As noted in the ESOP Subcommittee Spotlight, the panel has observed numbers criticisms of ESOP transactions by the Department of Labor (DOL). DOL scrutiny of ESOP purchases continue to focus (in part) on projections, negotiations, what constitutes “control”, and (possible) dilutive equity. Set forth below is a high level summary of complaints and assertions levied by the DOL in multiple violation letters.

**Projections and Valuation Methods/Issues**

- Criticism of projections as compared to historical operations.
- Criticism of projections as compare to historical growth of an industry
- Stressed focus on shifting technologies, customer concentration risk, industry competition
- [Valuation Method – Discounted Cash Flows] Discounting company specific risk premiums used to evaluate projections
- Assertions of added control premiums
- Transaction debt analysis did not consider ability to pay seller debt balloon payment (e.g., junior debt is commonly structured not to require amortized principal payments in deference to outstanding senior debt requirements so, absent prepayments, would require a significant outlay of cash at the end of the term)
- Second stage transaction – the incumbent valuator is no longer independent as the company may understand the valuation methodology to be undertaken in a second stage transaction as a result of historical review of the annual valuation process

**Control**

- Assertions of control covenants in documents
- Statements that continuation of board participation (pre and post transaction) indicates a lack of control
- Nomination of board members by the company for a directed trustee indicates a lack of control
- Requires a discount multiple be applied to the transaction (not just a lack of a control premium)

**Dilutive Equity**

- Management Incentive Plans reserving grants based on equity value/stock value are dilutive (regardless of feature, performance requirements) and should be discounted from transaction value
- Warrants should be treated as fully dilutive

**Negotiation Process**

- Lack of transaction scrutiny during committee meetings (assertions that meetings were minimal as to number held and duration)
- Deficient record as to concerns raised/addressed during the trustee process
- Negotiation process included discussions over a few terms and over the course of only “several” turns of a term sheet indicating a low level of negotiation participation by the trustee