net operating losses within the requisite time frame.

In August 2013, the SWS Group board of directors directed the CEO to significantly reduce costs due to continued poor financial performance. The board of directors remained concerned about the ability to meet financial obligations under the Credit Agreement.

Before a sales process began, equity analysts speculated that SWS Group might be an acquisition target. SWS Group stock traded higher in public markets as a result of merger speculation. At the time, Hilltop was considering an acquisition of SWS Group. Hilltop management expected the acquisition to provide synergistic benefits to its business operations.

On January 9, 2014, Hilltop made an offer to acquire SWS Group for $7.00 per share, payable in 50 percent cash and 50 percent Hilltop stock. This offer price reflected a premium relative to:

1. the closing price of $6.06 per share of SWS Group on January 9, 2014, and
2. the one-year average price per share of $5.92.

Two other interested parties approached SWS Group regarding an acquisition. The first interested party, Esposito, a small Dallas, Texas, broker-dealer business, never provided a formal offer. The second interested party, Stifel Financial Corp. ("Stifel"),[11] expressed interest at $8.15 per share.

However, SWS Group management was doubtful about the authenticity of Stifel's interest. According to SWS Group management, Stifel had a reputation of pursuing acquisitions, backing out, and then poaching key employees from the acquisition target.

On or around March 20, 2014, SWS Group reached a handshake deal to consummate a merger with Hilltop. At this time, Stifel was still expressing interest in purchasing SWS Group at a purchase price above Hilltop's offer price.

However, Hilltop made clear that it would not waive the merger covenant provided by the Credit Agreement. Stifel improved its offer to purchase the SWS Group, but Stifel was unable to complete its

due diligence to its satisfaction and no agreement ever materialized.

An SWS Group financial advisor provided a fairness opinion that concluded that Hilltop's proposal was fair to SWS Group shareholders. On March 31, 2014, the SWS Group board of directors approved the merger with a Hilltop subsidiary.

A few months prior to the merger closing, Oak Hill exercised the majority of its warrants on September 26, 2014, consisting of 6.5 million SWS Group shares. On October 2, 2014, Hilltop exercised the remaining equity warrants. After the subsequent warrant exercise, Hilltop owned 8.7 million SWS Group shares.

Subsequent to the warrant exercise, $87.5 million of SWS Group debt was eliminated. On January 1, 2015, the merger closed with Hilltop paying SWS Group shareholders total merger consideration of $6.92 per share.

The petitioners, former stockholders of SWS Group, dissented from the transaction and exercised their statutory right to a fair value appraisal. The petitioners were comprised of seven entities, which held, in aggregate, 7,438,453 shares of SWS common stock.

Certain stockholders of the petitioners started to accumulate shares shortly after the deal was announced. The apparent purpose of the share acquisition, after the transaction was announced, was to engage in an appraisal arbitrage strategy.

In *SWS*, several appraisal petitions were filed with the Chancery Court in January 2015. A four-day trial was held in September 2016 followed by a post-trial briefing. As noted by the Chancery Court, "as is typical in these proceedings, the experts present vastly divergent valuations."

The petitioner expert arrived at $9.61 per share and the respondent expert arrived at $5.17 per share.

The Chancery Court Analysis

At trial, neither expert relied on the merger price. The petitioner expert justified the decision to ignore the merger price by highlighting the flaws in the sales process. Also, according to the petitioner expert, the merger price should be ignored due to the fact that Hilltop had a partial veto of any potential acquisition of SWS Group by another entity.

It appears that from the petitioner perspective, it is a reasonable assumption that the fair value was not equal to the merger price. The instant case involved different facts and circumstances than in the *In Re Appraisal of Petsmart, Inc.,* matter where a rigorous sales process provided a reasonable indication of fair value.[12]

In the instant case, in addition to the partial veto issue, the Chancery Court found that SWS Group board of directors did not enter into a rigorous sales process.

The respondent expert argued that the merger price reflected the premium Hilltop paid for the shared synergies that it expected to realize from the transaction. The position of the respondent expert was that such a premium should not be considered in a fair value appraisal action.

The Chancery Court agreed with the petitioner expert that the merger price was an unreliable indicator of fair value. The Chancery Court found that price was unreliable because of the partial veto power Hilltop could exercise as part of its rights agreed to under the Credit Agreement.

As a result, the Chancery Court applied traditional valuation methodologies to arrive at a fair value conclusion.

Comparable Companies Analysis

Only the petitioner expert conducted a guideline comparable companies analysis for SWS Group, to which he gave a 20 percent weighting in his fair value conclusion.

The Chancery Court rejected the guideline comparable companies analysis. According to the Chancery Court, the selected companies do not have to be a perfect match, but the analysis must employ a good sample of actual comparable/guideline companies.

The Chancery Court found that the guideline companies selected were not sufficiently comparable given SWS Group's unique structure, small size, and poor performance.

Guideline publicly traded companies should be similar to the subject company—it is not necessary that the guideline companies be exact copies.

Assuming there is a sufficient amount of similarity between a subject company and potential guideline companies, the application of the guideline publicly traded company method is generally beneficial to the valuation analysis.

The advantages of using the market approach include the following:[13]

1. It is fairly simple to understand.
2. It uses actual data and is not as dependent on long-term estimates.
3. It generally includes the value of all business operating assets.

4. It does not rely on explicit forecasts, and future growth is embedded in the pricing multiples.

The disadvantages of using the market approach include the following:

1. No good guideline companies exist—the analyst may not be able to find sufficiently similar guideline companies.
2. An insufficient number of data points or guideline companies exist, thus creating a problem with not enough information available to form an opinion.
3. Certain assumptions may be hidden, as growth rate assumptions, subject equity risk assumptions, and margin assumptions are incorporated in pricing multiples but are embedded and not explicit.

The following sources can assist the valuation analyst in creating a potential list of guideline companies:[14]

1. Company management—ask company management about publicly traded competitors
2. Standard Industrial Classification ("SIC") or North American Industry Classification System ("NAICS")—base a search off of an SIC code or NAICS code using an online database
3. Online databases—use databases to find and screen potential guideline companies
4. Industry research—reading trade journals and industry reports can be helpful to identify guideline companies

In general, a valuation analyst may choose to focus a guideline search based on business description matching. After a group of companies has been identified, a typical next procedure is to identify the group of guideline companies that provides the most meaningful pricing evidence.

More often than not, though not in all valuation assignments, there is usually enough size variation among publicly traded companies that this method should be at least considered as a means to estimate value.[15]

As a means of eliminating guideline companies, the issue of size-related comparability is an important consideration in selecting guideline companies. One of the main reasons is that smaller companies typically have more business and financial risk than larger companies.[16]

Small company risk characteristics include the following:

1. Potential competition issues (it is easier to enter the market and compete with small companies while larger companies have resources to mitigate competitive challenges)
2. Economic issues and concern (larger companies can better cope with economic downturn than small companies)
3. Limited access to capital (small companies can find it difficult to obtain funding while larger companies typically have more options for funding)
4. Management depth concerns (large companies do not have key employee concerns in the same way that smaller companies do)
5. Customer concentration and product concentration risk (small companies are typically not as diversified in product offerings and are often beholden to a small group of customers)
6. Liquidity concerns and lack of market coverage (small companies do not enjoy the same level of analyst coverage and small company stock is typically less liquid than larger companies)[17]

Assuming a guideline publicly traded company is sufficiently similar to a subject business, in terms of business operations based on its business description, there are methods by which publicly traded guideline company multiples can be adjusted for differences in size and in growth. In general, adjusting guideline publicly traded company pricing multiples for size and growth is not commonly applied in valuation analysis.

It is generally more common for an analyst to use professional judgment and consider the size-related differences in the selection and application of pricing multiples. However, it is important to recognize that there are methods for adjusting pricing multiples.

For example, to prepare a size-adjusted guideline publicly traded company pricing multiples analysis, the following equation may be used:[18]

$$Adjusted\ Multiple = \frac{1}{\left(\frac{1}{Multiple}\right) + (\varepsilon\theta)}$$

where:

Multiple = Guideline publicly traded company pricing multiple

ε = Percent of equity capital in guideline company capital structure

θ = Percent difference between (1) mean return for guideline company based on its Center for Research in Security Prices ("CRSP") size classification and (2) mean return for subject company based on its CRSP size classification

The guideline publicly traded company pricing multiple size-premium adjustment is similar in concept to the equity-related size-premium adjustment. Based on arithmetic mean returns published in the Duff & Phelps publication *2017 Valuation Handbook – U.S. Guide to Cost of Capital*, companies categorized as the largest decile, size decile 1, provided an average return of 11.05 percent.[19]

Companies categorized in the subdecile 10z, the smallest subcategory decile, provided an average return of 25.54 percent.[20]

Based on relative size, if a subject company is classified as a subdecile 10z security, the previously provided equation can be used to adjust pricing multiples derived from larger guideline companies.

Assuming a guideline public company has a market capitalization of $1.98 billion, it is classified as a decile 6 security. The arithmetic average return for a decile 6 security is 14.81 percent.[21]

Therefore, the average return of a decile 6 security is 10.73 percent lower than the average return for a subdecile 10z security. The percent of equity capital in the guideline company capital structure is 86.9 percent.

Based on the previously provided formula, the adjustment to a market value of invested capital ("MVIC") to earnings before interest, taxes, depreciation and amortization ("EBITDA") market pricing multiple of 8.2 times is as follows:

Adjusted MVIC to EBITDA Pricing Multiple:

$$4.6 = \frac{1}{\left(\frac{1}{8.2}\right) + (86.9\% \times 10.73\%)}$$

Therefore, based on this singular example, a guideline public company pricing multiple of 8.2 is adjusted to 4.6 percent to reflect a more reasonably appropriate pricing multiple to apply to a subject company.

However, it is up to the analyst to decide if this type of adjustment is appropriate given the specific facts and circumstances of the valuation engagement.

Discounted Cash Flow Analysis

Both the petitioner expert and respondent expert prepared a discounted cash flow ("DCF") analysis. As discussed, the Chancery Court found that the experts presented significantly divergent valuation opinions. And, ruling out the guideline company method, the Chancery Court constructed its own DCF analysis.

In order to develop its own DCF, the Chancery Court made decisions regarding DCF valuation variables and inputs. The Chancery Court specifically decided DCF inputs including cash flow projections, terminal value growth rate, equity risk premium, beta, and equity size premium.

Cash Flow Projections

The respondent expert used management projections to prepare its DCF analysis and fair value conclusion. That is, the respondent expert used three-year financial projections prepared by management without any changes.

The petitioner expert made several adjustments to the three-year management projections of cash flow for SWS Group.

For the first adjustment, the petitioner expert used the management-prepared three-year projections and increased them by two years. At trial, the petitioner expert argued that SWS Group would not reach a steady state by the end of the three-year management projections.[22]

As a result, the expert added two years to the management projection in order to arrive at normalized financial performance. The petitioner expert's argued that at the end of three years, SWS Group profit margins were projected to be much lower than projected peer company margins.

According to the expert, the SWS Group financial projections were not indicative of a steady state of financial performance for the business where profit margins were in line with guideline company profit margins.

The Chancery Court rejected the petitioner expert's assumptions for two reasons:[23]

1. The Chancery Court rejected the claim that the peer companies were comparable to SWS Group.
2. The Chancery Court rejected the premise that SWS Group would have been able to realize consistent straight-line growth for an additional two years, after which SWS Group would have reached a profit margin much higher than management projections.

The Chancery Court decided to use management's three-year projections as the basis for its own DCF analysis—essentially agreeing with the approach of the respondent expert.

According to the SWS decision, the Chancery Court has long expressed its strong preference for management projections; projections prepared in advance of the merger are favored over litigation-facing expert derived projections.[24]

For the second adjustment, the petitioner expert made cash flow adjustments for the following items:

1. The Oak Hill and Hilltop warrant exercise
2. The distribution of excess regulatory capital provided for in the DCF analysis

The petitioner expert argued that the exercise of the warrants was part of the operative reality of SWS Group. The expert reasoned that the warrant exercise should be considered because it occurred prior to the merger.

The expert also argued that $117.5 million of excess regulatory capital should be added to fair value. In order to account for the excess regulatory capital, the expert added $87.5 million in year one and $30 million in year three to the DCF cash flow.

The respondent expert argued that the warrant exercise should be ignored and that the subsequent changes to the SWS Group capital structure should not be considered. As a result, the respondent expert claimed that the fair value of SWS Group should include $0 as the amount of distributable excess regulatory capital.

The Court decided that the warrant exercise was a part of the operative reality for SWS Group as of the date of the merger. It essentially agreed with the petitioner expert, that because the warrants had been exercised three months prior to the close of the merger, the warrant exercise was not contingent on the merger itself.

In *SWS*, the Chancery Court found that Hilltop and Oak Hill acted in their own self-interest by exercising the warrants.

The petitioner expert argued that excess regulatory capital must be treated similarly to excess cash that is not redeployed into the business; namely that the amount of excess capital should be added to the value of the DCF analysis.

The respondent expert argued that it is improper to add back the excess regulatory capital. That is because making a provision for a distribution assumes that SWS Group can distribute $117.5 million to shareholders with no adverse impact on business performance. And, that distributing $117.5 million would not impair the ability of SWS Group to meet management projections.

The Chancery Court noted that the warrant exercise did not inject any money into SWS Group, since that money had already been received upon execution of the Credit Agreement in 2011.

The Chancery Court acknowledged that the exercise of the warrants significantly changed the capital structure of SWS Group, cancelling $87.5 million in debt in exchange for more shares issued. The exercise of the warrants did not create excess capital in the sense of excess cash that was beyond what was needed for business operations.

Consequently, the Chancery Court rejected the petitioner expert's argument that $117.5 million of excess regulatory capital would be distributable.

For the third and final adjustment, the petitioner expert reduced management projected interest expense from the management projections. The Chancery Court agreed with this assessment and decreased interest expense in its DCF analysis accordingly.

The Terminal Value Growth Rate

The petitioner expert used a 3 percent terminal growth rate for his DCF analysis. The respondent expert used a 3.35 percent terminal growth rate. According to the respondent expert, the 3.35 percent terminal growth rate was based on the midpoint between the long-term expected inflation rate of 2.3 percent and the long-term expected growth rate of the economy of 4.4 percent.

In rebuttal, the petitioner expert adopted the 3.35 percent terminal growth rate. The Court also adopted 3.35 percent as the terminal growth rate for its DCF analysis.

A common procedure to estimate long-term (sustainable or perpetual) growth rates includes (1) establishing an expectation of inflation and (2) adding a selected real growth rate for the subject company. This methodology is discussed in the valuation reference *Ibbotson SBBI Valuation Yearbook*.[25]

When applying this approach, it is recommended that a valuation analyst use prospective information to estimate the long-term growth rate. For example, if a long-term projection for inflation is 3.0 percent (just for reference purposes, U.S. inflation has averaged 3.0 percent per year as measured from 1926 to 2016 according to the *2017 Valuation Handbook —U.S. Guide to Cost of Capital),* and real gross domestic product ("GDP") is projected to increase by 2.5 percent on average in the next 20 years.

The nominal long-term GDP growth rate can be estimated by adding 3.0 percent to 2.5 percent, which equals 5.5 percent.

Based on this example, the 5.5 percent rate is generally considered a perpetual growth rate ceiling. In theory, a company cannot exceed the long-term growth rate of its respective economy into perpetuity.

The Discount Rate

The petitioner expert and the respondent expert both used the capital asset pricing model to calculate cost of equity. Both parties agreed that the risk-free rate of return was 2.47 percent, but they disagreed regarding the equity risk premium, the equity beta, and the size premium.

Equity Risk Premium

The petitioner expert and the respondent expert disagreed about whether the historical equity risk premium ("ERP") or supply-side ERP should be used. The respondent expert used the historical ERP of 7 percent. The petitioner expert used the supply-side ERP of 6.21 percent.

The Chancery Court ruled that the supply-side ERP was the proper metric. This ruling appears to be consistent with what the Chancery Court has recently recognized as the default ERP valuation variable in similar actions.

Valuation analysts generally consider the supply-side ERP to be theoretically superior to the historical ERP. The reasoning behind the supply-side ERP selection can be traced back to a research paper written by Roger Ibbotson and Peng Chen.[26]

Ibbotson and Chen studied the components of historical equity returns from 1926 to 2000 using supply-side factors. The supply-side factors included inflation, earnings, dividends, price-to-earnings ("P/E") ratio, dividend payout ratio, book value, return on equity, and GDP per capita.

Ibbotson and Chen found that the supply-side ERP was lower than the realized ERP during the period from 1926 to 2000. The reasoning behind the lower supply-side ERP is understood to be due to underlying and contributory factors, some of which cannot continue into perpetuity.

Ibbotson and Chen concluded, "Although GDP per capita outgrew earnings and dividends, the overall stock market price grew faster than GDP per capita. The primary reason is that the market P/E increased 2.54 times during the same time period."[27]

Thus, the historical ERP contains an implicit assumption of an increasing P/E ratio. The implications of such an assumption are (1) the equity market will grow faster than the underlying economy into perpetuity and (2) investors will continue to pay a higher price relative to realized earnings. "In theory, eventually the supply-side ERP and the historical ERP should converge."[28]

As a result of the Ibbotson and Chen findings, the valuation reference book, *Duff & Phelps Valuation Handbook* series, calculates a supply-side ERP and a historical ERP.[29]

It is generally understood that this supply-side ERP calculation is theoretically superior to the historical ERP.

Beta

The petitioner expert used a beta of 1.10, whereas the respondent expert used a beta of 1.18. One of the primary issues was the consideration of an appropriate lookback period.

The respondent expert used a two-year lookback period of SWS Group weekly stock returns ending on January 3, 2014. This lookback period included the date preceding the announcement of Hilltop's initial offer.

The petitioner expert derived his beta, in part, by reference to peer companies. Although the Court found the peer group of guideline companies to be unreliable with regard to the market approach, the Chancery Court agreed with the petitioner expert's beta conclusion.

The Chancery Court rejected the respondent expert's beta estimate due to concerns over the behavior of SWS Group stock during the lookback measurement period. The Chancery Court cited the noise amongst analysts about a possible acquisition prior to January 3, 2014, and the increased volatility of SWS Group's stock price as evidence that the respondent expert's beta was unreliable.

The Chancery Court also noted that a five-year monthly lookback resulted in a beta of 0.81 and that a five-year weekly lookback resulted in a beta of 1.09.

As a best practice, it is often important to examine multiple lookback periods and frequencies when

determining a beta estimate. This is what the Court did when it examined the five-year monthly and five-year weekly beta estimates of SWS Group.

Ultimately, the goal of the valuation analyst should be to estimate a beta that fairly represents the systematic risk and stock price variability of the subject company as compared to the broad equity market, over a relevant time period. The analyst should keep in mind that the beta estimate is the mean of a statistical distribution that results from a regression analysis.

Factors that a valuation analyst can consider when examining multiple beta estimates include the following:

1. The mean of each distribution
2. The relationship between the means of each distribution
3. The dispersion about the mean for each distribution
4. The relationship between the dispersions about the means of each distribution

In the instant case, the Chancery Court considered the respondent expert's beta estimate unreliable primarily because merger discussions were known and knowable during the lookback period. The Court found that the merger discussions had an impact on the behavior of SWS Group stock price.

Size Premium

The petitioner expert applied a size premium of 2.69 percent to its cost of equity model. This alpha factor was based on the decile that corresponded with the expert's preliminary DCF valuation of $464 million.

The respondent expert selected a size premium of 4.22 percent. This was based on the market capitalization of SWS Group prior to Hilltop's offer, which was approximately $198.5 million.

The respondent expert criticized the petitioner expert's size premium selection, saying that the method used is circular. According to the expert, such a method is only used for private companies when market capitalization is not easily determined or unreliable.

In reply to the respondent position, the petitioner expert acknowledged that using the market capitalization to estimate a size premium is appropriate for public companies. However, the petitioner expert argued that the warrant exercise substantially altered the SWS Group market capitalization. This altered market capitalization resulted in a

flawed and inappropriate metric to use for determining the proper size premium.

The Chancery Court admitted that both parties presented persuasive arguments. Ultimately, the Court decided to take the midpoint of the two approaches. The Chancery Court selected a size premium of 3.46 percent in its DCF analysis.

As previously mentioned, it is generally accepted that, based on empirical observation, small companies are a greater investment risk than larger companies and, therefore, smaller companies have greater cost of capital than larger companies. In other words, there is a significant (inverse) relationship between size and historical equity returns.

However, there are many observations of the size-related phenomena theory, and of the CRSP size premium data, used by a majority of analysts.

Observations regarding these data include the following:

1. The small capitalization premium has disappeared in recent years (the empirical evidence supports varying size-related premium at different points in time, therefore, in certain time periods it would not be surprising for small capitalization stocks to provide lower investment returns than larger capitalization stocks).
2. The premium, at the smallest level, is unduly influenced by stocks of less than $5 million in market capitalization and stocks that trade at prices less than $2 per share—the most statistical noise in the CRSP size premium data is in the 10th decile classification and its smaller subcategory classifications, this factor may not be as relevant if

the subject matter company is a very small business that is similar to the companies that populate the 10th subcategories of 10y and 10z.

3. Other factors, specifically liquidity or lack thereof, provide important detail that analysts should consider in the decision to use, or not use, the CRSP size premium data.

In certain matters, the Chancery Court has heard criticisms related to the application of size-related premiums. On one such matter, the *Merion Capital L.P. and Merion Capital II L.P., v. Lender Processing Services, Inc.* ("*Merion Capital*"), one of the experts did not apply a size premium.

In *Merion Capital*, the petitioner's expert applied a 0.92 percent size premium.[30] The respondent expert did not add an equity size premium. The respondent expert reasoned that there "is no consensus in the academic literature as to whether such a premium still exists."[31]

Because the respondent expert did not add an equity size premium, and the exclusion of the size premium favored the petitioner, the Chancery Court accepted the respondent expert decision not to add an equity size premium.

In another matter, the *Just Care* decision, the Chancery Court recognized criticisms, but was not persuaded by the argument.[32]

According to the petitioner expert, because "the illiquidity premium reflected in the [CRSP] size premium data for small cap stocks is akin to a liquidity discount" such a discount "must be eliminated in a fair value determination—much like a discount for lack of marketability or minority interest."[33] Because of this embedded liquidity issue in the CRSP size premium data, the petitioner argued that the size premium should be adjusted to account for the embedded liquidity discount.

In *Just Care*, the Chancery Court found that the petitioner expert was correct that a general liquidity discount cannot be applied in an appraisal rights proceeding. Such a discount generally relates to the marketability of the company's shares and is, therefore, prohibited.

In *Just Care*, the Chancery Court ruled against the petitioner theory that the embedded liquidity premium in the Ibbotson's size-related data should be adjusted in order to develop a cost of capital estimate.

The Chancery Court found that the liquidity effect at issue relates to the company's ability to obtain capital at a certain cost and not a shareholder level liquidity discount issue. This finding suggests that the liquidity effect is related to a company's intrinsic value as a going concern, and it should be included when calculating its cost of capital.

Although the Chancery Court ruled against the petitioner argument in *Just Care*, it did not completely dismiss the idea of a challenge. The Chancery Court ruled that it may adjust a company's size premium where sufficient evidence is presented to show that the company's individual characteristics make it less risky than would otherwise be implied under its corresponding decile classification based on size alone.

The petitioner expert did not argue that *Just Care* was less risky than other companies in decile 10b. The petitioners devoted only one sentence in the opening brief to attempt to justify the treatment of Just Care as a decile 10a company.[34]

The Chancery Court concluded that because petitioners did not provide compelling evidence for treating Just Care as a decile 10a company, it ruled that the decile 10b was appropriate based on the company size.

Summary and Conclusion

In a matter that bears similarity to certain other recent fair value decisions, in *SWS* the Delaware Court of Chancery rejected a merger price indication in favor of its own DCF analysis. When the Chancery Court develops its own valuation analysis, such as it did in *SWS*, it is a clear indication that it did not trust the integrity of the respective experts' valuation findings.

In the instant case, the valuation analysts arrived at fair value opinions that were approximately 86 percent apart.

Several of the petitioning shareholders had acquired shares in the subject company with the hope of perfecting an appraisal arbitrage strategy. The Chancery Court concluded on a $6.38 per share fair value, approximately 7.8 percent less than the merger price of $6.92.

While arbitragers could certainly be encouraged by the *Dell I* decision, the appeal and reversion back to the Chancery Court in *Dell II* and the *SWS* decision serve as discouragement for arbitrage strategy purveyors.

In *SWS*, all parties involved, including the Court, rejected the merger price at issue as an indication of fair value. In *Dell II*, the Supreme Court encouraged the use of the merger price as an indication of fair value.

One of the primary differences between *Dell II* and *SWS*, aside from the Hilltops partial veto power,

was the argument that the SWS Group did not engage in a vigorous sales process. Perhaps if the sales process were a bit more fulsome, the Chancery Court would have considered the merger price to be more persuasive.

By performing its own analysis, the Chancery Court arrived at several conclusions related to valuation variables. There are several interesting conclusions provided by the Chancery Court in *SWS*.

First, the Chancery Court did not agree with the use of a comparable guideline company analysis. The reasoning for exclusion of the market approach included that the comparable companies were divergent from SWS Group in terms of size, business lines, and performance.

Assuming the guideline companies were comparable in terms of business lines, there are methods by which pricing multiples can be adjusted. One such adjustment is based on size differential.

As referenced above, using the pricing multiple adjustment equation, an 8.2 times EBITDA pricing multiple is adjusted to 4.6 times EBITDA by accounting for the impact of size on the publicly traded pricing multiple. It is not clear if size adjusting pricing multiples would have persuaded the Chancery Court, but is it a procedure that an analyst may consider.

Second, the Chancery Court was more persuaded by management projections prepared prior to litigation than it was by adjusted projections prepared after the fact—that is, prepared for litigation purposes.

On one side, the expert used unadjusted management projections. On the other side, the expert made several adjustments. In certain cases there are no available management projections, and it may be reasonable for a valuation analyst to prepare de novo financial projections.

However, in the instant case, the fact that SWS Group was underperforming financial projections was too much of a hurdle to substantiate an optimistic projection prepared for litigation.

Third, the decision to add back an excess of cash must agree with operative reality that there is cash to distribute. The Chancery Court ruled against adjustments to provide for a distribution of excess of regulatory capital to shareholders related to a warrant exercise. The warrant exercise occurred a few months prior to the merger, but it did not provide excess cash to distribute.

By exercising the warrants, Hilltop and Oak Hill relieved debt obligations of SWS Group and received equity in return. No new cash position was created, and, therefore, it is puzzling as to why the petitioners argued for a cash distribution.

Fourth, the ERP selection should be a rather noncontroversial variable selection. That is, if the decision regarding the selection is between historical ERP and supply-side ERP, practitioners will typically select the supply-side ERP indication.

There are other opinions related to an appropriate ERP selection, but it would be surprising if a valuation analyst would be able to support the historical ERP in a Delaware Court of Chancery proceeding.

Fifth, there are alternative analyses a valuation analyst could consider in order to estimate the SWS Group beta. The analyst could consider a lookback period longer than two years, which would allow the analyst to capture data prior to any public discussions regarding a potential merger.

The analyst could consider a lookback period prior to public knowledge of merger discussions, which might permit the analyst to estimate a beta based on a period during which merger discussions

would not have potentially affected the behavior of the SWS Group stock price.

By examining the stock price behavior before and after merger discussions became public knowledge would allow the analyst to determine whether there was, in fact, a meaningful change in the behavior of the SWS Group stock price.

And, finally, while not a primary issue in *SWS*, in other matters the Chancery Court has heard arguments as to why a size premium may not be relevant to a fair value matter. Or, even if it is relevant, the size premium may need to be adjusted to account for observed embedded liquidity concerns.

In *SWS*, both experts applied a size premium to develop cost of equity estimates. The Chancery Court found that both parties made persuasive arguments and, therefore, selected a midpoint between the parties estimates.

Notes:

1. In re Appraisal of SWS Group, Inc., C.A. No. 10554—VCG, 2017 WL 2334852 (Del. Ch. May 30, 2017).
2. The Court cited In Re Appraisal of Petsmart, Inc., No. 10782, 2017 WL 2303599 (Del. Ch. May 26, 2017) as evidence of Court precedent.
3. In a more recent matter, not specifically discussed herein, the Chancery Court arrived at similar conclusions. See In re Appraisal of AOL, Inc. ("AOL"), C.A. No. 11204-VCG, 2018 WL 1037450 (Del. Ch. Feb. 23, 2018) and Verition Partners Master Fund Ltd. and Verition Multi-Strategy Master Fund Ltd., v. Aruba Networks, Inc. ("Verition"), C.A. No. 11448–VCL, 2018 WL 922139 (Del. Ch. Feb. 15, 2018). In AOL, the Chancery Court rejected the deal price and relied on the discounted cash flow to establish its fair value conclusion. In Verition, the Chancery Court rejected the deal price and arrived at a fair value based on the thirty-day average unaffected publicly traded market price. In Verition, similar to SWS Group and the recent AOL decision in result, the concluded fair value was lower than the subject deal price.
4. In re Appraisal of Dell In., C.A. No. 9322-VCL, 2016 WL 3186538 (Del. Ch. May 31, 2016).
5. Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd., et al., 177 A.3d 1 (Del. 2017).
6. Id. at 1.
7. Id. at 44.
8. In Re SWS Group, Inc., 2017 WL 2334852.
9. Hilltop Holdings, Inc., provides business and consumer banking services. It became a bank holding company after its acquisition of PlainsCapital Corporation in 2012. Hilltop is headquartered in Dallas, Texas.
10. Oak Hill Capital Partners is a private equity and distressed company firm specializing in buy-outs, recapitalizations, and complex turnaround investments in middle-market companies. Oak Hill is headquartered in Stamford, Connecticut.
11. Stifel Financial Corp. is a financial services and bank holding company. Stifel is headquartered in St. Louis, Missouri.
12. In Re SWS Group, Inc., 2017 WL 2334852 at *1.
13. James R. Hitchner, *Financial Valuation: Applications and Models*, 4th ed. (New York: John Wiley & Sons, 2017), 296-297.
14. Gary R. Trugman, *Understanding Business Valuation a Practical Guide to Valuing Small to Medium Sized Businesses*, 5th edition (New York: American Institute of Certified Public Accountants, 2017), 324.
15. Hitchner, *Financial Valuation*, 309.
16. Ibid.
17. Roger J. Grabowski, "The Size Effect—It Is Still Relevant," *Business Valuation Review* 35, No. 2 (Summer 2016): 63.
18. Hitchner, *Financial Valuation*, 339.
19. See Duff & Phelps, *2017 Valuation Handbook: U.S. Guide to Cost of Capital* (New York: John Wiley & Sons, 2017), 7–11.
20. Ibid.
21. Ibid.
22. In Re SWS Group, Inc., 2017 WL 2334852 at *11.
23. Id., at *12.
24. Id., at *11.
25. See Morningstar, *Ibbotson SBBI 2013 Valuation Yearbook* (Chicago, IL: Morningstar, Inc., 2013), 52. The year 2013 was the last year that Morningstar published the valuation yearbook reference book and the last year that the valuation yearbook addressed estimating growth rates.
26. Roger G. Ibbotson and Peng Chen, "Long-Run Stock Market Returns: Participating in the Real Economy," *Financial Analysts Journal* (January-February 2003): 88–98.
27. Ibid.: 93.
28. James R. Hitchner, Shannon P. Pratt, and Jay E. Fishman, *A Consensus View—Q&A Guide to Financial Valuation* (Ventnor City, NJ: Valuation Products and Services, 2016), 82.
29. See Duff & Phelps, *2017 Valuation Handbook: U.S. Guide to Cost of Capital*, 3-34 through 3-36.
30. Merion Capital L.P. and Merion Capital II L.P. v. Lender Processing Services, Inc., C.A. No. 9320-VCL, 2016 WL 7324170 at *29 (Del. Ch. Dec. 16, 2016).
31. Ibid.
32. Gearreald v. Just Care, Inc., C.A. No. 5233-VCP, 2012 WL 1569818 (Del.Ch. April 30, 2012).
33. Id. at *10
34. Id. at *12.

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Kevin M. Zanni is a director in our Chicago office. Kevin can be reached at (773) 399-4333 or kmzanni@willamette.com.

Willamette Management Associates
Thought Leadership in Valuation, Damages Analyses, and Transfer Price Analyses

Willamette Management Associates consulting experts and testifying experts have achieved an impressive track record in a wide range of litigation matters. As independent analysts, we work for both plaintiffs and defendants and for both taxpayers and the government. Our analysts have provided thought leadership in breach of contract, tort, bankruptcy, taxation, family law, and other disputes. Our valuation, damages, and transfer price analysts are recognized for their rigorous expert analyses, comprehensive expert reports, and convincing expert testimony. This brochure provides descriptions of some recent cases in which we provided expert testimony on behalf of the prevailing party.

Transfer Pricing Testifying Expert Services

In the matter of ***Amazon.com, Inc. & Subsidiaries v. Commissioner*** (148 T.C. No. 8 (2017)), the U.S. Tax Court found in favor of the taxpayer plaintiff. The case involved a 2005 cost sharing arrangement that Amazon entered into with its Luxembourg subsidiary. Amazon granted its subsidiary the right to use certain pre-existing intangible property in Europe, including the intangible assets required to operate Amazon's European website business. The Tax Court held that (1) the Service's determination with respect to the buy-in payment was arbitrary, capricious, and unreasonable; (2) Amazon's CUT transfer price method (with some upward adjustments) was the best method to determine the requisite buy-in payment; (3) the Service abused its discretion in determining that 100% of technology and content costs constitute intangible development costs (IDCs); and (4) Amazon's cost-allocation method (with certain adjustments) was a reasonable basis for allocating costs to IDCs. Robert Reilly, a managing director of our firm, provided expert testimony on behalf of taxpayer Amazon in this Section 482 intercompany transfer pricing case.

Income Taxation Testifying Expert Services

On February 21, 2017, the U.S. Court of Federal Claims dismissed (with prejudice) the complaint filed by plaintiff **Washington Mutual, Inc.**, against the United States (Nos. 08-321T, 08-211T). The taxpayer plaintiffs were seeking a refund of at least $149 million in certain federal taxes paid by H.F. Ahmanson & Co. ("Ahmanson") during several tax years in the 1990s, based upon the abandonment loss and amortization deductions available under the Internal Revenue Code. The case involved the fair market value determination of the regulatory right to open deposit-taking branches in certain states other than California ("branching rights"), the contractual approval right to treat the goodwill created by certain acquisitions as an asset for regulatory accounting purposes ("RAP rights"), and certain other intangible assets. Curtis Kimball, a managing director of our firm, critiqued the valuation report presented by the plaintiff's valuation expert and provided rebuttal expert testimony on behalf of the U.S. Department of Justice regarding the valuation of branching rights and RAP rights intangible assets. The Claims Court dismissed the plaintiffs' tax refund claims.

Condemnation Proceeding Testifying Expert Services

In the matter of ***Town of Mooresville v. Indiana American Water Company*** (2014), Willamette Management Associates was engaged by the defendant to perform a valuation analysis of the Indiana American Water Company (the "company") retail water system located in Mooresville, Indiana. The purpose of the analysis was to assist the company in a condemnation proceeding initiated by the town of Mooresville, Indiana. Our assignment was to estimate the fair market value of the company total operating assets (as part of a going concern). The primary valuation issue in the dispute was: should all of the company operating assets (financial asset accounts, tangible property, and intangible assets) be assigned value in a condemnation proceeding? Or, should the condemnee receive the accounting book value (or regulatory "rate base") of the tangible assets only? After a jury trial, at which Robert Reilly, a managing director of our firm, provided expert testimony, the jury's decision favored our analysis and awarded Indiana American Water Company the value of both its tangible assets and its intangible assets.

Family Law Testifying Expert Service

In a marital dissolution matter in 2016, the Superior Court of Arizona, Maricopa County, found in favor of the husband in the family law case ***In re the Marriage of Julie Anne Bowe and Gregory James Vogel, Sr.*** (No. FC2014-001952), Willamette Management Associates was engaged by Gregory Vogel, as president and owner of Land Advisors Organization (LAO), a national land brokerage business, to prepare a valuation analysis. Charles Wilhoite, a managing director of our firm, provided expert testimony. The purpose of the analysis was to assist with facilitating the property settlement aspects of the parties' marital dissolution. The primary valuation issues in the dispute were (1) the most appropriate valuation date and (2) the appropriate historical period of operating results to be relied on as a foundation for estimating the expected future earnings in a capitalization of cash flow business valuation analysis. The Court favored the Willamette positions, resulting in a judicially concluded value for LAO significantly lower than the opinion offered by the opposing valuation experts. This case is currently being appealed.

Bankruptcy Testifying Expert Services

Willamette Management Associates was engaged by the proponents of a reorganization plan to prepare a declaration in the matter of *In re Plant Insulation Company* (No. 09-31347, U.S. Bankruptcy Court, N.D. Cal. 2014). Our assignment was to review the declarations of the opposing experts in this case and to offer our opinion on certain shareholder agreements related to the matter. In particular, we were asked to review a right of first offer agreement and to opine on its impact on the control, transfer, and value of common stock and warrant interests in Bayside Insulation and Construction, Inc. Following a trial, at which Willamette managing director Curtis Kimball offered rebuttal expert testimony, the U.S. Bankruptcy Court accepted the plan of reorganization proposed by the Futures Representative of the Official Committee of Creditors.

Property Taxation Testifying Expert Services

Willamette Management Associates was engaged by the plaintiff to prepare a forensic analysis expert report for *Sandy Creek Energy Associates, LP, and Brazos Sandy Creek Electric Cooperative, Inc. v. McLennan County Appraisal District* (No. 2014-3336-4, Dist. Ct. McLennan County, Texas, August 2016). The purpose of the Willamette expert report and expert testimony was to assist the owners of the Sandy Creek coal-fired electric generating plant (the "plant") in a property taxation dispute with the McLennan County Appraisal District (the "district"). Our assignment was to review and rebut the unit valuation expert report and testimony provided by the district's valuation expert. One issue in the dispute was the amount of economic obsolescence associated with the plant. As of the property tax assessment date, the plant's cost to produce electricity was significantly greater than the wholesale price of electricity. As described in the Willamette expert report, these operating conditions indicated that economic obsolescence was present in the plant. After a week-long trial, at which Willamette managing director Robert Reilly offered expert testimony, a jury decided that the fair market value of the plant was less than half of the value asserted by the district. This jury decision significantly favored the taxpayer, and it resulted in a substantial reduction in the plant's property tax assessment.

Dissenting Shareholder Rights Testifying Expert Services

In the case, ***In Re Appraisal of The Orchard Enterprises, Inc.*** (No. 5713-CS, 2012 WL 2923305 (Del. Ch. 2012), *aff'd* No. 470, 2013 WL 1282001 (Del. 2013)), Willamette Management Associates was retained on behalf of the petitioners in a case where the subject of the dispute was the fair value of the Orchard Enterprises, Inc. ("Orchard") common stock at the time the company was taken private. Orchard was a digital media services company specializing in music from independent labels with a mission to acquire distribution rights, build sales channels, and monetize these rights in new and innovative ways. The petitioners had received $2.05 per share in the going-private transaction. At trial, Tim Meinhart, a managing director of our firm, testified that the fair value of the Orchard common stock at the time of the go-private transaction was $5.42 per share. The court agreed with our overall conclusion that the transaction occurred at a price that was lower than the fair value of the stock. The court concluded that the common stock fair value was $4.67 per share at the time of the go-private transaction.

On Our Web Site

Recent Articles and Presentations

Robert Reilly, a managing director of our firm, authored a series of articles that appeared in the October/November 2017, December 2017/January 2018, and February/March 2018 issues of *Financial Valuation and Litigation Expert*. The title of Robert's article is "The Fair Value Valuation of Intangible Assets for Acquisition Accounting Controversy Purposes—Parts 1–3."

In part 1 of Robert's article, he focuses on the intangible asset valuation practical guidance that valuation analysts can extract from the acquisition accounting GAAP. Robert summarizes guidance found in ASC 805 and ASC 820. In particular, he discusses categories of intangible assets, data gathering and due diligence, intangible asset valuation approaches and methods, and tax amortization benefit adjustments. In part 2 of the article, Robert provides illustrative examples of the income approach and cost approach valuation approaches. In part 3, Robert provides an illustrative example of the market approach and reviews some common sources of royalty rate data. "Extracting Relevant Pricing Data from Market-Based Evidence."

Robert Reilly also authored an article that was published in the November 2017 issue of *Practical Tax Strategies*. The title of Robert's article is "Intangible Asset Valuations for Federal Taxation Purposes."

Robert's article focuses on the intangible asset valuation practical guidance that valuation analysts can extract from the acquisition accounting GAAP. Robert summarizes guidance found in ASC 805 and ASC 820. In particular, he discusses categories of intangible assets, data gathering and due diligence, intangible asset valuation approaches and methods, tax amortization benefit adjustments. Robert also provides illustrative examples of the three generally accepted valuation approaches.

Robert Reilly also authored an article that appeared in the September 2017 issue of *Practical Tax Strategies*. The title of Robert's article is "Unit, Summation, and Business Value in Property Tax Valuations."

Although the differences between unit value, summation value, and business value are subtle, the distinction is important. This is because each one values a different bundle of taxpayer interests. Robert discusses 14 important analytical differences as they relate to valuations performed for ad valorem property tax purposes.

Robert Reilly also authored a two-part article that appeared in the July/August 2017 and September/October 2017 issues of *Construction Accounting and Taxation*. The title of Robert's article is "Differences between Business Valuations, Unit Valuations, and Summation Valuations in the Construction Industry."

Part I of Robert's article discusses the conceptual and practical differences between the use of a unit valuation principle to value complex industrial and commercial properties and the use of the summation valuation principle to value more simple industrial and commercial properties. The article summarizes the procedural difference between the unit principle and the summation principle. In Part II of the article, Robert explores the analytical differences among business valuations, unit valuations, and summation valuations.

These and many other articles and presentations may be found at www.willamette.com/resources_presentations.html.

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Communiqué

In Print

Robert Reilly, firm managing director, authored an article that appeared in the Winter 2018 issue of the *American Journal of Family Law*. The title of Robert's article is "The Asset-Based Approach to Business Valuation in Family Law (Part III of III): The ANAV Method."

Robert Reilly also authored an article that appeared in the November 2017 issue of *Practical Tax Strategies*. The title of Robert's article is "Intangible Asset Valuations for Federal Taxation Purposes."

Robert Reilly also authored a series of articles that appeared in *Financial Valuation and Litigation Expert*. The title of Robert's article were "The Fair Value Valuation of Intangible Assets for Acquisition Accounting Controversy Purposes." The first part of that article appeared in the October/November 2017 issue. The second part of that article appeared in the December 2017/January 2018 issue. And the third part of that article appeared in the February/March 2018 issue.

Robert Reilly also authored a chapter in the BV Resources book *Valuing Physician Compensation and Healthcare Service Arrangements* 2nd edition. The title of Robert's chapter was "Chapter 15. Tax Regulations Affecting Tax-Exempt Healthcare Entities: An Introduction for Valuation Practice."

Robert Reilly also authored an article in the January/February 2018 issue of *Construction Accounting and Taxation*. The title of Robert's article was "Reasonableness of Compensation Guidance for Construction Industry Taxpayers."

Tim Meinhart, Chicago office director, authored an article that appeared in the February 2018 issue of *Trusts & Estates*. The title of Tim's article is "Valuation Treatment of the Built-In Capital Gains Tax."

Kevin Zanni, Chicago office director, authored an article that appeared in the November 16, 2017, issue of the *QuickRead*. *QuickRead* is an online publication for the National Association of Certified Valuators and Analysts. The title of Kevin's article is "The Application of Guideline Publicly Traded Company Risk Adjustment: Quantifying the Risk Adjustment."

Casey Karlsen, Portland office associate, and John Ramirez, Portland office vice president, co-authored an article that appeared in the February/March 2018 issue of *World Trademark Review*. The title of their article is "An Arm's-Length Approach to Trademark Royalty Rates."

Lisa Tran, Portland office vice president, and Casey Karlsen, Portland office associate, authored an article in the November 8, 2017, issue of *QuickRead*. The title of their article is "Reasonableness of Shareholder/Executive Compensation: Challenging and Defending Compensation and Use of the Independent Investor Test."

In Person

Tim Meinhart, Chicago office managing director, co-presented a webinar sponsored by *Trusts & Estates* on November 9, 2017. The topic of the webinar was "Valuation Implications of the Proposed Tax Regulations."

Curtis Kimball, Atlanta office managing director, delivered a presentation at the 26th Annual Advanced Course and Live Video Webcast for the American Law Institute Continuing Legal Education program on November 2-3, 2017, in Charleston. The title of Curt's presentation was "Valuation of a Family Business Interest: Selecting and Working with Appraisers."

Encomium

Sam Nicholls, Atlanta office manager, has earned the Accredited Senior Appraiser ("ASA") designation from the American Society of Appraisers.

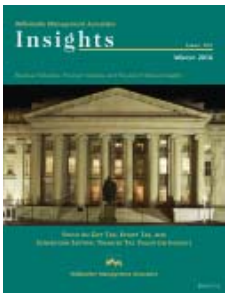
Insights Archives

❑ Winter 2018

Thought Leadership in the Asset-Based Approach to Business Valuation

❑ Winter 2017

Thought Leadership in Estate and Gift Tax Valuation Services

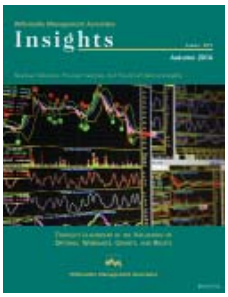


❑ Winter 2016

Focus on Gift Tax, Estate Tax, and Generation-Skipping Transfer Tax Valuation

❑ Autumn 2017

Thought Leadership in Dispute Resolution and Forensic Analysis



❑ Autumn 2016

Thought Leadership in the Valuation of Options, Warrants, Grants, and Rights

❑ Autumn 2015

Focus on Dissenting Shareholder Appraisal Rights and Shareholder Oppression Litigation

❑ Summer 2017

Thought Leadership in Property Taxation Planning, Compliance, and Controversy

❑ Summer 2016

Thought Leadership in Property Tax Valuation Issues

❑ Summer 2015

Focus on Reasonable Compensation in Eminent Domain and Expropriation Controversies

❑ Spring 2017

Thought Leadership in Family Law Financial and Valuation Issues

❑ Spring 2016

Focus on Intellectual Property

❑ Spring 2015

Focus on Corporate Transaction Advisory Services

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Willamette Management Associates
thought leadership

Willamette Management Associates provides thought leadership in business valuation, forensic analysis, and financial opinion services. Our professional services include: business and intangible asset valuation, intellectual property valuation and royalty rate analysis, intercompany transfer price analysis, forensic analysis and expert testimony, transaction fairness opinions and solvency opinions, reasonableness of compensation analysis, lost profits and economic damages analysis, economic event analysis, M&A financial adviser and due diligence services, and ESOP financial adviser and adequate consideration opinions.

We provide thought leadership in valuation, forensic analysis, and financial opinion services for purposes of merger/acquisition transaction pricing and structuring, taxation planning and compliance, transaction financing, forensic analysis and expert testimony, bankruptcy and reorganization, management information and strategic planning, corporate governance and regulatory compliance, and ESOP transactions and ERISA compliance.

Our industrial and commercial clients range from substantial family-owned companies to Fortune 500 multinational corporations. We also serve financial institutions and financial intermediaries, governmental and regulatory agencies, fiduciaries and financial advisers, accountants and auditors, and the legal profession.

Willamette Management Associates analysts apply their experience, creativity, and responsiveness to each client engagement. And, our analysts are committed to providing thought leadership—by delivering the highest level of client service in every engagement.

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