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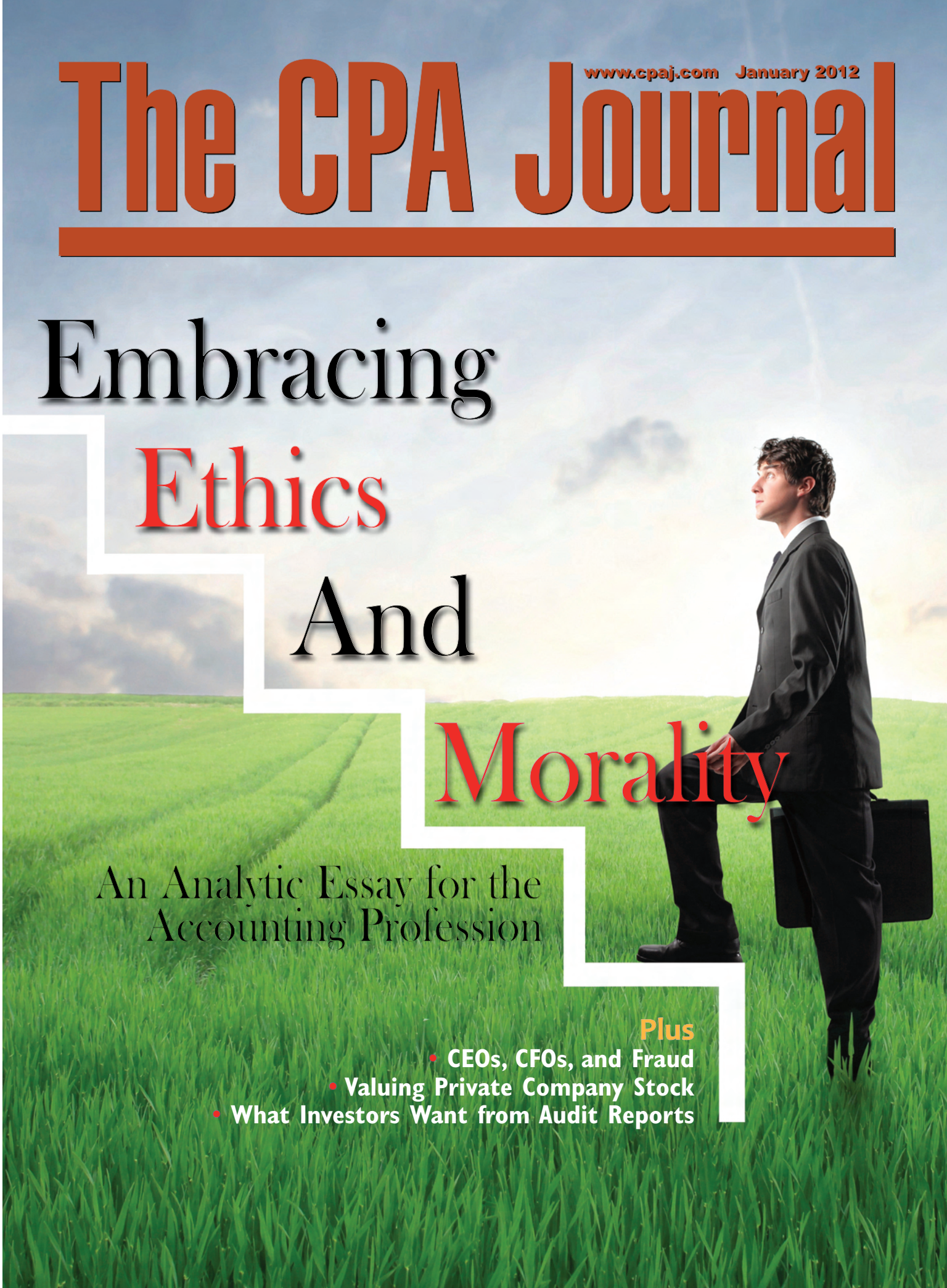
An Analytic Essay for the Accounting Profession



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Sale of Private Company Stock to Employees and Other Parties

By Robert F. Reilly

Accountants often assist closely held corporations (and their owners) with the planning, negotiation, and execution of the sale of company stock. CPAs often assist a closely held company with the taxation, structuring, financial planning, valuation, and other aspects of the stock sale transaction. The owners of a closely held company may sell their stock to obtain liquidity, diversify their wealth, manage their estates, start an ownership transition plan, reward and retain key employees, motivate strategic partners, and fulfill other purposes.

Some closely held corporation owners elect to sell private company stock to their employees through an employee stock ownership plan (ESOP). Some owners elect to sell private company stock directly to employees, to vendors and suppliers, to private equity investors, to financing sources, and to other strategic partners. In such cases, CPAs may assist closely held business owners with an ESOP feasibility analysis, with advice on related taxation and financial accounting considerations, with stock valuation analyses, and with the negotiation of the stock purchase financing.

Accordingly, accountants should be generally familiar with the basics of private company valuation and private company stock sale transactions. As a private company's most trusted advisor, a CPA may work with the company's legal counsel and valuation analyst

to structure stock sales that benefit the company, the selling stockholders, and the employees and other buyers.

First, the discussion below summarizes the generally accepted valuation approaches with regard to private company securities. These valuation approaches apply to sales of private company stock to an ESOP or to any other investor. In particular, this discussion considers the valuation factors related to the level of value, the stock rights and privileges, and the level at which funds are transferred from the private company to the ESOP. These factors affect the value of all private company stock sold or transferred to all parties (including the ESOP).

Second, the discussion below summarizes the valuation considerations in an analysis of private company stock sales to an ESOP, as opposed to other parties. This discussion focuses on the many reasons why two company stock sales that occur on the same day may transact at two different prices. Such an occurrence can be both fair to the ESOP and in compliance with legal and regulatory requirements. Such price differences may be due to differences in the private company securities (e.g., voting stock versus non-voting stock) or differences in the size of the block of closely held corporation stock. It may also be reasonable that two identical blocks of stock could be sold on the same day at two different prices—for example, one block sold to the ESOP and one block sold to a key employee. This discussion explains some of the reasons for such a pricing difference.

Valuation in Private Company Stock Sales to an ESOP

In addition to the generally accepted considerations that apply to any business valuation, there are three considerations that may make the valuation of the private company shares to be sold to an ESOP different from an otherwise identical block of stock:

- Level of value to apply in the valuation
- Contractual rights and privileges related to the ESOP
- Financing of the ESOP purchase of the private stock.

Valuation Approaches and Methods

There are three generally accepted approaches to the valuation of a private company. Many closely held corporation owners may tell their accountant that there are specific rules of thumb or unique shortcut formulas that are only applicable to companies in the subject industry. These rules or formulas often relate to a pricing multiple that is applied to a company-specific metric. For example, industry-specific formulas may include the following:

- multiple × annual revenue
- multiple × annual earnings before interest, taxes, depreciation, and amortization (EBITDA)
- multiple × number of customers.

When one examines these so-called industry rules of thumb, they may be categorized into the following three generally accepted valuation approaches:

- Income approach
- Market approach
- Asset approach.

Income Approach

The income approach is based on the principle that the value of the stock is the present value of the future income expected to be earned by the company owners. There are many different ways to measure income for valuation purposes, including the following:

- Net operating income
- EBITDA
- Earnings before interest and taxes (EBIT)
- Pretax net income
- After-tax net income
- Net cash flow.

Each of these measures of private company income may be applicable to the valuation, as long as the discount rate or capitalization rate corresponds to the selected benefit stream. A discount rate (also called a present value discount rate) is the required rate of return on an investment in the private company. Although there are several generally accepted models that valuation analysts use to estimate the discount rate, these models all incorporate some measure of market-derived rate of return, and some adjustment for the associated risk.

A capitalization rate is typically calculated as the discount rate minus the expected long-term growth rate in a particular income measure. Assume, for example, that a valuation analyst selects net cash flow as the income measure to value Alpha Private Company. The analyst concludes that 14% is the appropriate market-derived discount rate to apply to net cash flow and projects that Alpha's net cash flow will increase at the rate of 4% per year. In this case, the analyst would conclude a 10% direct capitalization rate (i.e., 14% discount rate – 4% growth rate = 10% capitalization rate).

The two common valuation methods utilizing the income approach are as follows:

- Yield capitalization method
- Direct capitalization method.

A valuation analyst will use the yield capitalization method when a private company's income (however defined) is expected to change at a non-consistent rate in the future. This method requires a discrete projection of annual income for many years into the future (typically until the expected long-term growth rate stabilizes). An analyst calculates business value as the present value of the projected future cash flow, using the present value discount rate described above. This is also called the discounted cash flow method, even when cash flow is not selected as the measure of the private company income.

A valuation analyst will use the direct capitalization method when a private company's income (however defined) is expected to change at a constant rate in the future. This method requires a one-year estimate of normalized income for the company. An analyst calculates business value by dividing the one-year income estimate by the direct capitalization rate. If the expected net cash flow for Alpha Private Company is $100, then, based on the aforementioned 10% direct capitalization rate, Alpha's business value would be $1,000 (i.e., $100 cash flow ÷ 10% direct capitalization rate).

To see how different measures of income can be used in the valuation, assume that Alpha's estimated next period pre-tax income is $1,200. Based on a 33% income tax rate, Alpha's estimated next period after-tax income is $800. Assume the analyst applies the cost of capital models to conclude an after-tax net income (and not net cash flow) capitalization rate of 8%. Applying this net income–based 8% direct capitalization rate to the $800 after-tax income estimate indicates that Alpha's business value would still be $1,000 (i.e., $800 after-tax income ÷ 8% capitalization rate).

Next, assume the analyst adjusts the 8% after-tax income capitalization rate for income taxes. The adjustment formula is as follows: the after-tax rate of

8% ÷ (1 – tax rate) = the pretax rate. The corresponding pretax income capitalization rate is as follows: 8% ÷ (1 – 33%) = 12%. If the analyst applies the 12% pretax income capitalization rate to the $120 pretax income estimate, Alpha's business value would still be $1,000 (i.e., $120 pretax income ÷ 12% capitalization rate).

These last two calculations also answer a common income approach question: Should a valuation be performed on a pretax basis or after-tax basis? As these calculations indicate, the answer is: It doesn't matter. As long as the income measure and the discount/capitalization rates are adjusted by the same income tax rate, either income approach should reach the same business value.

Market Approach

The market approach is based on the principle that a private company can be valued by referring to pricing guidance extracted from what investors paid in arm's-length transactions for comparative investments. The following are common market approach valuation methods:

- Guideline publicly traded company method (GPTCM)
- Guideline merger and acquisition transactions method (GMATM)
- Back-solve method.

In each of these methods, analysts identify and analyze market data regarding arm's-length transactions. Using these data, analysts extract pricing multiples to apply to a private company. These pricing multiples often include the following:

- Price to revenue multiple
- Price to book value multiple
- Price to EBITDA multiple
- Price to EBIT multiple
- Price to pretax income multiple
- Price to after-tax multiple
- Price to cash flow multiple.

An analyst may apply more than one pricing multiple in a market approach analysis, and examine more than one time period. For example, an analyst may derive pricing multiples to apply to the private company financial fundamentals for these different time periods:

- Latest (trailing) 12 months' actual results
- Next 12 months' projected results
- Three-year average actual results
- Five-year average actual results.

For both the GPTCM and GMATM analyses, an analyst first attempts to identify companies that are directly comparable to the private company. Such comparable companies are often about the same size, operate in the same industry or profession, compete with each other, have the same sources of supply, or have the same types of customers. Once an analyst can identify such comparable companies, the market approach analysis is relatively easy.

Of course, an analyst will have to adjust the financial statements of both the comparable public companies and the private company for non-operating items, non-recurring items, differences in accounting principles, and other so-called normalization adjustments. An analyst can often apply the derived mean or median pricing multiples to the private company's financial fundamentals. Analysts will typically synthesize (or weight) the various value indications into one market approach estimate.

It is rare, however, for a valuation analyst to identify comparable public companies for most private companies. Compared to most publicly traded or recently acquired companies, the typical private company is much smaller, operates regionally, and operates in a specialized segment of an industry; therefore, valuation analysts generally select and rely on guideline companies. Guideline companies are similar to the private company from an investment risk and expected investment return perspective. Guideline companies fit into the same investment portfolio of companies as private companies; that is, investors would expect the same rate and variability of returns for all of these companies. But guideline companies do not necessarily "look like" the subject company.

Guideline public company pricing multiples are more difficult for a valuation analyst to apply. It is not reasonable to assume that mean or median pricing multiples would automatically apply to the private company, because the selected companies are not directly comparable. Nevertheless, an analyst can compare a private company to guideline companies in terms of factors such as relative growth rates, relative profit margins, and relative returns on investment. From these comparative analyses, an analyst can extract pricing multiples to apply to the private company's financial fundamentals.

The GPTCM is based on an analyst's considerations of guideline public companies that trade on national and regional stock exchanges. Those trading prices and pricing multiples are typically based on relatively small trades (i.e., a few thousand shares per trade) of very liquid securities.

The GMATM is based on an analyst's assessment of recent mergers and acquisitions of entire companies in the private company's industry. These transactional prices and pricing multiples are typically based on what a strategic buyer is willing to pay to obtain operational control of an overall business enterprise.

The back-solve method looks at historical sales of stock in the subject company; in other words, an analyst investigates actual arm's-length sales of company stock and develops pricing multiples from those transactions. Such transactions typically represent sales of small blocks of stock in very illiquid (private company) securities. Based on the pricing multiples indicated by recent sale transactions, the analyst "back-solves" the value of the company overall business using the techniques described above.

As indicated above, different market approach valuation methods could all reach different levels of value. The related adjustments are summarized in "Levels of Value" below.

Asset Approach

The asset approach (also called the asset-based approach) is founded on the principle that a private company's equity value is equal to the value of the closely held corporation's assets, less the value of the closely held corporation's liabilities. The asset approach is used less frequently than the income approach or the market approach in the valuation of closely held corporation securities for the following reasons:

- It is more time consuming and, therefore, more expensive to perform.
- Many valuation analysts do not have the experience or expertise required to value individual assets and liabilities.
- Many valuation analysts are simply uninformed or misinformed regarding the application of this valuation approach.

The asset approach is, however, particularly applicable in the following circumstances:

- The company is either capital asset intensive or intangible asset intensive.

■ The company is either relatively new or has experienced a recent period of negative operating results.

■ A buyer or stock acquisition financing source wants to know the debt collateral value of the company assets.

■ A buyer or financing source wants to know the post-financing solvency of the company.

■ A third party wants to know what the post-transaction company fair value balance sheet will look like if the stock purchase results in a change of control.

■ A buyer wants to know why it is being asked to pay a multiple of earnings or a multiple of book value for the private company; in other words, what operating assets are the investors buying in the stock purchase transaction?

In order to perform an asset approach valuation, an analyst has to identify and value the following categories of assets and liabilities:

■ Net working capital (e.g., accounts receivable and inventory)

■ Tangible personal property (e.g., machinery and equipment)

■ Real estate (e.g., land and buildings)

■ Identifiable intangible assets (e.g., patents, copyrights, trademarks, licenses and permits, computer software, customer relationships)

■ Intangible value in the form of goodwill

■ Contingent liabilities

■ Recorded liabilities.

The following are some caveats to correct the misconceptions that many valuation analysts—and many CPAs—hold about the asset approach:

■ It does not conclude a liquidation value in the company; rather, all of the tangible and intangible assets are valued on a continued use/going concern basis, so the concluded business value is a going concern value.

■ It does not consider tangible assets only; rather, in most successful companies, most of the business value relates to identified intangible asset value and to goodwill.

■ It does not rely on speculative values for intangible assets; rather, these values are exactly the same as those that would be recorded on audited GAAP financial statements as the result of a purchase price allocation.

■ It does not result in the net book value conclusion as reported in the company's balance sheet; rather, a pre–fair value balance sheet and a post–fair value balance bear little relationship to each other.

■ The most common asset approach valuation methods include the asset accumulation method and the adjusted net asset value method.

The typical asset approach valuation formula is summarized as follows:

working capital value
+ tangible assets value
+ intangible assets value
= total assets value
– recorded liabilities value
– contingent liabilities value
= private company equity value

In addition to valuing a company's intangible assets, an analyst also has to identify and quantify any off–balance sheet contingent liabilities. Such liabilities include lawsuits, environmental concerns, and similar items.

Typically, the asset approach will indicate a company's total equity value on a marketable, controlling interest level of value.

At this stage of a private stock valuation, an analyst will typically adjust all of the indicators to be on the same level of value. Then, the analyst will synthesize (i.e., weight) the income, market, and (if performed) asset approach value indicators in order to reach one final value conclusion for the private company. This weighting is based on the analyst's assessment of the quantity and quality of available data, the applicability of each approach to the company, and the range and reasonableness of the various value indicators.

To simplify the discussion, assume that an analyst has concluded the company's total equity value. In practice, there is typically an intermediate procedure in which the analyst first concludes the company's invested capital value. From this invested capital, the analyst subtracts the company's long-term interest bearing debt, to reach the total equity value. From this total equity value amount, the analyst subtracts the value of any company preferred stock to conclude a preliminary common equity value. The analyst adjusts the total common equity value for the proceeds from any in-the-money stock options. The analyst then concludes the final total equity value (and the number of outstanding company shares, including exercised in-the-money options). This procedure is typically called a waterfall analysis.

Levels of Value

The term "level of value" refers to two investment criteria regarding private company stock:

■ Marketable versus nonmarketable—this criterion indicates how easy it is for the shareholder to sell stock and convert that investment into cash.

■ Control versus lack of control—this criterion indicates how much control the shareholder has over the company's business operations and strategic direction.

Many valuation analysts (and many CPAs) believe that there are only three separate and independent levels of value:

■ Marketable, controlling ownership interest (e.g., one shareholder owns 100% of the closely held corporation)

■ Marketable, noncontrolling ownership interest (e.g., as if the closely held corporation stock was publicly traded on a stock exchange)

■ Nonmarketable, noncontrolling ownership interest (e.g., stockholder shareholder owns a small block of stock in the closely held corporation)

In truth, the above-listed levels of value represent a gross oversimplification. For all companies, these two investment criteria each exist on a continuum. *Exhibit 1* more accurately reflects the level of value considerations that an investment analyst should assess with regard to company stock:

Where the subject block of stock falls in this X axis and Y axis continuum is a function of the following factors:

■ The absolute size of the block of stock

■ The relative size of the block of stock (compared to other stockholders)

■ The relative voting rights and policies of the private company

■ The state in which the private company is incorporated

■ The absolute number of directors on the board and the rotation of board elections

■ The potential for a corporate liquidity event (e.g., an initial public offering, stock tender offer)

■ The ability of a plan participant to put shares back into the company

■ The contractual rights of the block of stock (e.g., come-along rights, tag-along rights, rights of first refusal, registration rights)

■ The history of private transactions in the company stock

■ The age, investment, retirement, or estate plans of the private company's other major shareholders.

As mentioned above, a valuation analyst will adjust all of the value indicators so as to be in the same level of value. Then, the valuation analyst will adjust that level of value to be consistent with describes description of the actual marketability and control attributes of the transaction block of private stock.

Contractual Rights and Privileges

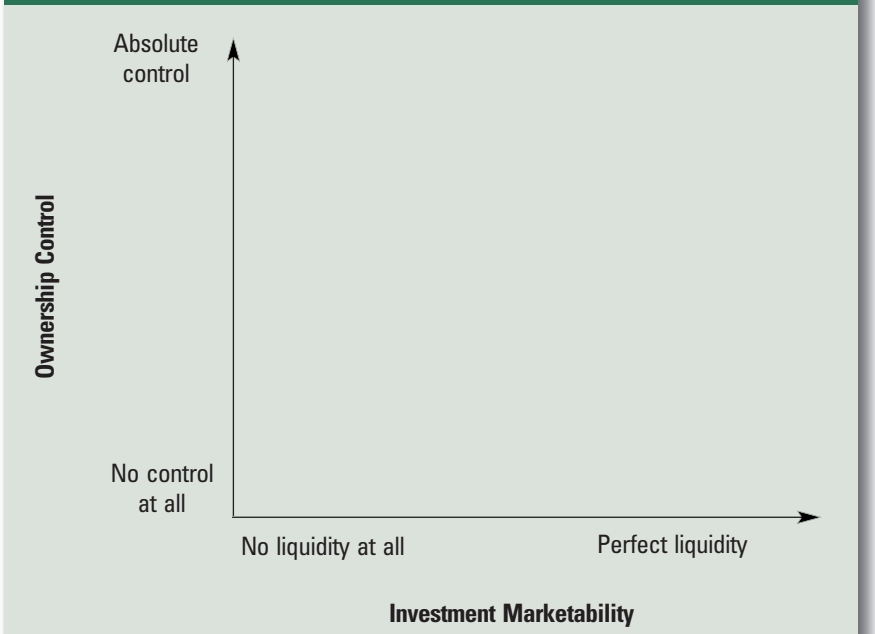
In addition to their effect on a stock's marketability and control attributes, some contractual rights and privileges can separately (and materially) impact the value of private stock. Valuation analysts should ensure that the value increment associated with contractual rights is not double-counted (i.e., both considered as a marketability/control attribute and then again as a contractual attribute). But an analyst should also ensure that the full value increment related to these contractual attributes be considered in the stock valuation. It is noteworthy that this value increment should be considered even if the ESOP block of stock is unique in enjoying that attribute. For example, there is still a value increment associated with dividend preferences or liquidation preferences, even if both the ESOP-owned stock and the key executive–owned stock both enjoy those preferences.

The following are some of the common contractual rights and privileges that a valuation analyst may consider:

■ Dividend and liquidation preferences
■ Mandatory redemption rights
■ Preemptive rights
■ Conversion and participation rights
■ Antidilution rights
■ Registration rights
■ Voting rights
■ Protective provisions and veto rights
■ Board participation rights
■ Drag-along rights
■ Right to participate in future equity offerings
■ Right of first refusal in future equity offerings
■ Management rights
■ Access to information rights
■ Tag-along rights.

Each of the above contractual rights may relate to a particular class of private company equity. More commonly, these particular rights and privileges may only relate, by contract, to a particular block of stock. For example, a block of private stock may be the stock sold to the ESOP, the stock granted to identified senior executives, or the stock retained by certain members of the company founding family. Each of these contractual rights and privileges has an economic value that should be considered in the allocation of the private company's overall value to that particular block of stock.

EXHIBIT 1
Private Company Common Stock
Levels of Value



Financing an ESOP Stock Purchase

Commonly, an ESOP purchase of closely held corporation stock is financed by debt capital. This statement is true whether the ESOP purchases a noncontrolling block of stock or the ESOP purchases 100% of the closely held corporation's stock. There are various structures through which an ESOP trust can finance the stock purchase. The following are common financing structures:

■ The ESOP borrows funds directly from a financial institution, in an outside loan.
■ The company borrows the funds from the financial institution, and the ESOP borrows the funds from the company through a minor loan structure.
■ The ESOP borrows some or all of the financing from the stock sellers through a seller-financed transaction.

The structure of the stock acquisition financing (including debt term, interest rate, and prepayment options) is important to the ESOP. The structure of the stock purchase financing is not that important to the valuation (i.e., pricing) of the common stock—but the structure of the stock purchase financing may be important to the stock valuation. This issue hinges on who will repay the stock acquisition loan: 1) the company (directly or indirectly) or 2) the ESOP (as a company shareholder). A more technical way to phrase this question is: What is the source of cash used by the ESOP to pay the stock acquisition loan? Is it: 1) employer contributions from the private company or 2) profit distributions from the private company? In both cases, the cash transfers from the company to the ESOP—and then from the ESOP to the bank, to repay the acquisition loan.

The answer to the question may affect the valuation of the stock. This is because ESOP contributions are accounted for as an operating expense of the company, just like any other retirement plan contributions would be. The company records that expense, which (like any other expense) reduces the profitability of the company. All other things

(such as discount rates and capitalization rates) being equal, a company with lower profits will have a lower stock value.

In contrast, ESOP distributions are not accounted for as an operating expense, just like any other profit distribution or dividend to shareholders. Distributions are the payment of net profits to the company stockholders. Unlike contributions, distributions do not represent an employer expense that reduces company profits; that is, the payment of distributions does not affect a closely held corporation's reported profitability. All other things (such as discount rates and capitalization rates) being equal, a company's profit distribution does not affect the subject stock value.

If an ESOP receives closely held company distributions and then repays the stock acquisition loan to the bank, this loan payment is just like any third-party investor who buys the common stock of a publicly traded company on margin. When the investor pays back the stockbroker from the corporation's quarterly dividend payments, that margin loan repayment does not reduce the value of the company's stock.

Example

To illustrate the effect of how a closely held corporation transfers funds to an ESOP, consider two identical companies. Beta ESOP Company transfers cash to the ESOP through contributions. Gamma ESOP Company transfers cash to the ESOP through distributions. Both ESOPs borrowed the same amount in a stock acquisition loan, and both ESOPs make the same annual principal and interest payments to the bank to repay those loans. The current-year summary financial statements for both private companies are presented in *Exhibit 2*.

In both cases, assume that the private company stock is owned 80% by an ESOP and 20% by senior management. In addition, to simplify the example, assume that each company is an S corporation for federal income tax purposes.

Both Beta and Gamma would have reported identical income statements prior to the purchase of the private company stock by the ESOP. For that reason, in both cases, the ESOP would pay the same price—and recognize the same fair market value—in the initial purchase of the private company's securities.

After the ESOP formation and the stock purchase, however, the structure for the stock acquisition loan could affect the stock valuation. Assume that both the Beta ESOP and the Gamma ESOP need to service $5 million of annual debt service on the stock acquisition loan. Beta transfers the cash as an ESOP contribution (i.e., an expense). If Beta were a C corporation, such a cash transfer would make a great deal of sense, because the $5 million contribution would be a tax-deductible expense for federal income tax purposes (assuming Beta meets the payroll-related deduction limitations).

Because Beta and Gamma are both S corporations, there is less value to the ESOP contribution tax deduction. In contrast to Beta, Gamma elects to not recog-

nize the cash transfer as an ESOP contribution expense. This recognition increases Gamma's pretax income. Because the Gamma ESOP owns 80% of the private company stock, it will receive 80% of all shareholder distributions. Assuming all income is distributed, the ESOP would receive 80% of the shareholder distributions (i.e., more than enough cash to service the stock acquisition debt). The non-ESOP shareholders (i.e., key management) would receive the remaining 20% of the profit distributions.

Unlike the Beta ESOP contributions, the Gamma profit distributions do not reduce the company's income. In addition, the Gamma ESOP distributions are not an economic burden on the non-ESOP shareholders. Each Gamma shareholder receives a proportionate profit distribution. That Gamma shareholder can use that profit distribution to pay stock purchase debt (as the ESOP will) or not. In contrast, the Beta $5 million ESOP contribution will cost the non-ESOP shareholders $1 million, because the company's income will be reduced by this amount and non-ESOP executives own 20% of the Beta income.

Stock Valuation and Debt

How an ESOP repays a stock acquisition loan—contributions or distributions—also impacts the effect of that debt on the stock valuation. Valuation analysts sometimes value closely held corporation stock using the direct equity method; that is, they value the common stock directly without reference to the company's total enterprise value. More frequently, valuation analysts value closely held corporation stock using the invested capital method—they value the corporation's total enterprise (also called total invested capital), then subtract the company's long-term debt, and finally subtract any preferred stock in order to reach a residual value for the company's common stock. As mentioned above, this residual valuation procedure is often called the waterfall procedure.

An ESOP sponsor company has two categories of long-term debt on its balance sheets. First, notes payable and bonds payable are recorded as long-term debt. These liabilities represent funds borrowed by the private company that are used by the company and that the company is committed to pay back. Second, under U.S. GAAP, a company must also record the ESOP stock acquisition debt as long-term debt on its balance sheet. This requirement applies even when the ESOP borrowed the funds directly from a third-party lender. This requirement stems from the fact that a company invariably guarantees the ESOP's debt; that is, if the ESOP does not pay off the stock purchase loan, a bank will look to the company to make good on the loan.

A valuation analyst will always subtract the sponsor's (non-ESOP) long-term debt in order to conclude the stock's value. And a valuation analyst will typically subtract the ESOP debt recorded on the company's balance sheet in order to conclude the stock value. This is because most companies make contributions to an ESOP, and the ESOP pays off debt from these contributions. As explained above, ESOP contributions: 1) result in an operating expense to the private company, 2) reduce the company stock value, and 3) are shared proportionately by all of the company's shareholders (through their percentage ownership of company stock). Typically, all C corporations, and many S corporations, use contributions to fund an ESOP's debt service payments.

Therefore, stock value is affected by both how a private company distributes funds to an ESOP for debt service purposes and how an ESOP receives debt service funds from the private company (relative to the other company shareholders).

Transactional Scenarios

There are numerous scenarios in which a stock sale to both an ESOP and another buyer can occur simultaneously. For purposes of this discussion, such a transaction would occur when an ESOP (through its trustee) participates in a stock purchase/sale transaction at about the same time that a non-ESOP party also participates in a stock purchase/sale transaction. In such scenarios, it is not uncommon for the two stock transactions to take place at two different prices.

The discussion below summarizes the valuation considerations related to the following types of stock transaction scenarios:

- An initial ESOP formation, when an ESOP purchases company shares and special employees also purchase company shares
- A secondary ESOP stock purchase, when both the ESOP and special employees purchase additional blocks of company shares
- A transaction in which the ESOP does not buy shares; only special employees buy shares
- The sale of shares only to a capital provider, such as a venture capital investor, a private equity investor, or a merchant bank investor
- The sale of stock only to a company strategic partner, such as a key customer

EXHIBIT 2
Current Year Summary Income Statement

	Beta Company	Gamma Company
Earnings before interest and taxes and ESOP contributions	$10,000,000	$10,000,000
– ESOP contributions	5,000,000	—
Earnings before interest and taxes	5,000,000	10,000,000
– Interest on (non-ESOP) long-term debt	3,000,000	3,000,000
Pretax income	$ 2,000,000	$ 7,000,000
Distribution to the ESOP (based on 80% equity ownership)		$ 5,600,000

or supplier, an intellectual property licensor or licensee

- A company repurchase of its own stock from a non-ESOP party
- The sale or other transfer of stock that does not involve either the ESOP or the company; for example, non-ESOP shareholder gift, estate, charitable contribution, or marital estate transfers
- Other contractual agreements between the company and special employees that do not include stock transfers; for example, employment, noncompete, consultancy, board membership, intellectual property license, and other agreements.

In these above-listed scenarios, a valuation analyst will likely have one set of valuation considerations for transactions involving an ESOP and a slightly different set of valuation considerations for transactions involving a non-ESOP party. For purposes of this discussion, the term "special employees" will be considered synonymous with the term "key employees." These are employees that the company wants to retain and are difficult to replace. In addition to senior management, this category could include skilled engineers, scientists, salesmen, production specialists, or quality specialists. What makes this class of employees special is that management may grant these employees options, warrants, or rights with regard to the company stock.

As CPAs are aware, ERISA provides that an ESOP may acquire employer stock "if such acquisition, sale or lease is for adequate consideration." With regard to pricing closely held corporation stock, ERISA defines adequate consideration as the "fair market value of the asset determined in good faith by the trustee or named fiduciary."

These ERISA definitions mean that an ESOP may pay no more than a fair market value price for private stock. An ESOP can, however, pay less than fair market value, if for example the trustee negotiates a favorable deal with the company or selling stockholders. Sellers may often unilaterally offer a below-market price to the ESOP as a form of gratitude to company employees or as a reward for years of loyal service. This is simply one explanation for why an ESOP may pay a different (in this case, lower) price for the stock than other shareholders.

There are also situations where a private company or selling shareholders may sell stock to non-ESOP shareholders for a below-market price. Such a situation often occurs when a company wants to attract, retain, or reward special employees. In a leveraged stock purchase transaction, the financing terms should be at least as favorable to an ESOP as they are to other deal participants. Just because a private company allows special employees to purchase stock at a favorable price, however, does not mean that the sale transaction is unfair to the ESOP.

Factors that Affect Valuation Considerations

There are a variety of reasons why a CPA might apply different considerations

to an ESOP stock purchase transaction, as compared to a non-ESOP stock purchase transaction. Twelve of these reasons are summarized below.

First, a company may perceive an ESOP stockholder and non-ESOP stockholder differently. To a closely held company, the ESOP is a relatively permanent company owner. Certainly, the ESOP is a long-term investor that will provide part of the permanent capital structure. In contrast, special employees, strategic partners, and certain capital providers are generally not long-term investors. The company wants to retain these parties, of course, and compensate them for their services. From the company's perspective, an ESOP stockholder and non-ESOP stockholder have different investment time horizons and different investment objectives.

Second, from a stockholder perspective, the ESOP and the non-ESOP party may perceive the company differently. ESOP participants own the company. The ESOP provides retirement benefits to the plan participants, of course, but plan participants often seek long-term capital appreciation rather than short-term income. Non-ESOP stockholders typically have a much more finite investment perspective. They typically plan for a specific exit event after five years (or some similar time period). Non-ESOP stockholders want to be compensated for the services they provide (e.g., executive talent, capital, intellectual property) during the period they provide that service—then they want liquidity. Again, from the stockholder perspective, an ESOP stockholder and non-ESOP stockholder have different investment time horizons and different investment objectives.

Third, ESOP and non-ESOP stockholders may be buying different classes of securities. Of course, the type of security will affect the valuation. For example, an ESOP might purchase common stock and non-ESOP stockholders might purchase preferred stock. In such a case, special employees, remaining family stockholders, or capital sources may want to be (relatively) assured of periodic dividend distributions. In some instances, an ESOP may purchase the preferred stock. This procedure sometimes happens when a company runs into contribution tax deduction limitations based on employee payroll levels. In that case, the preferred stock is intended to provide more cash for the ESOP than the company would be able pay through annual plan contributions. Accordingly, the type of security will affect the valuation.

Fourth, the form of ownership may affect the value of the stock. An ESOP will typically purchase stock in fee-simple interest, meaning that title to the stock is transferred from the company (or selling stockholder) to the ESOP, subject to any lien that the bank may have related to the stock acquisition loan. In contrast, a non-ESOP stockholder may receive only a fractional ownership interest in the stock. For example, a special employee may not actually receive ownership of the stock, but rather receive an option, warrant, grant, or related right. An employee or other non-ESOP stockholder's rights may vest over time. This vesting may be a function of the term of employment, stock ownership, debt financing provided, or some other relationship with the closely held company. Therefore, unlike for an ESOP, such stock ownership rights may be forfeited if the contractual relationship with the company lapses.

Fifth, a security's rights and privileges directly affect the stock value. This occurs when an ESOP and non-ESOP stockholder both acquire stock (perhaps of the same class) with different sets of rights and privileges. A valuation analyst will take these different rights into consideration in the relative valuations. For example, an ESOP and non-ESOP stockholder could each own stock with differing rights related to:

- Voting versus nonvoting
- Dividend and profit participation
- Liquidation preferences and participation
- Control of the board of directors or certain management decisions
- Registration, transferability, or other liquidity opportunities
- Rights of first refusal and preemptive rights.

Sixth, the expected term of the stock could affect the value of stock purchased by an ESOP compared to a non-ESOP stockholder. The common stock typically purchased by an ESOP is usually perpetual term stock, meaning that there is no plan for the ESOP trust to redeem the stock (other than the ERISA-required plan participant retirement put option). Stock sold to a non-ESOP stockholder is typically issued with an expected finite term, such as 5 or 10 years. After that term, the company may be able to call the stock, or the investor may be able to put the entire block of stock back to the company.

Seventh, the liquidity of any security typically affects that security valuation. As mentioned above, ESOP participants enjoy an ERISA-required put option. That is, a plan participant of a certain retirement-related age can put the employer shares in her account back to either the ESOP or the private company (depending on the plan terms). Over a specified pay-out period, the company must buy back the shares at a market price based on the valuation analyst's conclusion. Thus, the shares in the plan participant's accounts have a certain degree of liquidity. Unless there are contractual or other agreements in place, a non-ESOP shareholder may not have this liquidity expectation.

Eighth, share vesting and allocation periods may be different for an ESOP stockholder compared to a non-ESOP stockholder. An ESOP participant will expect purchased shares to be allocated to his account as the stock acquisition loan is paid by the ESOP, and contributions and distributions are made by the company to the ESOP. As mentioned above, a non-ESOP stockholder may experience a much different vesting (and, effectively, allocation) period. For a non-ESOP stockholder, the employer's shares may be transferred as the employee provides management, noncompetition, joint venture, financing, or other services.

Ninth, the expectation of a liquidity event is different for an ESOP compared to a non-ESOP investor. ESOP investors may give very little consideration to a liquidity event in their stock purchase decision, following a buy-and-hold strategy. ESOP participants generally view themselves as the permanent owners of the company. Typically, their only liquidity consideration is a company-wide liquidity event; such a liquidity event would include an initial public offering (IPO) or the overall acquisition of the company. In contrast, a non-ESOP investor typically plans for a specific, short-term liquidity event that is typically a contractual event and not a control event. In other words, a non-ESOP investor may expect to sell the stock back to the company under the terms of an employment, noncompete, intellectual property license, debt

indenture, or other contract. In contrast, an ESOP generally expects to be able to (at least) influence when a closely held company has an IPO or a merger and acquision (M&A) transaction occurs.

Tenth, there may be a difference in the information disclosure rights available to an ESOP compared to a non-ESOP investor. The ESOP trustee receives the company stock independent valuation report each year. That stock valuation includes: historical and current company financial statements; a current company, industry, and strategic analysis; and projections of future results of operations. The ESOP trustee receives a fair amount of company financial and operational information. Most closely held companies are not very forthcoming with such company-specific information. In contrast, unless they have specific contractual rights, non-ESOP stockholders do not have access to the same information. Even special employees (other than a CEO and CFO) may not have as much access to company-specific information as the ESOP trustee does. A company's financing sources might have contractual access to the financial statements, but they might not have access to the stock valuation reports.

Eleventh, ESOP stockholders and non-ESOP stockholders enjoy different levels of shareholder protection. The ESOP and the plan participants are protected by ERISA. The annual stock valuation must comply with ERISA, and is subject to contrarian review by the IRS and the U.S. Department of Labor. In contrast, a non-ESOP stockholder is not subject to ERISA protection, but rather only applicable state securities statutes. A non-ESOP stockholder has no assurance that it can purchase the stock for no more than fair market value and sell the stock for no less than fair market value. A non-ESOP stockholder may only be able to negotiate the best price it can to buy or sell the stock, which might be higher or lower than fair market value.

Finally, the most significant difference between an ESOP and non-ESOP stockholder may be the level of value issue. As described above, level of value relates to the following two investment criteria:

- Marketable versus nonmarketable interests
- Controlling versus noncontrolling interests.

Stock owned by an ESOP may represent a different level of value than stock owned by a non-ESOP investor. In fact, this is often the case, because two different shareholders cannot both own a controlling interest in a company. If the ESOP owns a controlling interest, then the non-ESOP does not, and vice versa.

In addition, many ESOPs have contractual rights that allow the plan to acquire ownership control over a period of time. For example, the contract may allow an ESOP to continue to buy blocks of stock each year until it either owns control of the company or owns 100% of the company. In such a case, an ESOP is often treated as a controlling owner—and the employer stock purchase/sale transaction is often treated as a control-level transaction—for stock valuation purposes.

In addition, as described above, there are numerous factors (contractual, regulatory, and otherwise) that affect the marketability of ESOP-owned stock compared to non-ESOP owned stock. A valuation analyst will consider all of these factors when assessing where each block of company stock falls on the marketability continuum.

Paying Attention to the Differences

CPAs understand that different fair market value estimates may be appropriate for different blocks of private company stock. Likewise, there may be different value estimates depending upon whether the same block of stock is owned by an ESOP or a non-ESOP investor.

There are generally accepted valuation approaches and methods related to the valuation of a closely held company. And there are generally accepted considerations related to the valuation of ESOP-owned and non–ESOP owned stock in a closely held company. These considerations are different because:

- An ESOP and a non-ESOP stockholder have different investment objectives and different investment time horizons.
- ESOP and non-ESOP–owned securities may enjoy different rights and privileges (including ERISA-related rights).
- An ESOP and a non-ESOP stockholder may own company stock at two different levels of value.
- ESOP and non-ESOP–owned stock may be paid for from two fundamentally different levels of company cash flow—employer contributions that reduce the company's income and value versus profit distributions that do not reduce the company's income and value.

This last difference is particularly important for S corporations. There is usually little income tax advantage for S corporations to make plan contributions, as opposed to shareholder profit distributions. Nevertheless, the stock valuation impact of this decision can be material. If an ESOP stock acquisition loan is repaid from company contributions, then all company shareholders share in the cost of the ESOP stock purchase. In contrast, if an ESOP stock acquisition loan is repaid from company profit distributions, then only the ESOP pays for the cost of the ESOP stock purchase. In this situation, non-ESOP stockholders do not subsidize the cost of the ESOP stock purchase through reduced (after plan contribution expense) company profits and reduced (due to lower profits) company stock values.

There are also several specific differences between ESOP-owned stock and non–ESOP owned stock. Many of those differences are summarized above. A valuation analyst should consider each of them in the analysis of the private stock to an ESOP versus another party.

There are many different scenarios where a private company might sell or otherwise transfer stock to an ESOP at a different price than to a non-ESOP investor. In many of these scenarios, a private company (or the selling shareholders) will sell stock to an ESOP, which will serve as a long-term owner of the company's permanent capital base. In contrast, a private company might sell stock to other parties for different reasons, such as to attract, retain, or compensate key employees, suppliers, joint ventures, or financing sources. The relationship between these parties and a closely held company is fundamentally different than the relationship between an ESOP and the company. And the investment criteria of these parties may be fundamentally different than an ESOP's investment criteria. A CPA should consider these differences when analyzing the fair market value of the stock to an ESOP, compared to the investment value of the stock to a non–ESOP stockholder. ❑

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