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## REGULATORY REPORT

# ADEQUATE CONSIDERATION GUIDELINES NEARING COMPLETION

A preliminary draft of proposed regulations on the definition of "adequate consideration" have recently been sent from the Department of Labor to the Office of Management and Budget for final review. Barring any major changes from OMB, the proposed regulations are expected to be circulated for public comment in the near future. Based on a review of a copy of the preliminary proposal, the proposed regulations would not impose any major change to current valuation procedures for closely held companies.

The preliminary draft of the regulations addresses the concept of fair market value as it relates to a determination of "adequate consideration" under section 3 (18) B of ERISA. The proposal also deals with the requirements that valuing fiduciaries act in good faith and discusses the use of independent appraisers in connection with the determination of good faith, and "is designed to provide a framework within which fiduciaries can fulfill their statutory duties" under ERISA. The proposal also sets forth the content requirements for written valuations used as the basis for a determination of fair market value.

The proposal would establish two criteria for determining adequate consideration: 1) the value assigned to an asset must reflect its fair market value, and 2) the value assigned to an asset must be the product of a determination made by the fiduciary acting in good faith. Fair market value is defined as the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset. In addition to this general definition, the proposal would also require that fair market value be determined as of the date of the transaction involving the assets in question, and that written documentation must support the valuation opinion.

Good faith efforts on the part of the plan fiduciaries to determine the fair market value of the assets would include a requirement that "the fiduciary making the valuation must itself be independent of all the parties to the transaction (other than the plan), or the fiduciary must rely on the report of an ap-

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## LEGISLATIVE WATCH

### NEW BILL WOULD REQUIRE EMPLOYEE APPROVAL FOR ESOPS

Senator William Armstrong (R-CO) has introduced a new bill in the Senate which would amend the Internal Revenue Code of 1986 to require a majority of employees to approve the establishment of an ESOP.

The bill, S.2078, which was introduced on February 22, 1988, is based on a resolution passed by the General Assembly of Colorado which was passed due to concerns raised by employee

groups opposing the proposed purchase of United Airlines by the company's pilots' union. The Colorado Resolution expresses support for the concept of "one person one vote" and urges Congress to enact legislation requiring such a vote to approve the establishment of an ESOP.

S.2078 would follow that concept by requiring that an employer wishing to establish an ESOP must notify employ-

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praiser who is independent of all the parties to the transaction (other than the plan). For these purposes, an appraiser will be deemed to be independent if he is independent of all parties participating in the transaction other than the plan. The proposal states further that "an appraiser will be considered independent of all parties to a transaction (other than the plan) only if a plan fiduciary has chosen the appraiser and has the right to terminate that appointment, and the plan is thereby established as the appraiser's client".

In regard to valuation content, the proposal largely follows the requirements of IRS Revenue Ruling 59-60 which are already used as a basis for valuation procedures. The proposal adds new requirements, however, such as a statement of the purpose for which the valuation is made, a statement as to the

relative weight accorded to relevant valuation methodologies, and a statement of the valuation's effective date.

The proposal also addresses the marketability of the securities being valued and specifically mentions the case of a put option feature in ESOPs. It states that "the Department believes that the existence of the "put" option should be considered for valuation purposes only to the extent it is enforceable and the employer has and may reasonably be expected to continue to have, adequate resources to meet its obligations.

The Department also proposes "that a plan may pay [a control] premium only to the extent a third party would pay a control premium". The proposal states that such a premium is unwarranted unless the plan obtains both voting control and control in

fact. The proposal also clarifies that a control premium would be justified on an installment sale "only to the extent that the understanding with the employer was actually a binding agreement obligating the employer to pass control within a reasonable time".

The proposal contains no mention of the valuation issues in multi-investor leveraged buyouts involving ESOPs. These issues are currently under review by the Department and may be addressed in separate regulations or guidelines.

As previously noted, the above guidelines have not yet been formally proposed and may be changed subject to current review by OMB and DOL officials. Once they are formally proposed, interested parties will be given an opportunity to submit comments on the proposed regulations.

### • DOL Complaint

The Department of Labor has brought a civil complaint against a former trustee of the ESOP of Citizen Bankshares of Ogden, Utah. The suit is in connection with the purchase of approximately \$550,000 of securities at prices exceeding market value. Citizens' president and CEO, his wife, four directors, and one of the directors' wives are also named in the complaint, which was filed in U. S. District Court for the District of Utah as Brock v. Columbia. The complaint seeks an order requiring repayment to the ESOP of any losses and also of any profits to other parties resulting from violations of ERISA.

### • Form 5330 Revision

Form 5330, Return of Excise Taxes Related to Employee Benefit Plans, has been revised by the I.R.S. to include the reporting of taxes on non-deductible employer contributions to certain plans, prohibited allocations of qualified ESOP securities, and reversions of plan assets.

### • PLR #8753011

ESOP and profit sharing plans do not qualify as accident and health plans, and amounts distributed for these purposes are not excludible from income.

### • PLR #8801042

A corporation is a member of a controlled group of corporations even when the corporation's stock is held in a voting trust.

### • SEC Ruling

The Securities and Exchange Commission has told the Sound Warehouse, Inc. ESOP that shares may be distributed without registration and that the shares will not be considered "restricted securities" (i.e., securities acquired from an issuer in a private transaction). The Dallas based firm wants to terminate its ESOP and distribute the shares; if the shares were considered "restricted" the employees would have limited ability to sell them, while registration would have imposed significant costs on the company.

### • FASB Ruling Affects ESOP Dividends

On December 31, 1987, the Federal Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards #96, "Accounting For Income Taxes". Included in the ruling was a provision noting that, in most cases, the tax deduction allowed for ESOP dividends should be recorded as a reduction in income tax expense rather than credited to stockholder equity.

## PRESIDENTIAL CANDIDATE KEMP ENDORSES ESOPS

Congressman Jack Kemp has reaffirmed his support of ESOPs, with a February 19, 1988 campaign statement pointing to his work on behalf of ESOPs in the past and Congressional Record statements in support of the need to expand capital ownership through ESOPs, and noting that "because of their importance in producing not only economic but social benefits, we preserved the incentives for ESOPs in the Tax Reform Act of 1986, when many other incentives were ended."

Congressman Kemp went on to say that it was time to "advance employee stock ownership the next step . . . now it's time to re-examine, and revise as necessary, the regulations and other impediments that have prevented too many American workers from enjoying part ownership of the businesses they work for."