Top Five Reasons You Should Consider Changing Your ESOP Valuation Firm

By Hillary Hughes

Typically, companies that sponsor an Employee Stock Ownership Plan ("ESOP") for the benefit of their employees are private companies whose shares are not traded on a public stock exchange. However, the Department of Labor ("DOL") requires that an independent third-party valuation expert issue an opinion regarding the fair market value of the ESOP stock at least annually.

At the formation of the ESOP, the Board of Directors appoints a trustee ("Trustee") of the ESOP, a qualified retirement trust. It is ultimately the Trustee's duty to determine the fair market value of the stock held by the ESOP. In other words, it is the Trustee's duty to hire an appraiser and to make a good faith judgement, based on the information provided in the valuation report, in order to determine the fair market value of the stock.

The Trustee's decision to select an appraiser is not one that should be taken lightly. This is because the law imposes a fiduciary duty on the Trustee to act in the best interest of the ESOP and its participants and beneficiaries. Some would say there is no greater duty under the law than to be an ERISA fiduciary. Indeed, the DOL has entered into several settlement agreements with institutional ESOP Trustees that highlight the importance of thorough and frequent vetting of the independent appraiser. Oftentimes, there are many important reasons why a Trustee should actually consider replacing the incumbent appraiser, including:

1. **Problems with the Valuation Report**—This may be the most common reason why a Trustee should consider changing its appraiser. There are an indefinite number of reasons and circumstances as to what could be considered a "problem" with the valuation report. Some of the more common issues include:
    - Inconsistent valuation conclusions
    - Inappropriate discounts and adjustments
    - Lack of thorough analysis, documentation and valuation reconciliation

- Errors or omissions
- Mathematical and/or logic errors

2. **Independence & Conflicts of Interest Issues**—The appraiser should be independent of the company and the members of the board of directors. A common conflict of interest arises when the appraiser performs work not only on behalf of the ESOP, but also for the company, board or related party. It is important that the appraiser only represents the Trustee. For Trustees that have multiple roles within a company (such as management, Board Member, shareholder/former shareholder), distinguishing the appraiser's independence is even more critical.

3. **The Incumbent Appraiser is Exiting the ESOP Appraisal Business**—Several ESOP appraisers have recently exited the business or are no longer actively pursuing ESOP-related engagements. This is largely due to increased scrutiny by the DOL. The DOL enforces the Employee Retirement Income Security Act ("ERISA"), which, in turn, governs ESOPs. The DOL has recently increased litigation and subpoena activity related to ESOPs (for example, see *Perez v. GreatBanc Trust Company, Sierra Aluminum Company and the Sierra Company Employee Stock Ownership Plan*). Given heightened scrutiny by the DOL, some appraisers have decided they do not want to risk that their work product may be challenged by the DOL. Also, we have seen some appraisers exit the business due to retirement; this may be the single greatest risk of a sole- or small-practitioner firm.

4. **Qualifications**—Most importantly, the ESOP appraiser should have significant experience issuing valuation reports for ESOPs. A Trustee should also review the appraiser's designations, certifications, activity and participation in ESOP trade organizations, published papers as well as any speeches given by the appraiser. Further, the appraiser should have a thorough working knowledge of general ESOP plan design, administration, accounting and financing. These aspects all have an impact on the cash flow stream and embedded assumptions about retirement benefit levels and repurchase obligation funding. Appraisers should be able to defend their work product to not only the Trustee but also to any outside party, including the DOL, and it may be difficult to do so without proper qualifications. Consideration should be given to the depth of the practitioner's knowledge and experience of the broader firm.

5. **Lack of Advice**—Too often an appraiser simply delivers the valuation report. However, a thoughtful appraiser should also be prepared to give consultative advice, be it solicited or unsolicited. The appraiser should have a wealth of ESOP and business experience from which to draw meaningful advice for the Trustee and company they are valuing.

While there are many reasons why a Trustee should consider a change to their appraiser, this article outlines five common reasons why a change should be contemplated. Changing an appraiser may not be easy, but it can be incredibly important, especially if the Trustee has identified material errors or peculiarities in the valuation report provided by their existing appraiser. The best practice is for Trustees to carefully vet their appraiser on an annual basis.

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