

# VALOREM PRINCIPIA

## Case Study

### *Former Executive Sues Fortune 500 for Ownership in Investments*

## **\$14 Million Claim Reduced to \$0** **Nevin Sanli's Testimony Wins the Jury**

### Case Background

The Plaintiff's a former Senior Executive of a Fortune 500 corporation, claimed that he was fraudulently induced to perform work beyond the scope of his employment in return for a percentage interest in an entity that invested in about 300 distressed properties. The Plaintiff's original claim for his alleged 4% interest was \$14 million. Later, his expert, a Ph.D. in Mathematics, opined that the value of the 4% interest was \$10 million. Mr. Sanli, working for the defense, determined that the entity had \$0 value because of its huge liabilities.

### Trial

During the six-week jury trial, the jury saw over 20 witnesses and about 300 trial exhibits. Mr. Sanli also provided rebuttal testimony highlighting inconsistencies in Plaintiff's expert's financial models and analyses.

### Verdict

The jury determined that no damages be paid to the plaintiff.



Nevin Sanli is President and co-founder of Sanli Pastore & Hill, Inc. He has valued over 2,000 businesses during his career. He specializes in providing fairness and solvency opinions on transactions and expert witness testimony in litigation cases involving business valuations and lost profits. He frequently speaks on business valuation to professional organizations. He has testified over 50 times in trial and over 200 times in deposition.



Michael Sherman is an accomplished trial lawyer in high-stakes "bet-the-company" litigation. He represents big and small companies and high-net-worth individuals on both the plaintiff and defense side of cases, in federal and state courts, bankruptcy court, and SRO and ADR tribunals. He has first-chaired numerous trials in complex matters in industries as varied as securities, consumer products, project development/finance, advertising, real estate and apparel.

For questions please contact Michael Sherman of Bingham McCutchen LLP at (213) 680-6400; or Nevin Sanli of Sanli Pastore & Hill, Inc. at (310) 571-3400.

# VALOREM PRINCIPIA

## Section 409A Requires An Independent Valuation If You Issue Deferred Equity-Based Compensation

Section 409A targets "non-qualified deferral compensation plans," placing restrictions on such plans, including distribution and acceleration limitations, and non-compliance penalties. Plans vulnerable to 409A include:

- Nonqualified stock options (NQSOs)
- Employee stock purchase plans
- Stock Appreciation Rights (SARs)

### *Why Be Concerned? The Penalties Are Costly.*

If plans do not comply with 409A, the following penalties apply:

- All amounts deferred for the participant (including earnings) are included in gross income and taxed immediately.
- Interest, at the underpayment rate plus 1%, is imposed on the underpayments measured from the date of deferral.
- A 20% additional tax is imposed upon the amount compensation.

### *Key Issue: Value on Date of Grant*

One of the important features of 409A is the provision that non-qualified stock option grants and stock appreciation rights that meet a "fair market value" requirement can be exempt from taxes and penalties when:

*the exercise price must not be less than the fair market value of the underlying stock on the date of the grant.*

The company issuing the NQSOs or SARs needs to ensure that deferred compensation is not being granted at a "discount" to fair market value, which would expose the grantee employees to unexpected taxes, penalties and interest costs.

### *Third-Party, Independent Valuations*

The penalties under Section 409A place considerable importance on establishing that deferred compensation (NQSOs and SARs) has been issued at fair market value. It behooves the company's executives and board of directors to ensure that the methodology and procedures are determining fair market value will withstand third-party scrutiny by the IRS. For private companies and investors in privately held firms, an independent appraisal removes the burden on the company and option holders and places it on the IRS to prove that the valuation is "grossly unreasonable." It also minimizes significant exposure to the business' board of directors and executives by providing independent opinions of value.

## VALOREM PRINCIPIA

## *The Power of ESOPs*

*By: Robert A. Frisch*

A fantastic tool exists that enables owners of privately held corporations to diversify their assets while maintaining effective control of their companies, minimizing their capital gains taxes and creating incentive for their employees – *Employee Stock Ownership Plans (ESOPs)*.

ESOPs are somewhat similar to profit sharing or pension plans in that the sponsoring corporation makes tax deductible contributions to an employee trust that invests the funds, and the employees receive cash when they retire. *There, the similarity ends.*

Profit sharing and pension plans must invest contributions outside of the sponsoring company, thereby reducing the company's working capital (cash). Alternatively, ESOPs are mandated by law to invest primarily in the stock of the employer. Another major advantage of an ESOP is that it is the only tax qualified plan that can borrow money to purchase stock from selling shareholders or to buy authorized but unissued stock from the company itself.

### *Diversification While Minimizing Taxes*

Owners of successful, private corporations face challenges with respect to estate planning, succession planning and asset diversification. An obvious option is an outright sale of the company. However, there are both financial and emotional costs for the seller associated with the sale avenue, such as:

- A large capital gain tax burden.
- Premature loss of their toy or passion in life – a stimulating place to go.
- No surety of continued employment for valued employees.

If the stockholder of a private corporation sells stock to an ESOP, and the transaction brings the ESOP's ownership 30 percent or more of the outstanding stock, the selling shareholder can defer or possibly avoid capital gains taxes on the sale. To achieve this favorable tax treatment, the selling shareholder must have held the stock of three or more years and must reinvest the proceeds in qualified replacement property – stocks or bonds of domestic operating public or private corporations – within twelve months. These replacement securities provide the selling shareholder with a diverse source of supplemental income.

If the seller retains the replacement property until death, then his/her heirs will get to step up the basis in the property, pursuant to estate tax laws. *This effectively eliminates all capital gains from the sale of the stock to the ESOP!*

### *Leveraging the ESOP*

Owners of private corporations often like the idea of selling the company to their management group, but employees seldom have sufficient capital to purchase the stock. A management buyout (MBO) in connection with an ESOP is often feasible due to two unique tax benefits:

- A lower price is demanded due to the tax advantages to the selling stockholders and to the corporation; and
- Both the principal and interest paid on a loan to an ESOP are tax free.

The process of leveraging an ESOP involves a few steps, starting with an appraisal by an independent valuation firm to establish the fair market value (FMV) of the stock being sold. Based upon the FMV, a lender makes a loan to the ESOP to enable it to purchase the stock from the selling shareholder. Alternatively, the lender may lend directly to the corporation, which then lends to the ESOP to enable it to buy the stock.

# VALOREM PRINCIPIA

The company makes deductible contributions in amounts equal to the loan's principal and interest payments to the ESOP to enable it to repay the loan to the bank. Through this process, *the corporation can deduct the principal payments*, in addition to the interest payments.

## *Employee Incentives*

ESOPs are a highly motivating method of compensation for employees. Technically, each participant has an ESOP account to which contributions in stock are made by the company in accordance with each employee's compensation. The employee that is paid \$50,000 annually gets twice as much allocated to his or her account than the one who earns \$25,000.

The values in the employees' ESOP accounts are subject to a gradual vesting schedule, generally becoming fully vested over a five or a seven-year period. The more the stock grows in value, the greater the amount in cash the employees receive at retirement. Studies have shown that ESOPs tend to improve productivity, indicating that *ESOP companies are 8% to 11% more profitable* than their peer companies without ESOPs.

## *ESOPs and Acquisitions*

The tax incentives provided by ESOPs also provide a great method for acquisitions. Normally, an acquirer would not be able to deduct the purchase price, and the seller would pay taxes on any gain on sale of stock. Through a leveraged ESOP, a company can deduct the cost of the acquisition while the seller avoids being taxed on the sale. As a result, a lower purchase price can be negotiated since it is based on pretax, not after-tax, dollars.

## *Implementing an ESOP*

The ESOP is an instrument of corporate finance, not merely an employee benefit plan. The ESOP should be implemented by a full-service firm whose primary activity is the cohesive implementation and administration of ESOPs. A specialist who devotes full time to ESOPs can help CEOs and CFOs with the unique issues connected with the possible adoption of an ESOP, such as:

- A preliminary feasibility study should be done to determine how an ESOP might help the owner and the company achieve their objectives.
- The stock of a private corporation must be valued by an independent appraiser to determine fair market value of the company, which does not involve an appraisal of assets.
- Financing sources should be investigated, including potential internal financing.

With proper advice by a firm that specializes in ESOPs, the implementation process can go smoothly and expeditiously.

*Robert A. Frisch is the author of six books on ESOPs and succession planning.*

# VALOREM PRINCIPIA

## SP&H – Trivia

- **Friggatriskaidekaphobia** - A word with a long pedigree in English is *triskaidekaphobia*, which comes from the Greek phrase meaning “fear of the number thirteen.” A fear of Friday the thirteenth adds the name of the Germanic goddess Frigga. Friday the thirteenth occurs at least once a year. This year, it appears three times!