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

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

Introduction

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

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

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

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

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

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

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

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

private equity fund, or otherwise nonmarketable assets.

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

Background on the Power of Substitution for Grantor Trusts

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

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

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

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

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

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

The *Condiotti* Case

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Texas Four-Step

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

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

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

Step One—The Seeding

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

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

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

Step Two—The Substitution with a Promissory Note

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Straight Bond Yield Analysis

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

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

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

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

S&P = Standard & Poor's

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

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

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

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

Sources: As cited and analyst calculations.

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

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

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

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

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

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

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

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

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

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

Fair Market Value of Security Interest

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Sensitivity Analysis

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

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

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

Scenario 2:
(1) Unsecured Note

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

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

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

Sensitivity Analysis

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

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

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

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

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

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

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

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

Conclusion

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

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

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

Calculation of Weighting Factor as Percentage of Principal Outstanding:

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

Calculation of Fair Market Value of Promissory Note:

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

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

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

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

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

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

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

Notes:

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

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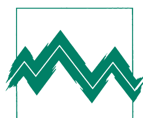

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ESOP Trustee Considerations in Multistage Stock Purchase Transactions

Scott R. Miller

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

Introduction

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

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

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

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

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

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

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

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

These three scenarios include the following:

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

secondary stock purchase of a noncontrolling ownership interest.

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

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

These issues include the following questions:

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

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

Initial Structuring of a Multistage ESOP Stock Purchase Transaction

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

What If the ESOP Loses Its Controlling Ownership Position?

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

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

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

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

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

Conclusion

One of the most important duties of an ESOP trustee is to ensure that the ESOP does not pay more than fair market value to purchase a block of sponsor company shares. One of the important aspects of determining the fair market value of a block of sponsor company shares is the appropriate level of control.

Although the Department of Labor has provided some guidance in this area, the appropriate level of control to apply may not always be clear.

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

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

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

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

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

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

Notes:

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

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