Valuation Disputes Over Control Premiums in an ESOP

The Changing Landscape of Control Premiums

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Agenda

- Traditional valuation theory on control premiums and the presence of an ESOP as affecting valuation theory
- DOL Regulations related to control premiums
- Literature on control premiums
- Court decisions on control premiums
- Current thought in the valuation community
- Current actions by the DOL in ESOP cases involving control premiums
- Discussion of hypotheticals
Traditional valuation theory on control premiums and the presence of an ESOP as affecting valuation theory
Standard of Value

- **Definition of Fair Market Value (“FMV”):**
  - *The price at which an asset would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset.*
  
  - Title I of ERISA and the Proposed Regulation Relating to the Definition of Adequate Consideration (Prop. Reg. Section 2510.3-18 (b)(2)(i))

- **Key Concepts:**
  - Arm’s-length transaction (i.e., third party transaction)
  - Hypothetical buyer and seller
  - No undue influence to buy or sell
  - Knowledgeable buyer and seller
  - ESOP is a financial buyer
What Does Control Get Me?

**Elect board members**
- Change governance documents
- Negotiate mergers and acquisitions

**Take on more debt**
- Acquire or sell assets

**Enter into licensing agreements for IP**

**Set strategic policy**
- Determine management compensation and perquisites

**Make product and service offering decisions**
- Declare and pay dividends

**Appoint or change operational management**

**Sell or acquire treasury shares**
- Select suppliers and vendors

**Enter joint ventures**

**Pursue an IPO**
- Make marketing and pricing decisions

**Exercise veto power**
Size of Block Dictates Control?

- Definitions:
  - Control Premium - an amount or a percentage by which the pro rata value of a controlling interest exceeds the pro rata value of a noncontrolling interest in a business enterprise, to reflect the power of control
  - Control - the power to direct the management and policies of a business enterprise
    - International Glossary of Business Valuation Terms
  - The control premium is a mathematical relationship between two indications of value (controlling and noncontrolling)
  - What is critical is how we quantify and qualify the economic benefits, if any, inuring to the subject block of stock
  - Size of the block of stock alone doesn’t guaranty a control premium, nor would a third party pay a premium based solely on gaining ownership of a majority interest
“Traditional” Levels of Value\(^1\)

- **Controlling Interest Basis**: Obtain directly by reference to actual change of control transactions or other control.
- **Control Premium**: Obtain indirectly by reference to freely tradable values via Control Premiums.
- **Marketable Minority Interest Basis**: Obtain indirectly by reference to control valuation via Minority Interest Discount.
- **Marketability Discount**: Obtain indirectly from Marketable Minority valuation by application of a Marketability Discount.
- **Nonmarketable Minority Interest Basis**: Obtain directly from actual transactions.
- **Minority Interest Discount**: Obtain directly by reference to “freely tradable” comparable companies or by “build-up” methodologies which develop capitalization rates by estimating required rates of return in relation to public markets.

How Do We Value Companies?

- Assuming these methods indicate a marketable level of value, do they yield control or lack of control? It depends!

**Income Approach**
- Common Methodologies
  - Discounted Cash Flow
  - Capitalized Earnings
  - Capitalized Cash Flow

**Market Approach**
- Common Methodologies
  - Comparable Public Companies
  - Comparable Transactions (M&A)
  - Prior Transactions in Company Stock

**Asset Approach**
- Common Methodologies
  - Liquidation Value Analysis
  - Adjusted Net Asset Value

**Overview of Approach**
- Based upon the fundamental premise that value of the business is a function of the economic benefit it can generate
- Most methods based upon capitalization of expected future economic benefit at an appropriate rate that captures the relative riskiness of the investment and the current economic environment

- Based on prices determined and tested by the marketplace
- Estimates the value of the business based upon evidence of prices investors are willing to pay for companies in similar lines of businesses

- Based upon the Company’s financial condition
- Focus on value of underlying assets (inventory, receivables, property & equipment, etc.) rather than cash flows generated by such assets
What Level of Control Yielded?

- General agreement among valuation professionals that comparable transaction method yields a controlling (and perhaps strategic) level of value
- Conversely, level of value from comparable public company method is widely-debated with propensity toward noncontrol
- Mixed opinions on income approach with most valuation professionals citing assumptions made about cash flows and required rate of return as determining factors
- Examples of assumptions impacting assumed level of control:
  - Officers’ compensation
  - Rent expense
  - Working capital requirements
  - Capital equipment and expenditures
- Rate of return inputs (e.g., capital structure, company-specific risk premium, growth rate, etc.)
- Explicit premium for control often applied to select indications, but must avoid double-counting
Key Questions About ESOP’s Control

- Did the ESOP pay a control-level price at inception?
- Would a third party have paid a control premium?
- How was the control-level price estimated?
- Did the ESOP receive control in form and substance?
- Does the ESOP have any influence over management of the subject company?
- What management incentive plans, if any, exist?
- What changes, if any, will be made to operations to realize the perceived benefits of control?
- Is there a call option allowing the ESOP to acquire a majority interest within specified time?
- Is creeping ownership (majority interest acquired over time) anticipated or possible?
- What is likelihood of ESOP ownership dissipation and how will it impact control?
DOL Regulations related to control premiums
Adequate Consideration / Control


- Never officially adopted.
- Federal courts have nonetheless treated the Proposed Regulation as authoritative.
- Plan purchasing control may pay a control premium.
  - “Only to the extent a third party would pay a control premium.”
  - Only where “the plan obtains both voting control and control in fact.”
  - **Retention** of prior officers, directors and shareholders as plan fiduciaries or corporate officials does not by itself defeat “control in fact.”
  - But such retention **when viewed in conjunction with other facts** may indicate that actual control has not passed to the plan.
  - Agreement to sell control to a plan in stages or increments permits control to be charged at each stage even though control has not yet passed.
Early Valuation Guidance

- The Proposed Regulation cites IRS Revenue Ruling 59-60 several times as a reference for estimating FMV.
- Factors to be considered for valuation of closely-held stock include (per § 4.01):
  - Nature and history of the business
  - Economic and industry outlook
  - Book value of stock and financial condition of the business
  - Earning capacity of the business
  - Dividend-paying capacity of the business
  - Goodwill and other intangible value
  - Prior sales of stock / size of block of stock to be valued
  - Prices of similar stocks traded on a market
DOL Control Premium Language

- Term “control premium” shows up 10 times in Department of Labor’s (“DOL”) Proposed Regulation on ESOP valuation.
- Specifically, valuations must address those items included in Revenue Ruling 59-60 and further address, “whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued, provided that in cases where a control premium is taken into account:
  - Actual control (both in form and in substance) is passed to the purchaser with the sale, or will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the sale, and
  - It is reasonable to assume that the purchaser's control will not be dissipated within a short period of time subsequent to acquisition.”
Literature on control premiums
Literature Relating to Control Premiums

- **General Valuation Literature**
Literature Relating to Control Premiums

- **General Valuation Literature (Historical)**
  - A control premium is the additional consideration that an investor would pay over a marketable minority equity value (publicly traded stock prices) in order to own a controlling interest in the common stock of the company
  - Looked to
    - State statutes on the value of control (supermajority, dissenter and dissolution rights)
    - Effect of Articles of Incorporation and Bylaws
    - Effect of Distribution of Equity Ownership
    - Potential Dilution
    - Preemptive Rights
    - Cumulative Voting Rights
    - Contractual Arrangements
    - Market evidence regarding control price premiums (Mergerstat)
Valuing a Business
Prerogatives of Control

Appoint employer corporation management
Establish employer corporation management compensation and perquisites
Establish corporate policy and business practices
Acquire or liquidate employer corporation assets
Enter into merger and acquisition transactions
Establish, maintain, or terminate contractual or other business relationships
Acquire or divest lines of business or business units
Liquidate, dissolve, sellout, or recapitalize the subject employer corporation
Sell or acquire employer corporation treasury shares
Register the employer corporation stock for an initial public offering
Declare and pay dividends

Change the employer corporation articles of incorporation or bylaws
Change the employer corporation accounting policies and fiscal year-end
Enter into borrowing arrangements
Pledge employer corporation assets as debt collateral
Enter into lease, sale/leaseback or similar arrangements
Change the employer corporation strategic direction
Change the employer corporation products/pricing policies
Make or defer capital expenditures
Make or defer R&D, new product introduction, marketing and advertising, and other expenditures
Change the employer corporation income tax status
Block any of the previous actions
Literature Relating to Control Premiums

- **General Valuation Literature (Modern)**
  - Control is indicated by ability to make adjustments to the cash flows to add value or reduce risk
  - Key differences
    - (Nath) Belief public companies trade at or near controlling interest value
    - (Nath) Premiums paid above publically stated value are synergistic or strategic
    - (Linden) Investors will not accept a lower expected return for purchase of a controlling interest than for purchase of a minority interest
    - (Damodaran) Measure control by determining the change in value from altering the way a company is operated and the probability this change will occur
Literature Relating to Control Premiums

General Valuation Literature (Modern)

Five paths to higher value

- Increase cash flows from existing assets by managing them more efficiently
- Increase expected growth rate during the high growth by either reinvesting more or reinvesting better
- Increased the length of the high growth period by augmenting existing competitive advantages or creating new ones
- Reduce the cost of capital by changing financing mix or type
- Manage non-operating assets to ensure that they do not drain from overall value

Implications

- The value of control will vary across firms
- There can be no rule of thumb on control premium
- The control premium should vary depending upon why company is performing badly
- The control premium should be a function of the ease of making management changes
Literature Relating to Control Premiums

- **ESOP Specific Valuation Literature**
  - Employee Stock Ownership Plans, Smiley et al. ed., Ch. 8, 9, App. 22 (2007)
  - Advanced Issue Brief #26, Control Premium Issues, Valuation Advisory Committee, ESOP Association.
Literature Relating to Control Premiums

- **ESOP Specific Valuation Literature**
  - (All) Track historical view superimposing DOL and IRS guidance, often justifying application of premium with regulatory language
  - (Issue Brief) Control premium is the difference in percentage or dollar terms, between the control value and the aggregate marketable minority interest
  - While mindful of DOL guidance, many discuss control in terms of percentage of ownership, including the effect of statutory protections for minority interests and “creeping control”
  - May balance inability to change intermediate cash flows with ability to sell control to outside purchaser
  - Organizational publications versus individual
Literature Relating to Control Premiums

- **ESOP Specific Valuation Literature - Outliers**
  - (Guide to ESOP Valuation) “Any additional consideration paid to purchase ownership control should be attributable to the identifiable and quantifiable economic benefits of employer corporation ownership control”
  - (Valuing a Business, Ch.32) “In some control ESOP transactions, no changes are expected to enhance cash flows. Although technically a control premium may be applied to these transactions, the application of a control premium may not be prudent.”
  - (ESOP Valuation, Ch.11) “Perhaps the most frequent culprit in over-valuations is the blind application of Mergerstat-like control premiums in valuations of small businesses…. Published control premium data frequently reflects synergistic motivations that go beyond financial considerations….”
• **ESOP Specific Valuation Literature - Outliers**
  
  (Employee Stock Ownership Plans, Ch. 9) “One reasonable interpretation [of the DOL Reg.], if the ESOP does not in fact have control, no premium should be reflected in the valuation for what an unrelated third party buyer might do differently with the company in the course of exercising his many prerogative of control.”

  (Employee Stock Ownership Plans, App. 22) “Typically the fiduciary is a passive financial investor, even in control situations.”
ESOP Specific Valuation Literature – Oddity?

“In estimating what a hypothetical third party buyer would pay, some appraisers believe we should give recognition to the facts and circumstances of the case, including any limitations that may be imposed on the ESOP as the buyer of the stock. Many of the unusual aspects of ESOPs – where elements of control may be present – result from the fact that the ESOP does not generally represent an active investor who is willing or able to make certain changes that could maximize the value of the stock. This condition may exist because the ESOP is represented by a fiduciary, and this fiduciary may be directed by an administrative committee made up of company management or employees. For example, employer corporation management may be taking excessive compensation or maintaining certain perquisites that a third-party buyer purchasing control of the company might eliminate. The ESOP, represented by its fiduciary, may choose not to force such changes. Therefore, the value of its stock would be negatively affected accordingly.”
Conclusions

• With limited exception, the general valuation literature analyzes control premiums more robustly than the ESOP-specific literature

• General valuation literature tends to be separated into historical theory (marketable minority plus premium) and modern theory (adjustments to cash flow)

• When the ESOP community discusses control premiums, the literature will always mention that control is something more than a numerical consideration of share ownership, often highlights the divergence of opinion in the valuation community, and justifies application of premium

• The top valuation experts believe that quantifying control premiums and lack of control discounts will be a major point of focus over the next decade
Court decisions on control premiums
Control defined as an interest which allows the shareholder “to determine management, distributions and corporate structure”: and decide whether to liquidate, merge or sell assets. (Estate of Newhouse v. CIR, 94 T.C. 193 at 251-252 (1990).

• These powers traditionally supported applying a control premium to a control block in order to reflect the inherent value of a control interest.
However, the Courts have recognized that the mere inherent value of a control block is not enough to validate application of a control premium.

- Must be able to show that use of voting control could be used in a way to assure an increased economic advantage worth the payment of a control premium.
- Examples:
  - Evidence that the business could be improved by better management or other changes to increase its income stream.
  - Evidence that company has been undervalued.
  - Evidence that company has interested buyers who have been willing to pay a premium for control.
  - Evidence that company would be a good merger partner and would have an enhanced financial value or synergistic value.
The question of whether a control premium is warranted for a control block depends upon the particular facts and circumstances of each case.

- Is the valuation prepared for an actual transaction or for administrative purposes using the hypothetical willing buyer/seller standard?
- ESOP or non-ESOP purposes?
- Quality of evidence submitted to establish real economic value.
Ahmanson Foundation v. U.S., 674 F.2d 761 (9th Cir. 1982).

- Government appeal from District Court decision rejecting inclusion of control premium in valuation of stock for estate tax purposes.
- Decedent owned an income interest in 11,000 shares of nonvoting HFA common stock but held a controlling interest in the voting HFA common stock (60% of all shares issued or outstanding) in a revocable inter vivos trust.
- Government argued that the 11,000 shares of nonvoting stock should be valued with control premium as a result of his voting control of HFA through trust.
Ahmanson Foundation – continued -

- HELD that government failed to show that a prospective buyer of both the control shares and the other related economic interests of decedent in HFA and its subsidiaries “would be able to use the voting control of HFA in such a way to assure an increased economic advantage worth paying a premium for.”

- Court rejected government’s argument that HFA control shares would command substantial premium in market by permitting owner to exploit corporate assets for personal advantage.
  - Such exploitation and self-dealing was highly unlikely in a highly regulated business like S&L industry.
  - Testimony was persuasive that HFA was already well managed and would not benefit economically by replacement of management team.

- Secretary of Labor sued bank trustee which served as ESOP fiduciary for breach of fiduciary duty in determining FMV of employer stock purchased by a new ESOP in an LBO transaction.
- Summary judgment granted in favor of Secretary of Labor.
- ESOP purchased a 60% block of stock in Kroy, Inc.
- One of the issues – whether the inclusion of a control premium in the purchase price was consistent with fair market value under the specific circumstances of the transaction.
- “Control is not an all or nothing matter.” Different premiums for control will be paid by purchasers holding varying degrees of control.
- Defendants alleged ESOP acquired control over membership of board of directors.
Reich – continued –

- HELD such power was never exercised and “appears to be only illusory.”
- Defendants also claimed that a control premium was appropriate because the ESOP acquired a put option which permitted the employee to sell his stock back to the company at a control value.
- HELD payment of a control premium for a put right was not prudent without consideration of the terms under which the company would pay the repurchase obligation, the time of repayment, the company’s short-term liquidity and long-term ability to finance its debt and the company’s financial history of repayment and continued viability.
- Here the transaction price rendered the company so shaky that survivability of the company was in doubt at the time of the transaction.
- Failure of the ESOP valuator to consider the likelihood of the company’s solvency and ability to finance debt post-transaction rendered control premium inconsistent with FMV.
Estate of Richard Simplot v. CIR, 249 F.3d 1191 (9th Cir. 2001).

- Estate tax deficiency lawsuit involving whether the valuation of decedent’s stock in a family controlled company should include a control premium.
- Two classes of stock with different voting and liquidation rights created a complex factual dispute as to whether decedent ever held control.
- Government argued control acquired because hypothetical buyer of decedent’s shares would obtain “inherent potential for influence and control” by gaining access to inner circle of family-owned company.
Estate of Richard Simplot – continued -

- Citing Ahmanson, Court held control premium should be excluded in valuation unless it is established that the purchaser would be able to use control in a way that **assures it would derive an increased economic benefit**.
- Government’s argument was **mere speculation** how a hypothetical buyer could use a future strategy to derive an increased economic benefit and is not a proper method of valuation.
- **TAKE AWAY FROM CASE** – a control premium requires evidence not speculation as to how a hypothetical buyer will derive an increased economic benefit from his ownership.
**Eckelkamp v. Beste, 201 F. Supp. 2d 1012 (E.D. Mo. 2012).**

- ESOP participants of a 100% owned ESOP company alleged that annual ESOP valuations understated value of company or that ESOP should have received dividends.
- Primary claim was that three executives who were ESOP trustees took unreasonable and excessive executive compensation.
- ESOP participants also argued that valuations failed to include a 15% control premium based on a database review of over 2,894 transactions involving purchase of controlling interests in public companies.
- Court distinguished between valuation for transaction purposes and for ESOP administrative purposes.
Eckelkamp – continued -

- Application of a control premium assumes that a company is for sale and what a prospective buyer might pay for control “in order to make changes to increase profitability” (citing Simplot).
- Court held control premium was not proper here because:
  - No evidence presented of a hypothetical buyer lurking in bushes waiting to snap up company.
  - No changes in company were expected to enhance cash flow since this small company was run efficiently and profitably.
  - In a controlled ESOP situation where no changes are expected to enhance cash flow, control premium may not be prudent.
  - Presupposing a sale for an administrative valuation is directly contrary to goals of employee ownership.
Eckelkamp – continued -

• Is this decision reliable?
  - ESOP paid for control when it acquired 100% of company.
  - Does it make sense to exclude control premium for administrative valuations thereafter absent plan language mandating same (see Foltz v. U.S. News & World Report, 865 F.2d 364 (D.C. Cir. 1989))?
  - Should there be distinction between transaction and administrative valuation?

• Key to decision – company cannot have its cash flows enhanced merely by reason of a change in control.

- Creditor action in bankruptcy to recover from affiliated corporations of debtor for alleged fraudulent conveyances.
- Battle of valuation experts using DCF and comparable company methods with inclusion or exclusion of control premium.
- Control was assumed and not disputed.
- Court rejected plaintiff’s expert testimony utilizing control premiums based upon database evidence of public companies because there was no evidence of the existence of prospective purchasers or that any prospective purchaser would be willing to pay a control premium for the business valued.
Lippe – continued –

• HELD expert conclusions amounted “to no more than theoretical speculation.”

• TAKE AWAY FROM CASE – evidence of even 100% control is not enough to validate the application of control premium.
Chesemore v. Alliance Holdings, et al., Western District Court of Wisconsin, No: 09-cv-418-wmc, Doc. 790.

- District court trial and judgment granted for Trachte ESOP in amount of $7.8 million.
- ESOP transaction in 2007 under which sellers were paid over $40 million for 100% ownership of Trachte Corporation’s total equity.
  - Defendants argued purchase price was fair because no control premium was charged.
  - HELD that overly aggressive and unrealistic projections used in the DCF analysis were the equivalent of charging a control premium.
  - The aggressive projections were unrealistic since Alliance had aggressively expanded Trachte’s sales from 2002 through 2007 with no material increase in total net profits to show for it in anticipation of a company sale “and did so in what was already a mature market with little or no prospect for further growth.”
Current thought in the valuation community
Converging Concern Over Control Premiums

- The valuation community is being encouraged by the IRS, SEC, and other authoritative entities to improve support for, and estimation of, control premiums (and conversely, discounts for lack of control)

- ESOP transactions and valuations subject to increasing DOL scrutiny stemming from perceived versus actual control
“With respect to analyzing the implied “control premium,” the SEC staff does not apply a bright-line test and understands that the application of judgment can result in a range of reasonably possible control premiums. Whether the analysis is quantitative, qualitative or some combination thereof, the SEC staff expects objective evidence to support the judgments that the implied control premium is reasonable. The SEC staff could request support for the implied control premium, including any identified transactions. The use of a “rule of thumb” to support the implied control premium would not provide sufficient evidence. The SEC staff also expects the amount of documentation supporting the implied control premium to increase as the control premium increases.”

- Remarks before the 2008 AICPA National Conference on Current SEC and PCAOB Developments by Robert G. Fox III, Professional Accounting Fellow, Office of the Chief Accountant U.S. Securities and Exchange Commission
On April 16, 2013, nearly one year ago to the day, the Appraisal Practices Board (“APB”) of The Appraisal Foundation released a non-binding discussion draft, entitled “The Measurement and Application of Market Participant Acquisition Premiums”.

The purpose of the discussion draft is to provide best practices support for preparing fair value measurements; however, it has been well-received by the valuation community as guidance for applying and estimating control premia.
Public Company Comparisons

• White paper suggests indicated values based on public company comparison may already reflect prerogatives of control (previously thought to represent a noncontrolling level of value)
• Concept based on relatively inactive M&A market for public companies and premise that public companies are typically run at or near full potential
• Therefore there may be little or no difference between publicly-traded, minority interest price and control value (see next slide)
Levels of Value Revisited

- Can / should the ESOP pay more at time of acquisition than the marketable minority value?

2. Ibid.
Monetizing Control

- White paper further suggests the prerogatives of control have no inherent value; rather, it is what’s done with the prerogatives to increase economic benefit and/or reduce operational risk that determines the existence and magnitude of a control premium.
- The probability of exercising rights to enhance economic benefit and/or reduce operational risk must also be considered; it does not matter what a third party would do if the specific buyer (e.g., an ESOP) has no intention of properly deploying the prerogatives of control.

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<thead>
<tr>
<th>Enhanced Cash Flow:</th>
<th>Lower Required Returns:</th>
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<tbody>
<tr>
<td>Superior revenue growth</td>
<td>Optimized capital structure</td>
</tr>
<tr>
<td>Increased margins</td>
<td>Company size and diversification benefits</td>
</tr>
<tr>
<td>Working capital efficiencies</td>
<td>Reduced operating risk</td>
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<tr>
<td>Capital expenditure efficiencies</td>
<td>Investment strategy improvements</td>
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</table>
Paying for Entire Control Premium

- Assuming economic benefits of control exist and can be monetized, it is imprudent to assume a buyer will pay a seller for all of the benefits

- To do so would give all of the upside to the seller
Business Characteristics Influencing Control Premium

• It is important to assess the reasonableness of the assumed economic benefits in the context of the characteristics of the subject company and the industry in which it operates. Considerations include:
  • Acquisition activity in the industry
  • Stage in company life cycle
  • Market participants types (strategic, financial, other)
  • Size of market participants relative to subject company
  • Transaction structure
  • Capital structure of subject entity
  • Management objectives
  • Quality of management
  • Regulatory factors
  • Corporate governance
Current actions by the DOL in ESOP cases involving control premiums
Control premium is improper or must be sharply discounted where Stock Voting Agreement ("SVA") signed by ESOP trustee in connection with its stock purchase of controlling interest prevents ESOP from exercising voting control for a period of years.

- Complaint filed by Secretary of Labor in *Perez v. PBI Bank, Inc., et al.*, Civil Action No. 3:13 CV 1400, in the Northern District of Indiana, South Bend Division, filed December 26, 2013.
- Involved $40 million ESOP stock purchase of 100% of equity in Miller’s Health System Inc.
• ESOP paid control premium but signed SVA which caused the Board of Directors to be comprised of selling shareholders and parties in interest while the Shareholder Loan remained outstanding (10 years).

• Similar position taken by Secretary in her Complaint styled *Solis v. First Bankers Trust Services, Inc.*, Civil Action No. 12 CIV 8649 in the Southern District of New York, filed November 28, 2012.

• Rembar ESOP paid $15.5 million for 100% of company equity from selling shareholders and signed Limitation Agreement that prevented ESOP from voting to remove the current board of directors as long as the Seller Subordinated Note was outstanding.

• See Decision denying Motion to Dismiss in *Solis v. First Bankers Trust Services, Inc.*, *supra*, filed January 13, 2014.
Control premium is an error and in fact duplicative in an ESOP appraisal using a management forecast which was prepared on a controlling interest basis rather than a minority interest basis.

- Preparation of forecast on controlling interest basis was evidenced by decision to exclude any discretionary compensation for the Chief Executive Officer after the ESOP transaction in the cash flow used by the ESOP valuator.
- This failed to take into account cost of obtaining and maintaining services of the CEO who previously had been compensated largely through discretionary compensation.
ESOP fiduciaries must reject a 15% control premium to the price paid by an ESOP in a stock purchase of 100% of the Omni equity where the valuator’s capitalization of earnings methodology is based upon and produces a control value and thus addition of a control premium is duplicative.

- Valuation performed five months before the stock purchase used projections that were 68% higher than actual performance through the month preceding purchase.
• Declining revenues should have been expected since Omni lost its single largest client and monthly staffing levels were declining along with industry prospects.

• *See Complaint in Perez v. Veronica Mueller, Civil Action No. 13-C-1302, filed in the Eastern District of Wisconsin, Milwaukee Division, filed November 18, 2013.*

• Secretary also alleged that any control premium in transaction was inappropriate because stock purchase agreement required the ESOP to keep primary selling shareholder Veronica Mueller as an officer, director and employee of Omni.
TAKE AWAY FROM THESE ENFORCEMENT ACTIONS.

- DOL is aggressively pursuing the perceived problem of appraisers accepting management projections of future earnings without assessment of their reasonableness.
- Unreasonable projections are being perceived by DOL as controlling interest cash flows in valuation methodologies and thereby producing the result of a control value before addition of a control premium.
- Any agreements that restrict ESOP trustee from removing selling shareholders from the Board of Directors post-transaction preclude the ESOP from acquiring “actual control” and prevent charge of a control premium in transaction price.
ESOP Control Premiums

- Case law and best practice treatises dictate the application and size of control premiums must be thoroughly evaluated and not arbitrarily assessed to a large block of stock.
- Control premiums are a function of the economic benefit / reduced operating risk to be realized upon acquiring control and the likelihood that necessary changes in management will occur; they should be quantified to the extent possible.
- The ESOP may pay a control premium if a third party would also pay such a premium; however, a premium may not be warranted if no economic benefit will be realized relative to the noncontrolling level of value.
- It is imprudent to pay a control premium based on total economic benefit; doing so would cede the entire reward and excessively enrich the seller.
Discussion of hypotheticals