The ESOP Association

TEA's Proposal for a U.S. Department of Labor Regulation Regarding the Definition of Adequate Consideration

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I. Preamble

Notice is hereby given of a proposed regulation ("Proposed Regulation") under Sections 408(e) and 3(18)(B) of the Employee Retirement Income Security Act of 1974 ("ERISA" or the "Act").

A. Background

In enacting ERISA, Congress established the legal framework for a type of employee benefit plan known as "employee stock ownership plans," or "ESOPs," which invest primarily in qualified employer securities. Congress has repeatedly encouraged employers to create ESOPs by, among other things, providing unique tax incentives and by exempting ESOPs from certain of ERISA's rules and regulations.[1]

Section 408(e) of the Act is one such exemption. It provides that the prohibited transaction rules found in Section 406 do not apply to the acquisition or sale by a plan of qualifying employer securities if, among other things, such acquisition or sale is for adequate consideration.[2]

The term "adequate consideration," in the context of securities for which there is not a recognized market, is defined in Section 3(18)(B) of ERISA as "the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary [of Labor]" (the "Adequate Consideration Exemption").[3] ERISA does not further define the components of the Adequate Consideration Exemption, including "good faith" and "fair market value."

A regulation further defining this broad statutory standard is crucial to promoting Congress's goal of encouraging the proliferation of ESOPs.[4] More specific guidance will ensure that ESOP fiduciaries, plan sponsors, service providers, and parties transacting with ESOPs are able to satisfy ERISA's obligations, thereby adequately protecting ESOP participants' interests. This regulatory certainty will encourage companies and their shareholders to establish new ESOPs and reverse the years-long deceleration in the growth of employee ownership, which has been driven largely by the current nebulous statutory standard.

B. Description of Proposal

This Proposed Regulation is divided into three major parts. Section (b) states the general rule and delineates the scope of the Proposed Regulation. Section (c) addresses "good faith" and describes the process that should be followed in assessing the terms of a proposed transaction that may fall within the scope of the Adequate Consideration Exemption. Section (d) discusses certain applications of the fair market value standard to transactions that may fall within the scope of the Adequate Consideration Exemption.

1. Overview and Scope of Regulation

The Proposed Regulation mirrors the language of the Adequate Consideration Exemption found in Section 3(18)(B) of ERISA. To fall within the scope of the Adequate Consideration Exemption, the price must be for no more than (in the case of an ESOP purchase) or no less than (in the case of an ESOP sale) the fair market value of the asset as determined in good faith by the trustee or named fiduciary (defined as the "Discretionary Fiduciary" in subsection (a)(5)). Section (c) of the Proposed Regulation delineates the process that the Discretionary Fiduciary should follow in order to satisfy the "good faith" portion of the exemption. Section (d) then provides an overview of specific applications of the fair market value standard in the context of ESOP transactions.

The Department's intention in providing separate sections of the Proposed Regulation for "good faith" and "fair market value" is not to create a distinct two-pronged test focusing on a *de novo* determination of fair market value; rather, the Department's view is that the Adequate Consideration Exemption is inherently process-based; that the good faith and fair market value concepts are inextricably intertwined; and, consequently, that the appropriate inquiry focuses on whether the price paid for the asset results from the Discretionary Fiduciary's good faith effort to determine the fair market value of the asset. That a *de novo* review by a court or another appraiser could have reasonably resulted in a different conclusion of value is insufficient for a transaction to fall outside the scope of Section 408(e).

The Department has structured the Proposed Regulation in this manner for several reasons. *First,* the Department recognizes that Section 408 exemptions are specifically referenced in Section 406's prohibited transaction rules.[5] As such, the Department reads the structure of ERISA's prohibited transaction rules to specifically exempt, without exception, any transaction that would otherwise be prohibited if such transaction meets the exemption in Section 408(e). In other words, if the transaction meets the Section 408(e) exemption, then Section 406 of the Act does not apply. Therefore, the Department believes that any review of a transaction that falls within the scope of Section 406 must begin by determining whether the transaction satisfies the exemption in Section 408(e).[6]

Second, it is the Department's view—consistent with case law addressing the issue—that the Adequate Consideration Exemption's requirements are co-extensive with the fiduciary duties set forth in Section 404(a) of the Act, as both concern ***the process*** a fiduciary employed in reaching a conclusion of fair market value. This view is consistent with the manner in which courts have viewed the Section 408(e) exemption.[7] Thus, the Discretionary Fiduciary satisfies Section 3(18)(B) of the Act if the Discretionary Fiduciary employed a prudent process in determining the asset's fair market value, even if a court or another appraiser conducting a *de novo* appraisal might disagree with the ultimate price paid in the transaction.[8]

Finally, in crafting the "fair market value" standards in Section (d) of the Proposed Regulation, the Department does not intend to alter the meaning of that term as used in the business valuation industry more broadly. Given the discrete issues that often arise in transactions that fall within the scope of Section 408(e) exemption, the Department wishes only to provide Discretionary Fiduciaries with examples of specific applications of the "fair market value" standard in these circumstances.

2. Good Faith

Good faith requires that the Discretionary Fiduciary employ a prudent process in determining an asset's fair market value before causing an ESOP to enter into a transaction. That process includes considering all material facts and circumstances as they were known or reasonably knowable to the Discretionary Fiduciary at the time it determines the asset's fair market value. Any facts or circumstances occurring after the close of a transaction will not be considered when determining whether the Discretionary Fiduciary acted in good faith.

To create a presumption that it has satisfied the adequate consideration standard and acted prudently, a Discretionary Fiduciary must satisfy four elements. *First,* the Discretionary Fiduciary should engage a qualified valuation advisor to provide an opinion of fair market value. The definition of "qualified" corresponds with Treasury Regulation 1.170A-13(c)(5) and is satisfied if the appraiser holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis, and is otherwise qualified to conduct appraisals of employer securities. The Proposed Regulation also specifies that, regardless of whether the definition of "qualified" is otherwise met, certain individuals or entities may not serve as an appraiser for a proposed transaction under any circumstances. The Department has included these exceptions given the inherent conflicts of interest that the listed individuals or entities may have with other parties in interest to the proposed transaction.

Second, the Discretionary Fiduciary may only rely on an appraiser's opinion if the Discretionary Fiduciary reasonably believes that the appraiser has had access to all material information the appraiser requires. The Discretionary Fiduciary may not restrict the appraiser's ability to obtain material information and, instead, must use its position to assist the appraiser in obtaining any such information.

Third, the Discretionary Fiduciary must ensure that the appraiser creates a written report outlining the appraiser's opinion (the "Valuation Report"). Such a report should include the information described in subsections (c)(2)(C)(i)¬–(x). The Department believes that this information should be reviewed by an appraiser in every instance and, therefore, a Discretionary Fiduciary cannot rely on an appraiser's opinion if the Valuation Report does not address all of the topics listed in subsections (c)(2)(C)(i)¬–(x).

Fourth, the Discretionary Fiduciary should, after reviewing the Valuation Report and understanding its contents, create its own written document reviewing the appraiser's analysis and opinion as to the asset's fair market value (the "Appraisal Review"). The Appraisal Review should include the information described in subsections (c)(2)(D)(iii)(a)–(c). The Department does not intend to require the Discretionary Fiduciary to conduct its own analysis of the asset's fair market value or become an expert in appraisals.[9] Rather, the Department believes that, by creating an Appraisal Review that includes the information described in subsections (c)(2)(D)(iii)(a)–(c), the Discretionary Fiduciary will ensure that it has reasonably reviewed the Valuation Report such that relying on it is reasonable.

3. Fair Market Value

The Adequate Consideration Exemption's use of the phrase "fair market value" reflects Congress's intent that a Discretionary Fiduciary apply that well-known and well-understood standard of value when determining the price at which it is appropriate to cause an ESOP to enter into a transaction. The Proposed Regulation adopts the generally accepted definition of fair market value: the price at which an asset would change hands between a hypothetical willing buyer and a hypothetical 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 such asset. Fair market value is determined as of the date of a transaction, based on information that was known or knowable to reasonably informed market participants.

As outlined in Section (d) of the Proposed Regulation, the Department acknowledges that there is no single, objectively correct conclusion of fair market value of a closely held company. Instead, because determining the fair market value of an asset for which there is no recognized market is an inexact science, the Department has long recognized that an appraiser's determination of fair market value should be expressed as a range of values and that different appraisers may reach different concluded ranges of values for the same asset.[10]

Moreover, because fair market value is analyzed from the perspective of a hypothetical willing buyer and a hypothetical willing seller who are both well-informed regarding the asset and under no compulsion to buy or sell, appraisers should not consider attributes of the actual buyer or seller when analyzing fair market value. The Proposed Regulation addresses certain specific applications of this principle in subsection (d)(3).

The Department does not intend for the Proposed Regulation to alter the meaning of fair market value as that term is used in the investment and valuation industries. To the contrary, the Department intends for Discretionary Fiduciaries and the appraisers on whom they rely to follow the well-delineated standards used in valuations.

Finally, the Department recognizes that certain discrete issues arise in the context of ESOP transactions. The Proposed Regulation addresses these issues in Section (d)(3). Further discussion of certain of these issues follows.

Acquisition debt in leveraged stock purchase transactions. Subsection (d)(3)(A)(i)(c) describes the Department's position that, as a result of the hypothetical nature of the fair market value standard, the manner in which a given transaction is financed—*e.g.,* whether a proposed transaction is financed with all cash, all debt, or a combination of the two—does not affect the subject asset's fair market value. This is consistent with how the Department and courts have long applied the fair market value standard in the context of ERISA Section 3(18)(B) transactions.[11]

Cost of acquisition debt in leveraged stock purchase transactions. Subsection (d)(3)(A)(i)(a) describes the Department's position that, not only should an appraiser not deduct the amount of an ESOP's acquisition debt from its conclusion of a company's fair market value, but an appraiser also should not deduct *the cost* of that debt.[12]

Interest paid to a lender is a common example of the cost of debt. However, a borrower may finance a transaction with instruments other than interest. For example, in non-ESOP transactions, it has long been common for borrowers to pay the cost of financing using warrants, additional interest, or performance-based payments. The same is true in the ESOP space, where it is common for sponsor companies to finance ESOP stock purchases using subordinated debt paid for with a combination of promissory notes and warrants.

Warrants, as most often used, give the holder the right at some future date to receive cash equal to the difference between the warrants' negotiated strike price and a company's share price. Parties to ESOP transactions typically couple warrants with a promissory note carrying an interest rate that is low relative to market rates, either because the senior lender will not allow cash to leave the company before being repaid, the transacting parties wish to give the ESOP sponsor financial flexibility to operate the business, or the company's cash flow would be stressed by a market interest rate. Used in this way, warrants operate as a form of interest—deferred, variable interest—which the borrower uses to pay the cost of debt. Warrants are thus a cost of financing that do not, under the hypothetical buyer standard, impact the sponsor company's fair market value at the time of an ESOP stock purchase so long as the warrants, when combined with any other tools for paying the lenders a return, such as the stated interest rate on an associated promissory note, yield a rate of return that is no greater than the market rate of return for similar debt.[13]

The Department acknowledges that there are many ways in which an ESOP can benefit from a financing structure that includes subordinated debt and warrants: warrants can relieve cash flow pressure on the sponsor company by reducing its fixed interest obligation; shift the risk of future economic uncertainty away from the sponsor company and onto the lender; and, in situations where the subordinated lender also has a role in company management, align the ESOP's and lender's economic incentives by ensuring that each are acting to improve the value of the sponsor company's stock.[14]

The ability to use warrants to shift risk away from the ESOP sponsor (as borrower) and onto the warrant holder (as lender) is particularly beneficial to ESOPs. In many leveraged ESOP transactions, the cost of interest-only subordinated debt may be 15 to 20 percent. Should the sponsor company underperform expectations and realize lesser cash flows than anticipated, the sponsor company nevertheless remains obligated to repay this interest expense in full. An ESOP sponsor using warrants not only pays a lower interest rate for its subordinated debt, it shifts the underperformance risk onto the warrant holder—that is, the warrants are only valuable insofar as the sponsor company is profitable. If the sponsor company underperforms, it will pay less to the warrant holder and may pay nothing at all.

Control premiums and discounts. Subsection (d)(3)(B) addresses valuation issues related to control. There are two major topics at the center of disagreements involving control: what it means for an ESOP to have control, and how to value a controlling or noncontrolling ownership interest in company stock.

First, appraisers must consider the extent to which a block of stock acquired by an ESOP carries control rights that one could use to impact a company's cash flows.

It is well established that control is not binary—*i.e.*, all-or-nothing—but exists on a spectrum such that one may possess, and derive value from, various indicia of control without having full and outright control.[15] As a general matter, an ESOP obtains "control" of a company to the extent it obtains the number of shares required to influence matters put to a shareholder vote.[16] The Department is aware that some have argued that, regardless of the percentage ownership interest acquired, an ESOP does not obtain control of the sponsor company where the ESOP's trustee is a "directed trustee"—that is, where the ESOP's governing documents require the trustee to vote shares as directed by a person or committee affiliated with the sponsor company.

This position is misguided because it ignores at least two well-established principles. *First,* it ignores that directed fiduciaries may not follow directions that are contrary to a plan's terms or to ERISA's fiduciary obligations.[17] *Second,* it ignores the core ERISA principle that "ERISA [fiduciaries] may wear different hats."[18] Applying this principle, it is the Department's view that the identity of the person with discretion to vote shares held by an ESOP is irrelevant. Regardless of where voting discretion lies, it is—and long has been—the Department's position that the person or entity exercising that discretion does so subject to ERISA Section 404(a)'s fiduciary duties of prudence and loyalty.[19] Consequently, a party directing a trustee is bound by ERISA's fiduciary obligations to vote the ESOP's shares prudently, solely in participants' interests, and consistent with the governing plan documents, meaning that the ESOP's control is unaffected by the identity of the person exercising voting discretion. Subsection (d)(3)(B)(ii) makes explicit that it is inappropriate to reduce an appraiser's conclusion of fair market value based on this and certain other circumstances that parties to ESOP lawsuits have erroneously argued restrict an ESOP's control rights.

Second, appraisers must consider the extent to which the ESOP's control rights, or lack thereof, affect value—if at all.

The Department is aware that ESOP appraisers have sometimes applied a percentage premium (or discount) to a block of shares based solely on the extent to which the shares possess (or lack) certain well-known indicia of control.[20] These appraisers typically select the percentage premium or discount without directly tying it to the amount of additional earnings the shareholder would actually obtain by exercising its control rights.

In the Department's view, valuing control rights in this way is inconsistent with the generally accepted valuation principle that an ownership interest's value is positively correlated with the earnings it allows the holder to achieve. In other words, control rights are valuable, not intrinsically, but only insofar as a shareholder could exercise them to increase a company's earnings in a way that the shareholder could not as a noncontrolling owner.[21] Consequently, it is the Department's view that an appraiser should value the stock being acquired by the ESOP based on the cash flows that would be expected to be received by a reasonably informed hypothetical buyer that would enjoy the projected level of earnings as being obtained by the ESOP.

It is important to note that, in many instances, ***there is no difference in value*** between ownership interests with different control rights. For example, a well-managed business that earns margins consistent with (or better than) industry peers may present little opportunity for a prospective control owner to generate incremental economic benefits through the exercise of those control rights. Moreover, unless a company's financial projections or forecasts reflect adjustments for control or lack thereof, the financial projections or forecasts are considered the company's "as-is" cash flows, or "actual cash flows of the [sponsor company that] thus already value the [sponsor company] from a minority or non-controlling standpoint."[22]

In such a scenario, Subsection (d)(3)(B)(i)(b) acknowledges that there is no difference in value to majority or minority shareholders—the company's cash flows are control neutral.[23, 24]

Guideline public company method. Subsection (d)(3)(C) acknowledges that an appraiser applying the guideline public company method must exercise professional judgment to derive a conclusion of value. As a consequence, two appraisers acting reasonably may decide to apply the method differently and/or reach different conclusions of value, without either appraiser being incorrect. While these principles hold true for virtually all aspects of valuation of closely held companies, this section is designed to encourage appraisers to use, and fiduciaries to accept, the guideline public company method without fear of defending challenges to the appraiser's exercise of professional judgment rooted only in another appraiser's *ipse dixit*.[25]

Terminal value in the discounted cash flow method. Subsection (d)(3)(D) is designed to acknowledge that calculating a company's terminal value in a discounted cash flow method requires an appraiser to exercise its professional judgment when selecting both the method (*e.g.*, Gordon growth method, exit multiples) and inputs (*e.g.*, growth rates, multiples) for valuing the terminal period. As with many other aspects of valuation, that different appraisers may select different methods or different inputs does not alone suggest that either appraiser's approach is unreasonable or conclusion of value is inaccurate.

Discounts for lack of marketability. The Department understands that, historically, appraisers in ESOP transactions have generally applied a minimal discount for lack of marketability to the fair market value of stock acquired by an ESOP. Subsection (d)(3)(E) reflects that, in the Department's view, it often is not necessary to apply ***any*** marketability discount in an ESOP stock purchase transaction. The reason is an ESOP sponsor's statutory obligation to repurchase stock (otherwise known as a "put option" or "repurchase obligation"), which guarantees participants an avenue to liquidate their shares.[26] In the Department's view, the put option significantly mitigates—or eliminates—the need to apply a marketability discount.

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II. Proposed Regulation

(a) Definitions.

(1) The term "Act" means the Employee Retirement Income Security Act, 29 U.S.C. §§ 1001 *et seq*.

(2) The term "Qualifying Employer Securities" has the same meaning as provided in Section 407(d)(5) of the Act. See 29 U.S.C. § 1107(d)(5).

(3) The term "Regulation" means the below standards further defining "adequate consideration" as used in Sections 408(e) and 3(18)(B) of the Act.

(4) The term "Department" means the Secretary of the Department of Labor.

(5) The term "Discretionary Fiduciary" means the trustee or the named fiduciary of the plan.

(6) The term "Qualified Appraiser" means, consistent with Treasury Regulation § 1.170A-13(c)(5), an appraiser who states to the Discretionary Fiduciary engaging the advisor that the person either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis, and the person is qualified to make appraisals of Qualifying Employer Securities.

(A) **Exclusions.** The following are excluded from serving as a Qualified Appraiser:

(i) The seller in a proposed transaction;

(ii) Any other party to the proposed transaction (including the plan sponsor);

(iii) Any person who is an employee of any party in the proposed transaction;

(iv) Any person with a lineal familial relationship to any party in the proposed transaction; and

(v) Any person who performed a majority of his or her appraisal work in the prior tax year for parties to the proposed transaction.

(7) The term "Valuation Report" means the Qualified Appraiser's written analysis of the fair market value of the Qualifying Employer Securities that contains the information described in subsection (c)(2)(C) of this Regulation.

(8) The term "Appraisal Review" means the Discretionary Fiduciary's written analysis of the Valuation Report containing the information described in subsection (c)(2)(D) of this Regulation.

(b) In General.

This Regulation provides guidance regarding the definition of "adequate consideration" as used in Sections 408(e) and 3(18)(B) of the Act.

(1) Section 406(a) of the Act expressly incorporates Section 408(e). Section 408(e) provides that Sections 406 and 407 shall not apply to the acquisition or sale by a plan of Qualifying Employer Securities if, among other things, such acquisition or sale is for adequate consideration. Section 3(18)(B) provides that, in the case of a plan asset other than a security for which there is a generally recognized market, the term "adequate consideration" means the fair market value of the asset determined in good faith by the Discretionary Fiduciary of the plan and in accordance with the regulations promulgated by the Department.

(2) The Department recognizes that, in integrating Section 408's exemptions into Section 406(a)'s prohibitions, Congress expressly intended that the prohibitions in Section 406(a) would not apply to transactions that satisfy the elements of Section 408. Thus, in the Department's view, any review of a transaction involving the acquisition or sale by a plan of Qualifying Employer Securities must begin with determining whether the elements of Section 408(e) have been satisfied. If so, the prohibitions of Section 406(a) do not apply.

(3) The Department views the requirements of Section 408(e) of the Act as co-extensive with the fiduciary duties set forth in Section 404(a) of the Act. Thus, a Discretionary Fiduciary satisfies the exemption in Section 408(e) by employing a prudent process in deciding to cause a plan to enter into a transaction involving Qualifying Employer Securities.

(4) The requirement in Section 3(18)(B) that transaction consideration must reflect "the fair market value" of the sponsor company does not alter the process-based nature of the Section 408(e) exemption. A Discretionary Fiduciary will not be liable where its prudent process caused the ESOP to pay what a court later determines was more than fair market value. Rather, Section 3(18)(B) expressly intertwines the concept of fair market value with the Discretionary Fiduciary's "good faith" determination of value. Thus, in the Department's view, when determining whether Section 408(e)'s exemption applies to a given transaction, the relevant inquiry will focus on whether the price paid for the asset results from a prudent, good faith process for determining fair market value and not whether a *de novo* review of the asset's fair market value would yield a different conclusion of value.

(c) Good Faith.

The requirement in Section 3(18)(B) of the Act that a Discretionary Fiduciary must determine the fair market value in good faith establishes an objective standard that is analyzed in light of all of the material information reasonably available to the Discretionary Fiduciary at the time it causes a plan to enter into a transaction.

(1) *Standard.* A Discretionary Fiduciary meets the good faith requirement by reasonably relying on legal and valuation advisors to assist in the Discretionary Fiduciary's due diligence process and assessment of the range of fair market value of the subject Qualifying Employer Securities. A Discretionary Fiduciary reasonably relies on advisors if the Discretionary Fiduciary:

(A) Engages qualified advisors;

(B) To the best of its ability, strives to ensure that the qualified advisors have access to all material information that the advisors request in writing;

(C) Ensures that the qualified advisors explain their conclusions orally and in writing; and

(D) Reviews those conclusions for reasonableness.

(2) *Elements.*

(A) **Engaging a Qualified Appraiser.** A Discretionary Fiduciary satisfies the elements of subsection (c)(1)(A) with respect to a valuation advisor if the Discretionary Fiduciary engages a Qualified Appraiser.

(B) **Access to material information.** Pursuant to subsection (c)(1)(B) of the Regulation, a Discretionary Fiduciary ensures that a Qualified Appraiser has access to all material information if the Discretionary Fiduciary acts within the extent of its authority and to the best of its ability to facilitate the Qualified Appraiser's acquisition of all material information that it requests. A Discretionary Fiduciary will not rely on a Qualified Appraiser's opinion if the Discretionary Fiduciary actually knows that the Qualified Appraiser did not have all material information in forming its conclusion of value.

(C) **Written conclusions.** Pursuant to subsection (c)(1)(C) of the Regulation, a Discretionary Fiduciary ensures that a Qualified Appraiser explains its conclusion in writing if the Qualified Appraiser provides a written Valuation Report that contains the following information:

(i) Methodology. A description of the methodologies the Qualified Appraiser used to determine the range of fair market value of the Qualifying Employer Securities and an explanation of how those methods yielded the conclusion of value.

(a) The Valuation Report must include an explanation of why the Qualified Appraiser chose to apply the valuation method(s) it used to determine the range of fair market value of the Qualifying Employer Securities.

(b) If the Qualified Appraiser uses more than one valuation method in determining a range of fair market value of the Qualifying Employer Securities, it must explain the process and rationale used in reconciling the different approaches in reaching the final range of fair market value.

(ii) Financial Projections or Forecasts. An analysis of the financial projections or forecasts of the plan sponsor provided to the Qualified Appraiser. Such analysis must include a discussion of the steps the Qualified Appraiser took to evaluate the financial projections' or forecasts' reasonableness, risks associated with achieving the financial projections or forecasts, and any adjustments the Qualified Appraiser made in exercising its professional judgment to apply to the financial projections or forecasts.

The Qualified Appraiser must also discuss the following topics:

(a) *Conflicts of Interest.* Whether the individuals who prepared any financial projections or forecasts that the Qualified Appraiser used in generating its valuation of the Qualifying Employer Securities have an actual or potential conflict of interest that may preclude them from providing reasonably attainable projections or forecasts.

(1) Notwithstanding any actual or potential conflicts of interest, the Department acknowledges that a sponsor company's owners and/or management are best positioned to create financial projections or forecasts because they have first-hand knowledge of the plan sponsor's operations and future business plans. Thus, that a person with an actual or potential conflict created financial projections or forecasts does not mean that the projections or forecasts are not reasonable or must be adjusted. There is no mathematically correct way to adjust such projections or forecasts based on perceived, actual, or potential conflicts; it is a matter left entirely to an appraiser's professional judgment in light of all relevant facts and circumstances, and reasonable appraisers may take differing approaches or reach different conclusions.

(2) The analysis of actual or potential conflicts of interest of the individuals who prepared any financial projections or forecasts shall include:

(A) The name and title of the individual(s) who prepared the financial projections or forecasts;

(B) An explanation of any actual or potential conflicts of interest between the plan and the individual(s) who prepared the financial projections or forecasts, including but not limited to whether the individual is a seller or buyer (other than the Discretionary Fiduciary on behalf of the plan) in the contemplated transaction, or whether the individual serves as an agent or employee of a seller or buyer (other than the Discretionary Fiduciary on behalf of the plan) in the contemplated transaction; and

(C) A statement that, if the Qualified Appraiser considered whether to adjust financial projections or forecasts, the Qualified Appraiser was aware that a person with an actual or potential conflict prepared the financial projections or forecasts.

(b) *Interviews.* Any interviews the Qualified Appraiser conducted. In assessing actual or potential conflicts of interest with respect to the preparation of financial projections or forecasts, the Qualified Appraiser should, when practical, interview a person with knowledge of the manner in which the financial projections or forecasts were created. If the Qualified Appraiser interviews such an individual, the Qualified Appraiser must document the following:

(1) The name of the Qualified Appraiser who conducted the interview;

(2) The name of the individual(s) from the plan sponsor interviewed and that individual's role and responsibilities within the plan sponsor;

(3) The date and location of the interview; and

(4) Any other material information and/or observations the Qualified Appraiser obtained during the interview.

(c) *Historical and Projected or Forecasted Financials.* The relationship between historical and projected or forecasted financials.

(1) The Qualified Appraiser should review a company's historical financial performance relative to projected or forecasted financial performance. Such review should include the reasonableness of the projections or forecasts in the Qualified Appraiser's professional judgment when compared to the plan sponsor's relevant historical performance and the relevant historical performance of any guideline public companies, which may include the following metrics:

(A) EBIT and EBITDA margins;

(B) Ratio of capital expenditures to sales;

(C) Revenue growth rate or revenue projection or forecast;

(D) Ratio of working capital to sales; and

(E) Any other metric the Qualified Appraiser determines in its professional judgment to be relevant to its valuation analysis.

(2) To the extent the Qualified Appraiser determines in its professional judgment to disregard any of the metrics listed in subsections (c)(2)(C)(ii)(c)(1)(A) through (E) above, the Qualified Appraiser must explain the basis for disregarding the metric.

(3) The Department acknowledges that the fact that historical performance differs from financial projections or forecasts is not evidence that financial projections or forecasts are unreliable. Where financial projections or forecasts materially differ from historical performance, the Qualified Appraiser should explain its understanding of the reasons for the difference. If the Qualified Appraiser determines in its professional judgment to adjust the financial projections or forecasts, the Qualified Appraiser must explain the nature and basis for making such an adjustment.

(d) *Arithmetic Correctness.* Whether the financial projections or forecasts contain any material mathematical errors that are readily apparent from a reasonable review of the projections or forecasts. To the extent the Qualified Appraiser believes that the projections or forecasts include material mathematical errors, the preparer of the projections or forecasts must correct them before the Qualified Appraiser can rely on them. The Qualified Appraiser may reasonably rely on the company's data and is not required to audit the data underlying the financial projections or forecasts for any purpose, including for arithmetic correctness.

(e) *Industry Expectations.* If the financial projections or forecasts diverge from the expected future economic conditions of the industry within which the plan sponsor operates, a description of the reasons for the observed divergence. This may include an explanation of the rationale underlying the long-term growth rate that the Qualified Appraiser selected to apply to the financial projections or forecasts.

(f) *Other risks.* A description of any other risks facing the sponsor company that could materially affect its projected or forecasted financial performance. The Qualified Appraiser must make its assessment from the information available to it, including from interviews with management and material information the Qualified Appraiser has collected and use its professional judgment to determine how these risks affect the company's value.

(g) *Terminal period.* A description of the material assumptions the Qualified Appraiser used to value the terminal period, including a description of the method used to value the terminal period earnings or cash flow (*e.g.*, Gordon growth method or exit multiples), the Qualified Appraiser's rationale for selecting the particular method, and the Qualified Appraiser's rationale for selecting the inputs to that method if applicable (*e.g.*, long-term growth rate, multiples).

The Department acknowledges that financial projections or forecasts are forward-looking assessments that should not be judged in hindsight, but rather in light of the contemporaneous information available to the persons creating, overseeing, and/or providing the projections or forecasts. Financial projections and forecasts are challenging to create, and whether a plan sponsor meets a set of financial projections or forecasts depends on myriad factors, many of which are outside the control of, or not known or knowable to, the person making the projection or forecast. Thus, that a plan sponsor failed to meet financial projections or forecasts is not evidence that they were unreachable or "wrong" at the time they were created.

(iii) Discount rate. When the Qualified Appraiser uses a valuation methodology that incorporates present value techniques, an explanation of the discount rate selected. For example, when a weighted average cost of capital ("WACC") is used, the Qualified Appraiser should explain how the concluded WACC was determined, including an explanation of the component parts. Where appropriate, the Qualified Appraiser may choose to include a sensitivity analysis to contextualize its discount rate conclusion.

(a) The Department acknowledges that discount rate components—such as whether a company specific risk premium is included or how a debt-to-equity ratio is selected—require an appraiser to exercise its professional judgment based on the facts and circumstances of the particular asset. Appraisers may reasonably exercise their professional judgment differently with respect to these aspects of the discount rate.

(iv) Guideline Public Companies and Transactions. If the Valuation Report relies on the guideline public company or transaction method to draw a conclusion of fair market value, an analysis of the factors that the Qualified Appraiser used to select the specific guideline companies or transactions and how the Qualified Appraiser selected multiples, including how the plan sponsor's financial performance and risk/return profile compares with the financial performance and risk/return profile of the guideline public companies and transactions.

(v) Material Differences with Past Valuations. To the extent the Qualified Appraiser has been made aware of and has access to them, a description of why there may be material differences between the Qualified Appraiser's determined range of fair market value and any formal written valuation of the sponsor company in the preceding three years or any prior offers to purchase some or all of the sponsor company's stock in the preceding three years. The Qualified Appraiser shall include the date of the valuation or offer and the name of the appraiser or offeror, to the extent such information is available. A Discretionary Fiduciary does not fail to satisfy this subsection if the Qualified Appraiser or Discretionary Fiduciary are unable to obtain prior valuations or information regarding prior offers despite their reasonable efforts.

(vi) Historical Financial Statements. A description of any adjustments the Qualified Appraiser made to the plan sponsor's financial statements, including the basis for making such adjustments.

(vii) Strength and Weaknesses of the Sponsor Company. An assessment of the sponsor company's attributes of value. Such analysis may include any factors that the Qualified Appraiser in its professional judgment determines could reasonably be expected to affect the plan sponsor's future financial performance and perceived market value.

(viii) Control. A description of the elements of control that will accrue to the ESOP and how and why those elements of control were considered in the appraisal, including whether and how the Qualified Appraiser made control adjustments, if any, consistent with subsection (d)(3)(B).

(ix) Marketability. A description of the marketability of the Qualifying Employer Securities, whether the Qualified Appraiser applied any discount to the range of fair market value in light of the stock's marketability, and the Qualified Appraiser's rationale for applying a discount, if any.

(x) Other Considerations. Any other considerations or variables that the Qualified Appraiser reasonably determines may materially affect the value of the Qualifying Employer Securities.

(D) **Appraisal Review.** A Discretionary Fiduciary satisfies subsection (c)(1)(D) of the Regulation if the Discretionary Fiduciary creates a written Appraisal Review, as described below, summarizing its analysis of the Valuation Report and the concluded range of fair market value described therein.

(i) In General. Discretionary Fiduciaries are permitted to rely on the expertise of the Qualified Appraiser. The Department acknowledges that the Discretionary Fiduciary's obligations under this section do not require it to become an expert in every aspect of an appraiser's analysis. In general, and as described more specifically in this section, the Discretionary Fiduciary must review the Valuation Report to understand its conclusions and major underlying assumptions, and ensure that the conclusions are logically consistent with the major assumptions and analysis stated in the Valuation Report.

(ii) Summary Document. The Appraisal Review must state that the Discretionary Fiduciary:

(a) Read the Valuation Report and understood the contents thereof;

(b) Identified the underlying material assumptions of the Valuation Report;

(c) Determined whether the information contained in the Valuation Report is materially consistent with the information the Discretionary Fiduciary has learned; and

(d) Determined whether the Valuation Report's conclusions are materially consistent with the data, analysis, and assumptions described in the Valuation Report or otherwise learned by the Discretionary Fiduciary upon which those conclusions are based.

(iii) Analyzing the Valuation Report. In the Appraisal Review, the Discretionary Fiduciary should also address the following topics:

(a) The reasonableness of the Qualified Appraiser's treatment of:

(1) Any discounts or premia included in the appraisal;

(2) Any control adjustments to financial projections or forecasts, or lack thereof;

(3) Any adjustments the Qualified Appraiser accepted or made to the sponsor company's historical financial data, including an explanation of why any adjustments were reasonable;

(4) Forms of equity-based management compensation, such as stock appreciation rights, issued in connection with the subject transaction;

(5) The Qualified Appraiser's analysis of the material risks associated with achieving the financial projections or forecasts used in the Valuation Report;

(6) The discount rate(s) the Qualified Appraiser selected, if any;

(7) The long-term growth rate that the Qualified Appraiser selected to apply in any income approach analysis;

(8) To the extent the Qualified Appraiser relied upon guideline companies and/or transactions in performing its analysis, the selection of such guideline companies and/or transactions and the multiples derived therefrom; and

(9) The Qualified Appraiser's exercise of professional judgment in weighing the methodologies the Qualified Appraiser applied to arrive at a range of fair market value.

(b) The process the Discretionary Fiduciary used in determining whether to proceed with the contemplated transaction in light of the Valuation Report, including whether such process deviated from the standard process the Discretionary Fiduciary normally employs.

(c) Whether the Discretionary Fiduciary believes it is appropriate to rely upon the Valuation Report's conclusions in determining whether to proceed with the transaction.

(d) Fair Market Value.

The following considerations apply to the Discretionary Fiduciary's determination of fair market value.

(1) *In General.*

(A) Except as otherwise provided in this section, the term "fair market value" as used in Section 3(18)(B) of the Act shall mean the price at which an asset would change hands between a hypothetical willing buyer and a hypothetical 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 such asset.

(B) The fair market value of an asset must be determined based on facts that are known or reasonably knowable as of the date of the transaction involving the asset. Facts or circumstances that are unknown or unknowable do not impact the fair market value of the subject asset as of the transaction date.

(C) This section is intended to incorporate, rather than alter, the definition of fair market value as defined by authoritative valuation texts, treatises, and professionals. In enacting this section, the Department's intent is to provide specific examples and applications of the fair market value standard in the context of transactions that commonly occur under Section 406 of the Act and to which the exemption in Section 408(e) of the Act applies.

(i) To the extent a Qualified Appraiser values an asset other than one within Section 3(18)(A) of the Act, the fair market value analysis should result in a range of values. A value anywhere within or below (where the ESOP is the buyer) or within or above (where the ESOP is the seller) that range of fair market values satisfies the requirements of Sections 3(18)(B) and 408(e). Determining the fair market value of such an asset is an inexact science, and reasonable appraisers may arrive at different conclusions for the range of fair market values with the same set of facts for a given asset. The fair market value of a single security may change significantly in the short term. That the fair market value of an asset may differ significantly from another recent indication of fair market value for the same asset is not evidence that either indication of fair market value is inaccurate.

(2) *Fair Market Value Determination.* The range of fair market value of the asset must be determined by a Qualified Appraiser, and the fair market value range must be stated in a Valuation Report.

(3) *Specific Fair Market Value Considerations.*

(A) **Hypothetical standard.** As a consequence of the hypothetical standard, attributes of the specific buyers or sellers should not affect the sponsor company's fair market value. These attributes include the following:

(i) The manner in which the transaction is financed, including the cost of any debt used to finance the acquisition. The Department notes the following specific applications of this principle:

(a) When determining fair market value of a sponsor company's stock, the Qualified Appraiser should not reduce fair market value by either the debt that the plan sponsor or the plan uses to acquire the sponsor company, or the cost of that debt.

(b) If a plan's acquisition of Qualifying Employer Securities is financed, the cost of any debt incurred may be paid using one or more instruments, including promissory notes with an interest rate, payment-in-kind interest, synthetic equity (such as warrants), and/or any other type of deferred payments. There are no *per se* restrictions on the instruments available to plan sponsors or plans to pay the cost of acquisition debt.

(c) The Department is neutral as to which type of instrument a plan or plan sponsor uses to obtain acquisition financing so long as the financing cost is no greater than the market rate, as of the transaction date, for the type and character of the debt in question. Debt characteristics affecting the market rate include, but are not limited to, whether the debt is secured or unsecured; the debt's position in the company's capital structure (*e.g.*, senior, mezzanine, subordinated); and the risk profile of the plan sponsor and its borrowing base.

(B) **Control.**

(i) In a stock purchase transaction, the Qualified Appraiser should consider whether the projected or forecasted financial results reflect any assumptions or incorporate any adjustments that only a controlling-interest buyer would make (outside of contractual obligations put in place at the time of the ESOP purchase that would directly impact future cash flows) and also be able to obtain, and which differ from the sponsor company's actual expected results. If the projections or forecasts do not incorporate such adjustments, the Qualified Appraiser should not downwardly adjust for lack of control.

(a) The Department acknowledges that any language in a Valuation Report stating that the valuation is done "on a controlling interest basis" or "on a noncontrolling basis" (or words to that effect) does not necessarily mean that the Qualified Appraiser has adjusted its conclusion of fair market value for control or lack thereof, as a Qualified Appraiser can value a controlling interest or a noncontrolling interest directly based on the level of earnings or cash flows being used.

(b) The Department acknowledges that a sponsor company's projected or forecasted income may reflect performance on an "as expected" (*i.e.*, based on contractual changes to the sponsor company's cash flows going forward) basis or "as-is" basis, in which case "controlling" and "noncontrolling" values are substantively the same.

(c) It is the Department's view that any adjustments for control should be specifically reflected in financial projections or forecasts and not applied as a percentage discount from, or premium to, fair market value.

(ii) The following circumstances are not, on their own, evidence that downward adjustments to financial projections or forecasts are warranted:

(a) Members of the sponsor company's pre-transaction management team or board of directors continue in their roles following a stock purchase transaction;

(b) The sponsor company's former shareholders participate in the company's operations or governance following a stock purchase transaction;

(c) The buyer obtains less than a fifty-one percent interest in the sponsor company; or

(d) The plan's governing documents provide that, pursuant to Section 403(a) of the Act, the plan's trustee shall be directed as to the manner of voting the Qualifying Employer Securities by one or more named fiduciaries, including such named fiduciaries who are officers or directors of the plan sponsor.

(1) The Department acknowledges that a plan that acquires a block of qualifying employer securities with associated voting rights does not fail to obtain the benefits of those voting rights where the trustee is a directed trustee within the meaning of Section 403 of the Act with respect to voting. Rather, the plan obtains the benefits of those voting rights because the individual, individuals, or entity responsible for directing the trustee provide directions subject to the Act's fiduciary duties of prudence and loyalty. This is true regardless of whether the individual, individuals, or entity responsible for directing the trustee was formerly a shareholder of the plan sponsor or is currently employed by the plan sponsor.

(C) **Guideline public company and transaction methods.**

(i) Because the guideline public company and transaction methods involve comparing a closely held sponsor company to publicly traded companies or acquired companies, these methods will often require the Qualified Appraiser to draw comparisons with companies that are typically much larger, have a more diversified business mix, and/or have greater resources than the sponsor company The Department believes that such selected public companies or transactions may be used as benchmarks where the Qualified Appraiser reviews the similarities and differences between the sponsor company and the guideline companies to understand where the sponsor company might be valued by market investors.

(ii) The Department acknowledges that this exercise requires the Qualified Appraiser to exercise a considerable amount of professional judgment based on the facts and circumstances of the particular engagement and that size is often not as relevant as industry factors, the company's outlook, and the company's risk and return profiles to the application of these methods. Consequently, it is likely that different appraisers applying this methodology could reasonably reach different conclusions in selecting appropriate guideline companies and transactions, selecting financial metrics from which to derive multiples, and deriving multiples. That different appraisers exercised their professional judgment differently is not alone evidence that one appraiser arrived at an objectively incorrect conclusion of fair market value.

(D) **Terminal value in the discounted cash flow method.**

(i) A Qualified Appraiser may reasonably select one or more generally accepted methods for valuing the sponsor company at the end of the period of projected or forecasted cash flows in the discounted cash flow method, including the Gordon growth method or exit multiples derived from market data.

(ii) The Department acknowledges that this exercise requires the Qualified Appraiser to exercise a considerable amount of professional judgment based on the facts and circumstances of the particular engagement. Consequently, it is possible that different appraisers could reasonably apply different methods for determining the sponsor company's terminal value and/or arrive at different conclusions in selecting appropriate long-term growth rates and/or exit multiples. That different appraisers exercised their professional judgment differently is not alone evidence that one appraiser arrived at an objectively incorrect conclusion of fair market value.

(E) Discounts for lack of marketability.

(i) When determining whether to discount Qualified Employer Stock for lack of marketability, the Qualified Appraiser should consider the plan sponsor's repurchase obligation described in 26 U.S.C. § 409(h)(1)(B). In the Department's view, the repurchase obligation substantially mitigates marketability concerns such that a no discount, or a *de minimis* discount, is appropriate in ESOP stock purchase transactions.

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III. References

[1] *See Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 416 (2014) (describing congressional interest in encouraging ESOPs); 26 U.S.C. § 404(a)(9) (making employer contributions to ESOPs tax deductible); 29 U.S.C. § 1104(a)(2) (exempting ESOPs from ERISA's duty to diversify); *id.* § 1108(e) (exempting ESOP stock purchase and sale transactions from Section 406's enumerated transactions).

[2] *See* 29 U.S.C. § 1108(e); *id.* § 1106(a) (prohibiting certain types of transactions "[e]xcept as provided in section 1108 of this title").

[3] *Id.* § 1002(18)(B).

[4] *See, e.g., Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983) (court encourages the Department to adopt regulations under Section 3(18)(B)).

[5] *See* 29 U.S.C. § 1106(a) ("Except as provided in section 1108 of this title[,] [a] fiduciary . . . shall not cause the plan to engage in a transaction . . . .").

[6] *See, e.g., Cunningham v. Cornell Univ.*, 86 F.4th 961, 974-75 (2d Cir. 2023) (explaining that "when one cannot articulate what the statute seeks to prohibit without reference to the exception, then the exception should be understood as part of the definition of the prohibited conduct—and thus its inapplicability must be pled" and holding that to plausibly allege a violation of Section 406(a)(1)(C) regarding "payments by plan fiduciaries to third parties in exchange for plan services," a complaint must allege that the Section 408(b)(2)(A) exemption does not apply); *see* also Staff of S. Comm. on Finance, 96th Cong., Employee Stock Ownership Plans: An Employer Handbook 29 (Comm. Print 1980) ("In the event that the purchase price paid for employer stock by an ESOP to a party in interest exceeds adequate consideration, a prohibited transaction results.").

[7] *See, e.g., Donovan*, 716 F.2d at 1467 ("ERISA's requirement that ESOP fiduciaries purchase employer stock for 'adequate consideration' must be interpreted so as to give effect to the Section 404 duties to which those persons remain subject. . . . [A] pure heart and an empty head are not enough."); Howard v. Shay, 100 F.3d 1484, 1488 (9th Cir. 1996) ("Like the inquiry into whether a fiduciary acted with loyalty and care, the inquiry into whether the ESOP received adequate consideration focuses on the thoroughness of the fiduciary's investigation."); Chao v. Hall Holding Co., 285 F.3d 415, 437 (6th Cir. 2002) ("The statutory reference to good faith in Section 3(18) must be read in light of the overriding duties of Section 404.") (quoting *Donovan,* 716 F.2d at 1467-68); *Henry v. Champlain Enters., Inc.*, 445 F.3d 610, 619 (2d Cir. 2006) (explaining that the "good faith" standard "expressly focuse[s] upon the *conduct* of fiduciaries"); *Matousek v. MidAm. Energy Co.*, 51 F.4th 274, 278 (8th Cir. 2022) (explaining that when analyzing a Section 404(a) breach of the duty of prudence claim, "[t]he process is what ultimately matters, not the results"); Eyler v. *Comm'r*, 88 F.3d 445, 455 (7th Cir. 1996) ("[T]he adequate consideration test focuses on the conduct of the fiduciaries in determining the price, not the price itself.").

[8] *See Henry*, 445 F.3d at 619-20 ("The role of courts in reviewing the adequacy of consideration in an ERISA case is to determine whether the fiduciary can show that the price paid represented a good faith determination of the fair market value of the asset, not to redetermine the appropriate amount for itself *de novo*.") (internal quotation marks omitted); *Fish v. GreatBanc Tr. Co.*, No. 09-cv-1668, 2016 WL 5923448, at *52 (N.D. Ill. Sept. 1, 2016) ("However, plaintiffs' criticisms of [the appraiser's] financial analysis, even if accepted at face value, do not establish any breach by GreatBanc. Plaintiffs failed to connect any alleged mistakes by the non-fiduciary [appraiser] with a fiduciary breach by GreatBanc, and advanced no factual or expert evidence that allows the Court to connect [the appraiser's] alleged errors with a breach of prudence by the plan fiduciary, GreatBanc.") (footnote omitted); *Perez v. Commodity Control Corp.*, No. 1:16-cv-20245, 2017 WL 1293619, at *14 (S.D. Fla. Mar. 7, 2017) (denying plaintiff's request for summary judgment "based **solely** on the fair market value prong" because courts must focus on fiduciary process and "refrain from looking back at a transaction, well after the fact, to determine whether a stock beneficiary plan acquired stock at a hypothetically correct or fair price"); Staff of S. Comm. on Finance, 96th Cong., Employee Stock Ownership Plans: An Employer Handbook 29 (supporting the position that "a good faith effort to determine fair market value is ordinarily shown where (a) the person making the valuation is not a disqualified person and is both competent to make the valuation and is not in a position to derive an economic benefit from the value utilized, and (b) the method utilized in the valuation is a generally accepted method for valuing for purposes of arm's length business transactions where valuation is a significant factor.").

[9] *See, e.g., Donovan*, 716 F.2d at 1474 ("ERISA fiduciaries need not become experts in the valuation of closely-held stock—they are entitled to rely on the expertise of others."); *Eyler v. Comm'r*, 69 T.C.M. (CCH) 2200 (1995) ("The law is well settled that ERISA fiduciaries need not themselves possess experience or expertise in appraisal . . . ; a fiduciary may rely on the ad-vice of experts or other professionals."), *aff'd*, 88 F.3d 445 (7th Cir. 1996).

[10] *See* Proposed Regulation Relating to the Definition of Adequate Consideration, 53 Fed. Reg. 17632-01, 17634 (May 17, 1988) (hereinafter "1988 Proposed Regulation") ("The Department is aware that the fair market value of an asset will ordinarily be identified by a range of valuations rather than a specific, set figure. It is not the Department's intention that only one valuation figure will be acceptable as the fair market value of a specified asset. Rather, this proposal would require that the valuation assigned to an asset must reflect a figure within an acceptable range of valuations for that asset.").

[11] *See, e.g., Scott v. Evins*, 802 F. Supp. 411, 415-16 (N.D. Ala. 1992) (noting that the "common stock of [the sponsor company] exists independently of the debt used to leverage the purchase, whether or not guaranteed by the corporation" and finding that "[w]hen the stock was appraised [in this case], no such debt existed and was therefore properly not taken into account" in the appraisal), *aff'd*, 998 F.2d 1022 (11th Cir. 1993); *see* also 1988 Proposed Regulation, 53 Fed. Reg. at 17634 (defining "fair market value" without reference to how the proposed transaction is financed); *Dole v. Farnum*, No. 90-0371 (D.R.I. filed July 30, 1990).

[12] *See* Dole, No. 90-0371.

[13] An appraiser may reasonably choose to use one or more approaches—*e.g.*, relative rates of re-turn, Black-Scholes model—to value warrants to determine whether the aggregate financing cost of the subject debt is reasonable in light of the cost of comparable securities in the market.

[14] *See* A. El-Tahch et al., *Warranting Further Discussion: Why the Use of Financing Warrants in ESOP Transactions Benefits American Workers*, Business Valuation Review (Spring 2022), at 6-9. Financing instruments like warrants are also properly excluded from the fair market value analysis in ESOP stock purchase transactions for a second reason: they do not exist as of the valuation date.

[15] *See* Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* 392 (6th ed. 2022) ("Controlling and noncontrolling concepts are not black and white with a bright dividing line. Control is a relative concept and covers a broad spectrum.").

[16] *See* id at 386 ("Control, in its simplest form, is often represented as the sole owner of 100% of the single class of outstanding equity, or who at least has voting control of the equity.").

[17] *Pegram v. Herdrich*, 530 U.S. 211, 225-26 (2000).

[18] *See* 1988 Proposed Regulation, 53 Fed. Reg. at 17636 ("In the Department's view, . . . a plan would not fail to receive control merely because individuals who were previously officers, directors or shareholders of the corporation continue as plan fiduciaries or corporate officials after the plan has acquired the securities.").

[19] *See* Pratt, *supra* n.15, at 391.

[20] *See*, e.g., *id.* at 926 ("Buyers of companies do not pay premiums for the right to control the companies. They pay premiums for the expected benefits in terms of enhanced cash flows and their growth and, perhaps, expected reductions in risk.") (quoting Z. Christopher Mercer and Travis W. Harms, *Business Valuation: An Integrated Theory* 39 (3rd ed. 2020)).

[21] *Walsh v. Preston*, No. 1:14-cv-4122, 2022 WL 17959237, at *13 (N.D. Ga. Sept. 20, 2022) (citing "multiple valuation treatises that support" the position that as-is cash flows are minority, noncontrolling cash flows); *see also id.* at *29 (holding that appraisal expert "improperly . . . includ[ed] an additional ten percent (10%) minority discount . . . when he had valued [the sponsor company] on an 'as-is' basis, which is already a minority-interest valuation").

[22] *See, e.g.,* Mercer, C., *Business Valuation: An Integrated Theory* 80 (2d ed. 2007) ("The financial control premium is created by any differential in cash flows or growth that the control buyer is willing to price into a deal. In other words, . . . a control buyer would pay a financial control price based only on the expectation of greater future cash flows than expected at the marketable minority level. . . . Control premiums are paid for the right to run the enterprise differently to achieve enhanced cash flow or accelerated growth. The price is paid for the expected cash flow and not for the naked right, or prerogative. . . . [U]nless the control buyer expects to achieve augmented levels and growth of cash flows, the financial control premium could be zero, or at least, quite small. The reason is simple: If a substantial premium were paid with no expectation of augmented cash flows, then the control buyer would have to accept a substantially lower re-turn.").

[23] It is necessary to differentiate between control-level adjustments to earnings, which reflect enhancements to a sponsor company's earnings and cash flows that a controlling owner could hypothetically make but that the sponsor company has no intention of making, and normalizing adjustments to earnings, which reflect adjustments to a sponsor company's earnings and cash flows based on contracts or legal agreements that obligate the company to operate in such a manner going forward.

[24] *See Fish*, 2016 WL 5923448, at *52 (finding that plaintiffs had not demonstrated that an appraiser erred where "plaintiffs' criticisms . . . are the result only of 'two reasonable and skilled analysts making a different judgment'").

[25] *See* 26 U.S.C. § 409(h)(1)(B) (describing put option); 1988 Proposed Regulation, 53 Fed. Reg. at 17636 (discussing impact of put option on marketability); Pratt, *supra* pg. 7, at 926-27 (noting industry practice of including discount for lack of marketability of 0% to 15% based on repurchase obligation); *Reich v. Hall Holding, Co.* 60 F. Supp. 2d 755, 762 (N.D. Ohio 1999) (finding 5% marketability discount reasonable); *Walsh v. Bowers,* 561 F. Supp. 3d 973, 990 (noting that Department's valuation expert applied a 7% marketability discount).

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