Report of the NCEO Task Force on

ESOP Valuation and the Repurchase Obligation

COREY ROSEN

NCEO | NATIONAL CENTER FOR EMPLOYEE OWNERSHIP

Contents

Introduction **1**
- The Basic Problem: Rising Stock Prices Mean Rising Obligations 1
- Appraiser Views and Company Practices 1
- Cases Addressing the Repurchase Issue 3
- The DOL Process Agreements 3
- Accounting Standards and Repurchase Obligations 3
- Common Approaches to Considering the Repurchase Obligation 4
- The NCEO Task Force 4

ESOP Valuation Basics **6**
- Trustee Responsibilities 6
- Legal Guidance 7
- How ESOP Valuations Are Done 9

Specific Issues **12**
- Should the Repurchase Obligation Be Considered at All? 12
- Approaches to Factoring the Repurchase Obligation into Valuation 13

Recommendations **16**
- What Companies Can Do 16

About the NCEO and the Author **17**

The National Center for Employee Ownership
510-208-1300
www.nceo.org
customerservice@nceo.org

Introduction

Antioch Publishing was a small 100% ESOP-owned printing company in Yellow Springs, Ohio. It printed calendars, bookplates, and other products. In the 1980s, it diversified by buying Creative Memories, a direct-sales supplier of scrapbooks. The acquisition supercharged Antioch's stock-price growth, with long-time employees holding seven-figure ESOP accounts. Creative Memories was a cyclical business that went through a downturn, accelerated by the growth of digital cameras and cell phones. Many employees decided to leave and cash in. Antioch was already carrying significant debt from the Creative Memories transaction and from borrowing in 2003 to go from a minority ESOP to 100% ESOP ownership. The company was unable to buy back shares from participants who were eligible for distributions during this downturn and ended up in Chapter 11.

In a post-mortem meeting with Antioch's advisors, the advisors agreed that had the valuation reflected the rapidly growing repurchase obligation, the share price would not have gone up nearly as fast, and Antioch might have been able to buy back the shares and avoid bankruptcy, although its heavy debt could have still led to the same result. But the prevailing view at the time was (and still is among many appraisers) that because a hypothetical willing buyer would eliminate the repurchase obligation by buying all the shares, the emerging obligation should not be factored into the appraisal in any way. Of course, this is true only if the hypothetical buyer buys the entire company. If not, the company's obligation to buy back shares represents a liability that will reduce cash flow and hence value.

The Basic Problem: Rising Stock Prices Mean Rising Obligations

Antioch was an extreme situation. It is one of the rare ESOP companies forced into bankruptcy at least in part because of its repurchase obligation. But every private ESOP company faces a more mundane version of Antioch's problem. If a company's stock price goes up, its repurchase obligation goes up along with it. This represents what can often be a substantial ongoing financial liability. Other expected future costs, such as deferred compensation, equity rights that can be exercised in the next several years, a substantial balloon payment on a loan, and other deferred costs, would all be reflected on financial statements and result in a lower value per share. If these obligations are not included in value, the company could overpay for shares that might be liquidated before the obligations are due. Similarly, with an ESOP, if the valuation ignores the repurchase obligation, people who leave in the near term may be paid a higher price at the expense of those who stick around. In extreme cases, a company may find that this creates an obligation it cannot sustain. But if the valuation assumes that a willing buyer would buy 100% of the company (as opposed to buying shares in the company but not the whole company), the obligation would go away and so should not be counted. At the time Antioch dealt with this problem, many appraisers and trustees believed that ignoring the emerging obligation was what the Employee Retirement Income Security Act of 1974 (ERISA) required because the valuation was supposed to assume a willing financial buyer who would acquire 100% of the company.

Appraiser Views and Company Practices

The consensus view today, as explained below, is more nuanced. While some appraisers still say the repurchase obligation can be ignored, the large majority at least consider it. They may decide it is not an issue, often arguing the company has the funds, either in reserve or in the ESOP, to cover the obligation, or they may incorporate the repurchase obligation in the discount for lack of marketability, the company risk factor, projected future earnings, funds set aside in reserve for repurchases, or a combination of factors.

Another way to think about this issue is what happens if the ESOP company funds the repurchase obligation by making cash contributions to the ESOP. Once the cash is in the ESOP, it is no longer a corporate asset. The money has been spent, and the company's balance sheet is now weaker than it would have been if it did not fund the plan and retained the money. On an ongoing basis, if the amount needed to be contributed is above what the company would otherwise contribute to a retirement plan, an appraiser usually would normalize earnings to reflect what a hypothetical buyer would contribute to a retirement plan, typically adding back some of the additional contributions the ESOP company makes. The company and trustee might conclude, however, that these higher contributions are part of its business model for success and should not be normalized. Appraisers would not add back the cash held in the ESOP for repurchases as a company asset, however, because once it is in the trust, the cash in participant accounts is an obligation the trust pays out. If the company puts the same amount of cash in a company reserve account that is set aside for use for repurchases, it could be added back to value, in part because an appraiser could conclude that the money could, if needed, be used for other purposes.[1] In other words, the same funding dollars could have a very different impact on value depending on whether they are irrevocably set aside by putting them in the ESOP trust or only theoretically irrevocably set aside by being held in corporate reserves.

While companies could fund the repurchase obligation by contributing to the ESOP, most 100% ESOP-owned companies prefer to buy the shares back at the company level to recontribute to the ESOP in accordance with a predictable, stable percentage of compensation rather than an often much more variable amount that would fluctuate with annual repurchase needs. This approach also means that contribution levels can be better managed to leave more money in reserve or for growth in the company.

Another way the company might have the repurchase obligation factored into value more automatically would be for the company to releverage the ESOP. In releveraging, the company borrows money and loans the funds to the ESOP to buy back shares, with the loans repaid over time. This leverage adds a future cost to the company that reduces expected future earnings. This approach has become more common in high-value, mature ESOPs, with some doing it on an annual basis. It has the effect of allocating shares to participants more slowly (since the shares are allocated over the term of the new loan, which may be several decades) so that the annual required contributions, although still usually generous, are more manageable in the long term. The debt reduces the value of the shares and thus the size of the repurchase obligation.[2] This only works, however, if the debt is from a third-party lender. Releveraging can be done using internal cash reserves, which would not normally reduce the share price.

These complex interactions can be and are viewed differently by different appraisers. There is no single agreed-upon approach to how they should affect valuation among appraisers or trustees. The result is sometimes significant variation in how this issue is assessed.

1. This may depend on whether the ESOP has a controlling interest because in a minority interest case, the ESOP trustee could not, as a non-controlling shareholder, require the money to be set aside for a particular purpose.

2. Note that some companies may create what is called a floor offset plan. In these plans, the company guarantees that the effect of the reduction in value will not be reflected in the share price that participants receive at distribution while the debt is still being repaid or some fixed number of years, commonly five. The benefit is typically made available only to employees over a certain age, very often 55. The plan is funded by the company directly making up the difference at distribution to employees. It is not considered part of the retirement distribution. The floor offset plan would normally be reflected in the valuation. This is arguably another example of how obligations related to the ESOP may be factored into valuation under one circumstance and not another.

Cases Addressing the Repurchase Issue

The implosion of Antioch led to years of litigation. In 2016, in *Fish v. GreatBanc Trust Company,* No. 09 C-1668 (N.D. Ill. Sept. 1, 2016), a district court ruled in favor of the defendants. The 131-page ruling dismissed all claims, saying that the process the trustee used met fiduciary standards and that the valuation was reasonable given the thoroughness and independence of the process. Only one other case explicitly addressed the repurchase issue, *Armstrong v. LaSalle Bank National Ass'n,* 446 F.3d 728 (7th Cir. 2006). In that case, one of the key issues was whether LaSalle National Bank, acting as the ESOP trustee for the Amsted Industries ESOP, appropriately considered the impact of the repurchase obligation on valuation. The court did not specifically conclude how that should be considered, but it did indicate that the trustee should consider the impact.

The DOL Process Agreements

GreatBanc later became one of several trustees to enter into "process agreements" with the US Department of Labor (DOL) over fiduciary issues generally, but especially valuation. The agreements were focused on transactions between the ESOP and owners of the company, not on ongoing appraisals for the repurchase obligation. The agreements are detailed in the NCEO book The DOL Fiduciary Process Agreements for ESOP Transactions. The agreements, among many other things, provide that the appraiser's report or trustee's documentation should demonstrate consideration of how "plan document provisions regarding stock distributions, the duration of the ESOP loan, and the age and tenure of the ESOP participants may affect the ESOP sponsor's prospective repurchase obligation, the prudence of the stock purchase, or the fair market value of the stock." While some trustees and advisors have concluded that the DOL believes the repurchase obligation should be factored into ongoing valuations, nothing in the agreements specifically addresses this issue, and the agreements focused on purchases from original owners selling to an ESOP.

Accounting Standards and Repurchase Obligations

The issue has come up again in the context of possible accounting standard changes. The Private Company Council, an advisory body for the Financial Accounting Standards Board (FASB), is looking into whether financial statements should provide lenders, surety bonding firms, and creditors a clearer idea of the potential financial impact of the repurchase obligation. The issue is not unlike what the FASB faced in the early 2000s when it considered how companies should record the obligation implied by outstanding stock options. Beginning in 2006, the FASB required that companies show the present value of awards as a cost on income statements.

At this point, it does not appear the Council will recommend that the repurchase obligation show up on income statements. Instead, the Council discussed options such as disclosing five-year cash flow projections, the number of employees eligible to retire now or in the next three to five years, the most recent share value, how the company has been meeting the obligation, and whether a repurchase obligation study has been done.

The Council is clearly concerned that companies' financial capacity be considered in light of the repurchase obligation. Many advocates for ESOP sustainability argue that unless the repurchase obligation can be considered, some ESOP companies will be forced to sell, especially those that have not planned well for repurchases, face an unexpected downturn, have an unusually high number of employees leave with high account values, or face other unplanned-for events. There is also an issue of equity. If the repurchase obligation is not factored into valuation, the company is arguably paying employees who leave in the near term a price that does not reflect the company's ongoing financial commitments. The employees who leave later would, by definition, receive a lower stock price than if the earlier share valuation had incorporated the repurchase obligation.

Common Approaches to Considering the Repurchase Obligation

So where does the ESOP community now stand on this issue? And where should it stand? To help address that question, the NCEO asked a number of experienced ESOP trustees what they see as common practices among appraisers on valuation and the repurchase obligation. Everyone agreed that the repurchase obligation is not a factor if one of two things is true:

- The company has adequate cash in the ESOP trust to handle obligations for the near to mid-term. That cash means the obligation will not impact the company's future income.
- The obligation is small for the near to mid-term, usually because the ESOP is in its early stages.

For companies where neither one is true, practice varies widely:

- The repurchase obligation should not be considered at all because the valuation standard specifies a willing buyer who would eliminate it.
- If the company has adequate cash reserves or cash flow, the repurchase obligation need not be factored into the valuation.
- The repurchase obligation can be accounted for by adjusting the discount for lack of marketability, which is almost always between 5% and 10%.
- The obligation to fund repurchases can be factored into the company's future cash flow projections, usually by calculating the excess amount over what a hypothetical buyer would need to fund a retirement plan.
- The company-specific risk premium (incorporated into the discount rate used in the valuation) can be adjusted upward to reflect anticipated costs.
- Some combination of approaches.

Each of these models presents potential problems, putting both appraisers and trustees in a bind. Ones that tend to downplay the obligation run the risk of causing a significant cash drain on the company and even a forced sale (indeed, these models are premised on the idea that the company could always be sold). Accounting for the repurchase obligation, however, runs the risk of courts saying that the appraisal was inconsistent with the standard of value for ESOPs, meaning paying out terminated participants at too low a price. No case to date has addressed this specific issue, however.

The NCEO Task Force

These were the issues the NCEO task force on valuation and the repurchase obligation was designed to address. The task force was made up of NCEO founder Corey Rosen and the following ESOP trustees:

- Chip Brown, TI-Trust
- Kjersti Cory, SCJ Fiduciary
- Brian Ippensen, TI-Trust
- Mickey Maier, Professional Fiduciary Services
- Jeanine Pendergast, Spinnaker Trust
- Joel Phillips, Fiduciary Services
- Kyle Spader, Acumen Advisors
- Scott Storjohann, GreatBanc Trust
- James Urbach, Urbach Law

The task force met over the summer of 2026. Its initial findings were sent to the following ESOP valuation professionals for review:

- Craig Olinger, ESI Equity
- Henry Ventura, Prairie Capital
- Laurie-Leigh White, BVA Group

The task force's goal was not to develop a specific approach to handling the repurchase obligation and valuation, but to determine whether the repurchase obligation should be considered and, if so, the pros and cons of each competing approach.

The task force considered the impacts the repurchase obligation would have on company cash flows, strategic plans, and business risk. While the task force agreed that the repurchase obligation should be considered, it also recognized that current valuation guidance does not provide a clear pathway for doing so. In fact, the common presumption of value that is based on what a hypothetical 100% buyer would pay could seem to preclude considering the effect of the repurchase obligation, absent some generally agreed-upon workaround. This issue can be definitively resolved only by regulatory guidance. The DOL is now in the process of proposing regulations on ESOP valuation as required by the SECURE 2.0 Act. The DOL has indicated that proposed regulations will be issued in late 2026.

The task force also looked at the most commonly used approaches to considering the repurchase obligation and valuation listed above. Relying only on adjusting the marketability discount was seen by most (but not all) members as the least exact and reliable method, in part because the large majority of ESOP appraisals put the discount at 5% regardless of the repurchase obligation and other factors, such as the inability to cash in shares at any time, that affect the size of the marketability discount. It might be theoretically possible, however, to create models for calculating the discount that are more precise. The repurchase obligation may show up in other parts of the valuation as well, however, so the discount for lack of marketability may be only part of the process. The task force agreed that using multiple approaches can often make sense.

Factoring the added expected costs into the amount that needs to be contributed to the ESOP was also seen as a theoretically elegant solution, but one that might not stand up under a legal challenge.

Adjusting the company-specific risk premium presented what most task force members saw as a potentially workable compromise, but all agreed that any of the three methods might work, even if they all end up leaving a lot to judgment.

A different way to think about this might provide an alternative solution. In developing forecasts for the appraisal firm, a company could include the appropriate retirement plan costs to fund the plan. The operational consequences would be modeled in the forecast, including whether this requires a pullback in growth and/or capital expenditures. This approach allows for a more mathematically precise assessment of the impact without changing the basic assumption that the repurchase obligation would go away if the company was sold. Of course, this depends then on companies actually developing these careful forecasts, which is often not the case. The forecasts would have to be for multiple years into the future, which introduces significant uncertainty. Trustees could play a role here in encouraging clients more vigorously to do this, which some already do.

One potential dilemma raised by one of the task force members was whether the repurchase obligation, if considered, should also be a factor at the time the ESOP initially purchases the shares. Currently, the repurchase obligation plays no role in this initial purchase from an outside shareholder other than that a small lack of marketability discount is applied. If it did, it could mean that these sellers would have to accept a lower price from the ESOP than is currently the case. Some sellers might then decide not to do an ESOP in the first place. For the large majority of transactions, because the ESOP repurchase obligation will not become material for many years, its present value is so close to zero that it would not have a meaningful impact. Some task force members, however, said there are times that the share price is likely to grow very quickly even at the outset, and factoring in repurchase obligations could affect initial valuations. Others believe this is not an issue, or at least is very unlikely to be. Again, this issue would need to be resolved through regulatory guidance that allows the initial transaction to be at a fair market value that does not incorporate these future obligations.

ESOP Valuation Basics

Before we get to a detailed discussion of these approaches, we first review ESOP valuation basics. Readers already familiar with this process can skip to the next section.

ESOPs have been around since the 1950s and have been part of federal law since 1974. While that law requires an independent appraisal to ensure that the ESOP does not pay more than fair market value for the shares, there have never been regulations on how the appraisal should be done. The DOL first proposed regulations in 1988, but it never finalized them. During that time, however, the DOL has been actively engaged in investigations, litigation, and process agreements with ESOP trustees that provide some guidance on the DOL's positions on some, but not all, valuation issues. These process agreements, however, legally apply only to the specific trustees with whom they were made. There are differing views on whether this uncertainty over valuation has affected the ESOP formation rate and, if so, how much.

The first ESOP was created in 1956, although at the time ESOPs were called Kelso plans after their creator, Louis Kelso. Plans had to be approved one by one by the IRS before getting started, a process that often took two years. About 300 plans were created through 1973. In 1974, Congress took the basic structure of these plans, now called ESOPs, and formalized them as part of ERISA. ERISA governs all retirement plans, and ESOPs were deemed to be retirement plans. At the time, retirement plans included profit sharing, pension, and stock bonus plans (401(k) plans came later). The law made statutory what Kelso had argued applied to Kelso plans, namely that contributions to the plan were tax-deductible within annual contribution limits (then set at 15% of eligible pay per year) but not taxable to employees until the accounts were paid out. The law put the assets in a trust governed by an appointed trustee. ERISA set no rules on who that needed to be, and in the early days of ESOPs, it was most often one or more insiders. The trustee was obligated to act for "the exclusive benefit of plan participants," meaning that if there was a conflict of interest between what was best for participants and what was best for existing owners or executives, participants should be favored. Over time, Congress added significant new tax benefits for ESOPs.

At first, many of the promoters of ESOPs envisioned them being used primarily in public companies, where share prices were determined by the market. Fairly quickly, however, it became clear that the primary market for ESOPs would be closely held companies, most often when owners were looking to sell some or all of their shares. Until the late 1990s, almost all ESOP transactions were done in stages, often starting at 30% so the seller could defer taxes on the gains (the law requires that the ESOP be in a C corporation and own at least 30% of the shares for this tax benefit to apply). In 1996, Congress passed a new tax benefit for ESOPs by allowing them to hold shares in an S corporation and not pay any tax on profits attributable to the trust. The result was that by the 2020s, over two-thirds of private ESOP companies were S corporations, and most ESOP transactions were for 100% of the stock.

Trustee Responsibilities

One of the most important responsibilities of the trustee is to determine whether the ESOP is paying no more than fair market value for shares in these closely held companies, both when it buys shares from existing owners and when it buys shares from employees when shares are diversified or distributed. The ESOP cannot pay more than fair market value in the former case and cannot pay less than fair market value in the latter. The trustee must hire an independent, outside appraiser to do a valuation to help make that decision. In some ESOP transactions with existing non-ESOP owners, the appraisal firm will determine a fair market value and report that to the trustee. The trustee may have questions about the appraisal and, in some cases, ask for changes. The trustee would then negotiate with the seller and/or board of directors to determine the final price, but this final price cannot exceed the determined fair market value. In other cases, the trustee will ask the appraisal firm to provide a fairness opinion that creates an acceptable range of value. If the trustee determines that this range of value is acceptable, the trustee would then again conduct negotiations to finalize the deal, this time within that acceptable range.

The appraisal firm is hired by the trustee, not by the board or the seller. The trustee is responsible for making sure that the appraisal firm is qualified and does the appraisal properly. If there is litigation concerning the appraisal, the trustee almost invariably is a party to the litigation. The appraisal firm, however, is almost never a party to the litigation, although in very rare cases appraisal firms have been sued by one or more parties in ESOP litigation for malpractice. The appraisal firm, however, is not considered a fiduciary for the transaction but rather only an advisor.

The trustee is not simply concerned with the sale price. The trustee must also approve the deal structure. This is usually straightforward if the ESOP is purchasing shares with cash contributed by the company to the trust or the shares are being purchased entirely with senior debt from a bank or other third-party lender. Most ESOPs, however, are financed at least in part through seller notes. Because seller notes are less secure than senior bank debt, they can reasonably carry a higher rate of interest. Trustees must determine whether that interest rate is fair to the ESOP. Seller notes can also be structured to include warrants. A warrant gives the seller the right to purchase shares in the company at the transaction price, generally in return for reducing the interest rate on the note. If the stock price goes up in subsequent years, the company would redeem the warrants. In effect, warrants are similar to purchased stock options. Trustees must determine whether the number and value of the warrants are reasonable based on the overall blended return expected for the seller. While these considerations do not directly factor into the appraisal, they do affect the overall determination of whether the deal is fair to the ESOP.

Legal Guidance

There has never been a clear definition or regulatory guidance on what fair market value means. In December 2024, the DOL issued proposed regulations that would govern the valuation of company stock in an ESOP, although the Trump administration withdrew the rules in January 2025. The 2022 WORK Act, part of SECURE 2.0, requires the DOL to issue valuation regulations. As previously noted, the DOL has scheduled new proposed regulations for November 2026, although proposed regulation schedules are often pushed back. The DOL leadership has indicated that the new valuation regulations will take a lighter-handed approach than the proposed regulations.

Lacking established regulations, appraisers and trustees have generally relied on guidance issued in 1959 by the Internal Revenue Service for the transfer of property, including stock in closely held companies. The DOL also proposed valuation regulations in 1988, but they were never finalized, withdrawn, or made available for comment.

The 1988 proposed regulations state that the valuation should be "at a 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." It does not define whether the asset in question is the entire company or shares in the company. The guidelines discuss appropriate documentation, timing, and the use of financials from the company. They discuss the various methods used to determine value, including discounted future earnings, comparable company sales data, comparable public company data, and asset-based approaches. They state that ESOPs can pay for control only if they actually have it. The proposed regulations deal more with process than specific guidance, something that the 2024 proposed regulations did do. They did not address the issue of repurchase obligations.

The 2024 proposed regulations also drew on the proposed 1988 guidelines and Revenue Ruling 59-60, guidance issued by the IRS in 1959 mostly for valuing gifts and estates. The Retire through Ownership Act, which unanimously passed the Senate in October 2025 (and is pending in the House as this is written in the summer of 2026), would allow ESOP trustees to rely on independent appraisals by qualified ESOP appraisal firms using guidance under this ruling. Revenue Ruling 59-60 outlines the basic valuation principles that ESOP valuations typically use, such as weighting earnings, assets, and comparable company approaches; using discounted or capitalized earnings to project enterprise value; and calculating discount rates based on the weighted average cost of capital.

Revenue Ruling 59-60 is just 3,861 words long, about 12 pages. The recently proposed DOL valuation guidelines were 128 pages long. Revenue Ruling 59-60 provides a very general description of what fair market value means and how it should be determined. It was developed mostly for gifts and estates but can be applied to other private transactions. The core concept of Revenue Ruling 59-60 is that fair market value is "the price at which the property 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, both parties having reasonable knowledge of relevant facts." Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property. When appraisals are done for ongoing ESOPs, the assumption is that the entire company, not just some of its shares, is being sold, although adjustments are made (as discussed) for control issues and lack of marketability.

The rule applies only to determining the value of the asset being purchased (in this case, shares in the ESOP company), not to the overall terms of the transaction.

The following factors, although not all-inclusive, are fundamental and require careful analysis in each case:

a. The nature of the business and the history of the enterprise from its inception.
b. The economic outlook in general and the condition and outlook of the specific industry in particular.
c. The book value of the stock and the financial condition of the business.
d. The earning capacity of the company.
e. The dividend-paying capacity of the company.
f. Whether or not the enterprise has goodwill or other intangible value.
g. Sales of the stock and the size of the block of stock to be valued.
h. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business. Earnings are considered the most important aspect of the valuation, but assets must also be considered.

Revenue Ruling 59-60 notes that "a determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings." This could include an assessment of factors such as weighting assets, earnings, and comparable company approaches, control discounts, assessing the riskiness of earnings and the accuracy of projections, and other common issues, but Revenue Ruling 59-60 provides no guidance on how to do that. The law does not direct the Secretary of the Treasury to issue regulations on how Revenue Ruling 59-60 would be used.

For trustees in an ESOP, this only answers one part of the question they are asked to address, namely whether the transaction overall is fair to the plan participants. The ruling does not provide guidance on such tricky issues for ESOPs as the impact of warrants, the impact of debt post-transaction, the interest rate charged on the seller note, and other factors considered in the DOL proposal. Nor does it indicate how an appraiser must be selected and what determines independence. These ambiguities will need to be resolved by DOL valuation guidelines that it is required to issue as well as by the courts.

If the Retire through Ownership Act becomes law, trustees must still determine whether a transaction is fair for participants. Fairness looks at all the terms of a transaction discussed above, not just the price of the shares that Revenue Ruling 59-60 addresses. Trustees could then say that they relied on an independent appraisal following the guidelines for the determination of share price but still must look at all of the terms of the transaction and document their work.

The Retire through Ownership Act states that the Secretary of Labor can issue additional guidance for ESOP transactions. That arguably leaves the ESOP community in much the same place where it is now, namely that Revenue Ruling 59-60 is used as a guideline for determining how valuations for shares should be done but not providing specific guidance on the many issues that come up concerning the overall fairness of the transaction.

None of the proposed guidance has addressed whether or how the repurchase obligation should factor into valuation. The lack of regulatory guidance for valuations in general has left the issue to courts to make decisions. These cases end up largely being battles between dueling experts, and the resulting decisions do not provide clear and consistent guidance on how to proceed. Between 1990 and 2026, 109 cases concerning valuation made it to court. The large majority have settled, meaning there is limited definitive guidance from courts on valuation.

How ESOP Valuations Are Done

The ESOP appraiser is required to determine what a hypothetical willing financial buyer would pay for the shares being valued. A hypothetical strategic buyer cannot be considered because this presumes the ESOP company becomes part of another company. A financial buyer is essentially concerned with whether the amount invested justifies the risk of the investment relative to other investment opportunities. To do this, the buyer must assess the assets and liabilities of the company, what similar investments in similar companies would yield, the relative risks of the investments compared to other alternative investments, etc.

The large majority of ESOP valuations are based primarily on expected future earnings. A hypothetical buyer is paying a price today for those future earnings and must assess what rate of return is reasonable given the alternative uses for the buyer's funds. To determine that investment return requirement, the appraiser calculates a weighted average cost of capital (WACC), which is the rate used to discount future earnings. The idea of the discount rate is that any investor will pay less for the right to earnings in the future than earnings in the near term because they are less certain. If the discount rate is 20%, the investor will pay five times earnings; if it is 25%, the investor will pay four times, and so on.

To calculate this, the appraiser looks at what the investor could make in very safe investments (such as T-bills and money market funds), equity funds, the cost of debt, and riskier investments (such as smaller companies). These numbers are based on publicly available data and do not vary much from one appraisal to another. Investing in a closely held company, of course, adds more risk because it is likely smaller than the kinds of public companies an investor might invest in, is probably less diversified, and its shares are not liquid.

While much of the weighted average cost of capital calculation is based on publicly available numbers, appraisers must also assess company-level risk. This is a judgment call. It is largely based on how accurate company projections about future earnings have been, but it can also be influenced by other foreseeable risks, such as possible changes in markets or departures of key personnel. The bigger the risk, the larger the added discount. This number can range from 0% to 15% or more but is usually between 2% and 7%.

This can have a big impact on value. The company risk is added to the cost of equity, and the proportion of equity in the capital structure affects how much company risk impacts the final discount rate/WACC. Variations of a few to several percent in this risk factor will affect the price of shares by a multiple of that risk factor number. Companies that are consistently overoptimistic about earnings, even if they do well in absolute terms, will see a negative impact on valuation. As we discuss more below, one way to approach the repurchase obligation issue would be to increase the company-level risk as the repurchase obligation increases.

The appraiser will adjust the weighted average cost of capital based on the cost of and need for debt and use that discount rate to discount projected future cash flows back to the present, creating an enterprise value. The resulting number must then be adjusted for remaining assets and liabilities not included in the enterprise value. One of the key issues here is the notion of "excess cash." This is cash on the balance sheet that is in excess of the company's normal needs for emergencies and cyclicality. This cash can be added to the value a buyer would be able to pocket.

The appraiser can also calculate value based on two other approaches: asset value and comparable companies. Asset value is straightforward. It estimates the fair market value of the assets and liabilities. This presumes the buyer would buy the company for its asset value, meaning it could be worth more for its assets if closed than its future earnings if kept open. Adjustments need to be made for things such as depreciated real estate showing up as a lower value on a balance sheet than its actual fair market value. In companies that are performing well, asset value usually gets little or no weight.

Finally, the appraiser will look at the prices paid for the shares of comparable companies. This can be difficult to do for many closely held companies. As a proxy, the appraiser can look at comparable public companies (if any) and see what the price-to-earnings ratio is for shares in those companies, adjusting for the fact that these shares are more liquid than those in an ESOP company.

The appraiser then uses judgment to weight the three approaches and determine an enterprise value. This is the value of the whole company. The value of an individual share is not simply the enterprise value divided by the number of shares, however. The enterprise value should be adjusted by debt, cash, and any other non-operating assets/liabilities to arrive at the fair market value of equity, which is then divided by the number of shares.

Buying a security that can be sold any time in an active market is more valuable than buying one where you have to sell the whole company, a process that takes time and adds uncertainty. Private ESOP companies have a requirement to buy back shares at fair market value, so their shares are more liquid, albeit not in the same way as shares in public companies that can be sold immediately whenever the seller chooses. Most appraisers add a 5% discount for lack of marketability, but it can be as high as 10% to 15%. The number is almost always just an assumption by the appraiser, not the result of calculation.

Finally, control rights must be assessed. In the past, appraisers had one price for control and a lower price for lack of control. The difference often was 25% to 35%. In recent years, the concept of control value and how to calculate it has become more nuanced, constructed more from a set of calculations. Differences of 10% to 15% are more common now. Appraisers have shifted to a new model that never pays for control per se but rather applies multiples to earnings based on a variety of company attributes that they contend provide a more accurate way of thinking about what ESOP shares are really worth. If the ESOP does not have governing control, this number is discounted based on the elements of control it lacks. Even when the ESOP owns a majority of the stock, however, control may be subject to contingencies on loans or practical constraints on how the ESOP trustee can exercise control, all of which can also result in discounts. Control elements are priced not on a general assumption but on a calculation.

Finally, of course, appraisers may assess the impact of the repurchase obligation, as discussed in detail in this paper. The end result of all of these factors will be a conclusion of value per share. The trustee needs to review the report and make a final determination as to value.

Specific Issues

Should the Repurchase Obligation Be Considered at All?

Alternative 1: The repurchase obligation should not be considered at all because the valuation standard is a willing buyer who would eliminate it by buying the entire company.

Although the position that the repurchase obligation should not factor into valuation could lead to more Antioch-like situations, some valuation firms take this approach. Some trustees we asked said they agreed; most others said they would never accept this approach, and one even said he would replace the valuation firm.

The argument for this position is that the valuation standard says nothing about repurchases, and the issue would not be relevant for a willing buyer. They are buying 100% of the shares; the ESOP simply changes who gets the value. The flip side, from a fiduciary standpoint, is that if a company does well but then experiences a downturn or other event that reduces the assets it planned to use for repurchases, this can effectively force a sale of the company in some circumstances. That might be great for some employees, but many, if not most, would do better if the ESOP were maintained for the long term. Employees with high account balances who are closer to retirement would find the higher prices resulting from not factoring in the obligation a great benefit; newer employees in a hypothetical sale would not have very large balances and would not profit as much from a sale. All employees would likely end up moving from a company-funded retirement plan (the ESOP), with a higher-than-average company contribution for a retirement plan, into a 401(k) plan that employees fund mostly themselves with a far lower company contribution/match. The question for the trustee is what is for the exclusive benefit of plan participants. Should it be the long-term value of the ESOP to participants or the short-term stock price? Most task force members agreed that the repurchase obligation should be a factor, but a few argued it should have a relatively modest or no impact on value if the company has the financial capability to handle it.

We can look at the argument about whether the repurchase obligation should count by considering the stock option analog to ESOPs. Say that a company has 10 executives of different ages. Stock options were granted at $20/share, and the stock price is now $100. The present value of all options is $10 million, with $3 million held by two people nearing retirement. The company is valued mostly based on income statement projections that assume that there is no financial obligation tied to the options (they cannot do this under FASB rules, but for the sake of argument here we are assuming they can do so). The two executives leave, and the company's income statement and/or balance sheet drops by $3 million. The stock value drops for the other eight people. Does this constitute a plan feature or a bug? If the present value of options were recorded all along (as required by FASB), the cost and resulting impact on stock value would be more evenly divided among the 10 people. In ESOP companies, this same issue comes up when some employees have stock appreciation rights or sellers have warrants, both of which appraisers consider dilutive to value in the same way the ESOP repurchase obligation is.

If the repurchase obligation is to be considered, task force members believe one of the following approaches should be used.

Alternative 2: If the company has adequate cash reserves, the repurchase obligation need not be factored into the valuation.

This approach assumes the repurchase obligation can affect the value, but only if the company's cash flow and/or balance sheet is not adequate to handle it. Under this approach, a company with strong cash flow and a growing share price will pay more in the short run for shares from departed employees and less in the long run because it will have less cash than if the repurchase obligation were factored into earnings expectations. A number of trustees, however, said that they agree with the view that the repurchase obligation should not reduce share prices if the company is well positioned to finance the obligation.

Alternative 3: The repurchase obligation should be a factor in valuation.

Most of the task force members agreed that the repurchase obligation should be considered in valuation. There was unanimous agreement that if the company funds repurchases by contributing cash to the ESOP, that would largely resolve the issue from a valuation standpoint because these funds could no longer be counted as corporate assets.

The task force looked at four options for considering repurchase where this is not the case, as detailed below.

Approaches to Factoring the Repurchase Obligation into Valuation

Alternative 1: The repurchase obligation can be accounted for by adjusting the marketability discount applied, which is almost always between 5% and 10%.

This is one of the most common approaches. The assumption is that if the repurchase obligation is large relative to the financial capacity to pay for it, the shares become potentially less marketable because there is a greater chance the company will not be able to pay for them. A major difficulty with this model is that although the marketability discount is often preceded by multiple pages of discussion on the theory and math of the calculation, the chosen rate is almost always 5% or 10%, and most often 5%, suggesting the number is more an assumption than a calculation. Adding to this concern is that the marketability discount also assesses other ESOP features. ESOP stock accounts are less liquid than public company shares because holders cannot sell their shares when they choose. The put right makes them more liquid than shares in other private companies, but there is still some level of discount needed to reflect the inability to sell when desired. A 5% or even 10% discount for lack of marketability is arguably a modest reduction in share price just on the timing issue. Would a hypothetical investor pay just 5% less for shares that could not be sold until that investor retired or terminated employment at their company when the investor could invest in public company stocks and sell at any time? If this argument is correct, then it would seem that if the repurchase obligation is reflected in the marketability discount, when that obligation is substantial, it requires an increase in the marketability discount from its baseline early on in the ESOP, along with a (preferably) mathematical calculation, although this would not be on a one-to-one basis in a leveraged ESOP because debt is paid off over time.

Because of these concerns, the task force did not think the marketability discount was a preferable method, assuming that the repurchase obligation should factor into valuation.

Alternative 2: The obligation to fund repurchases can be factored into the future cash flow projections of the company, usually by calculating the excess amount over what would be needed by a hypothetical buyer to fund a retirement plan.

Earlier in this paper, we discussed the idea of company forecasts incorporating expected repurchase needs and their impact on earnings and capital expenditures. To the extent a company is being valued based on discounted future free cash flow methods, this seems like the most mathematically elegant solution. The forecast would help the appraiser assess how much more the company needs to put aside to fund the repurchase than it would if it were a similar non-ESOP company. This excess amount is then factored into earnings projections. Say the company is expected to earn $4 million per year for the next five years but will need $2 million of that for repurchases. That $2 million is $1.5 million more than it would need for employee retirement contributions if it were not an ESOP. The earnings projections would then be reduced by this amount.

There are a few challenges here. There are two components: shares to be repurchased and share price. The first one is easier to get a rough estimate of; the second one would require a sophisticated financial model. Even if this can be done with some accuracy, there are additional issues. First, the appraiser may be normalizing earnings to reflect the larger contribution, which would increase the stock value. When the appraiser normalizes retirement contributions, it compares what the ESOP company contributes to its ESOP and (if applicable) 401(k) to what would be typical for that industry (often 3% to 5% of payroll). ESOP company contributions are frequently a great deal higher, often 8% of pay or more. The appraiser would take the difference and add it back to earnings projections because a hypothetical buyer would not make contributions that large. Some companies, however, argue that these high levels of contribution are required to sustain their business model because they attract and retain the talent they need, and that argument is often accepted, in which case no normalization is done.

For the approach to repurchase that reduces earnings by factoring in excess contributions to work, the argument about sustainability would have to be extended to the importance of the ESOP being sustainable in the long term, and trustees would have to accept this as reasonable. If regulatory guidance were to allow this, valuations could factor in the obligation with some accuracy through mathematical modeling.

Alternative 3: The cash set aside for repurchases is put in a hypothetical "lock box" and not counted as an asset.

This approach has theoretical appeal but does not appear to be used. The idea is that the company sets aside a reserve fund to buy back the shares, which may or may not be recycled. The funds are not counted as an asset because, in effect, they are offset by a liability. Theoretically, this is similar to what would happen if the company put the funds in the ESOP trust, except, of course, that if the cash is in the trust, it legally belongs to the participants. In that case, the company's assets would be reduced, and the valuation would reflect that. But, perhaps paradoxically, if the funds are kept outside the trust and the shares repurchased are recontributed to the ESOP, the impact on valuation in most valuation models would be different. Trustees told us that valuation firms would simply add back the value of these funds rather than sequester them. These company assets are still considered company assets by banks, bonding companies, and most importantly by creditors and/or the courts. Some appraisers told us they have also seen company boards go back and use "restricted" funds when an acquisition or other capital need opportunity arose.

For this approach to be acceptable, there would need to be regulatory guidance authorizing it.

Alternative 4: The company risk factor can be adjusted upward to reflect anticipated costs.

Finally, some appraisers solve the problem by increasing the company-specific risk factor used to compute the weighted average cost of capital. This has intuitive appeal because if the company has to spend more money buying back shares, there is a greater risk that future earnings projections will not be met. There is a mathematical paradox here, however. If the company does not do an accurate job of projecting its risk, the company-specific risk would go up (especially if the company developed a pattern of spending more than it projected, making its earnings projections less reliable) and the stock value would go down, making the repurchase risk more manageable and thus the risk lower. Because of iterative impacts like these, the valuation model would ideally specify just how the added risk number is derived in a way that is convincing to trustees. Because the company risk number in the weighted average cost of capital is currently just a judgment call anyway, however, adding the obligation into that judgment may be acceptable. A willing buyer would eliminate that risk, however, so this can run into the same argument about what the standard of value should be.

Recommendations

The task force was unanimous that the ideal solution is for the DOL to first address whether the standard of value necessarily implies that a hypothetical financial buyer would eliminate the repurchase obligation and, therefore, that the repurchase obligation cannot be factored into valuation. As noted above, the DOL stated in process agreements that the appraiser's or trustee's documentation should address how ESOP participant demographics may affect the repurchase obligation, but the DOL did not address how this would affect ongoing valuations. Ideally, the DOL would stipulate that a trustee can require an appraisal to consider the long-term sustainability of the ESOP. This would mean the standard of value is not simply based on what might be good for participants who leave when an ESOP company is sold, but on what would be good for all ESOP participants over the long term. A clear statement of position on this issue would then allow appraisers and trustees to consider just what the impact of the repurchase obligation should be on valuation.

Second, the regulations should specify how appraisals should factor the repurchase obligation into valuation. This task force looked at various approaches. The one that appears the most theoretically appealing would be for the company to be able to set aside a reserve fund that would not be counted as a corporate asset for valuation purposes. Alternatively, or additionally, regulations could allow appraisal firms to model the impact of the repurchase obligation on future cash flows without being required to normalize excess contributions to the ESOP to fund repurchases.

Third, regulations could provide guidance on when the repurchase obligation does not need to be considered—for instance, when it is not projected to be material for a significant number of years or the company has a specific strategy of building the company to be sold.

If the DOL does not create this kind of regulatory guidance, ESOP trustees have some limited leeway to make their own decisions about what is appropriate. The task force agreed that the repurchase obligation should be considered in some way and that the company, the appraiser, and the trustee should have ongoing discussions about what is desirable and what is feasible within the current constraints of the law. Of the methods considered, adjusting the company risk factor was the one that members favored the most as a good compromise between what is allowed and what would be ideal, although there was no consensus. Trustees should require an explicit discussion of the repurchase obligation in valuation reports and should report to the company's board on the rationale used for the decisions made.

What Companies Can Do

Companies have some leeway in how they fund the ESOP, which can effectively factor the repurchase obligation into valuation even if the appraisal itself does not do this directly. The first option is the one we mentioned: funding the repurchase obligation through contributions to the ESOP. As noted, the assets set aside for this purpose no longer count as corporate assets and reduce company value in a way that holding these assets in reserve outside of the ESOP would not.

Companies that find this approach too restrictive in managing benefit levels and the repurchase obligation can fund the obligation through releveraging. In releveraging, the company borrows money and reloans it to the ESOP to buy back shares from former employees. As the loan is repaid, the shares are allocated. This additional debt would reduce the value of ESOP shares if the debt is external. This approach is becoming more common, especially in companies that have had very strong stock performance.

The task force welcomes comments from readers of this document. Comments should be directed to Corey Rosen of the National Center for Employee Ownership at crosen@nceo.org.

About the NCEO and the Author

We are the National Center for Employee Ownership (NCEO), a nonprofit organization that has been supporting the employee ownership community since 1981. We have thousands of members because we help people make smart decisions about employee ownership, with everything from reliable information on technical issues to inspiration to help companies reach the full potential of employee ownership.

We generate original research, facilitate the exchange of best practices at our live and online events, feature the best and most current writing by experts in our publications, and help employee ownership companies build ownership cultures where employees think and act like owners.

Whether you are considering employee ownership, managing an existing plan, or advising clients, we can help. Our members have access to all of our online resources, and we are committed to providing extensive materials for anyone interested in learning more about employee ownership, from people considering employee ownership to decision-makers at employee-owned companies to ESOP participants to journalists to stock plan administrators and other service providers. We welcome everyone to sign up for our email list on our website and to visit our blog.

Our staff covers the nation from multiple locations in the US, and our board includes representatives from employee-owned companies and the professional advisors who serve them.

We are supported almost entirely through membership fees and our activities, but we do accept donations, which are tax-deductible (we are qualified as a 501(c)(3) nonprofit charitable organization).

Corey Rosen

Corey Rosen is the NCEO's founder and former executive director and now is its senior staff member. Corey has spoken on various subjects related to employee ownership all over the world with government, business, and union leaders, and he is regularly quoted in leading magazines and newspapers. He has appeared on national television and radio programs and also has authored four books on employee ownership, plus more than 100 articles for various business, academic, and professional publications. He has authored or coauthored several of the NCEO's practical and research publications. He holds a PhD in political science from Cornell University.

The National Center for Employee Ownership
510-208-1300
customerservice@nceo.org
www.nceo.org

NCEO
NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP