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To:
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Subject: Adequate Consideration

Concerning our discussion about "adequate consideration" this is an exerpt from a memo that I did on "adequate consideration", hopefully it will be helpful to you:

Section 4975(d) of the Code provides various exceptions to the prohibited transaction rules. In particular, section 4975(d)(13) excludes any transaction which is exempt from the comparable restrictions on prohibited transactions under section 408(e) of the Employee Retirement Income Security Act of 1974 ("ERISA").

ERISA section 408(e) provides that the acquisition or sale by a plan of qualifying employer securities does not constitute a prohibited transaction if various requirements are met, including that the sale be for "adequate consideration".

ERISA section 3(18) (B) defines adequate consideration in the case of an asset for which there is no generally recognized market (e.g., stock of a closely held corporation) as the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with the regulations promulgated by the Secretary of Labor.

Recognizing that the definition of "adequate consideration" will be "of particular importance to the establishment and maintenance of ESOPs," the Department of Labor in 1988 issued a notice of proposed rulemaking in which it sought to clarify the meaning of the term. Proposed Regulation Relating to the Definition of Adequate Consideration, 53 Fed. Reg. 16732 (proposed May 17, 1988) ("Proposed DOL Regulations") (to be codified at 29 C.F.R. § 2510-3(18) (b)). In the proposed regulation section 2510.3-18(b), the DOL stated that a fiduciary seeking to invoke the adequate consideration exception must prove the following: (1)The value assigned to an asset must reflect its fair market value as determined pursuant to proposed section 2510.3-18(b)(2), and (2) The value assigned to an asset must be the product of a determination made by the fiduciary in good faith as defined in proposed section 2510.3-18(b)(3). The regulations provide that a fiduciary will only be considered to have gotten adequate consideration in accordance with section 3(18) (B) of the ERISA if both of these requirements are satisfied.

The term "fair market value" is defined in proposed section 2510.3-18(b) (2) (i) 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.

Proposed section 2510.3-18(b) (2) (ii) requires that fair market value must be determined as of the date of the transaction involving that asset.

Proposed section 2510.3-18(b)(2)(iii) states that the determination of fair market value must be reflected in written documentation of valuation meeting the content requirements set forth in section 2510.3-18(b)(4) (The valuation content requirements are discussed below.)

First, proposed section 2510.3-18 (b) (4) (i) (E) requires a statement of the purpose for which the valuation was made. A valuation undertaken, for example, for a yearly financial report may prove an inadequate basis for any sale of the asset in question. This requirement is intended to facilitate review of the valuation in the correct context.

Second, proposed section 2510.3-18 (b) (4) (i) (F) requires a statement as to the relative weight accorded to relevant valuation methodologies. The DOL’s experience in this area indicates that there are a number of different methodologies used within the appraisal industry. By varying the treatment given and emphasis accorded relevant information, these methodologies directly affect the result of the appraiser's analysis. It is the DOL's understanding that appraisers will often use different methodologies to cross-check their results. A statement of the method or methods used would allow for a more accurate assessment of the validity of the valuation.

Finally, proposed section 2510.3-18 (b) (4) (i) (G) requires a statement of the valuation's effective date. This reflects the requirement in proposed section 2510.3-18(b) (ii) that fair market value must be determined as of the date of the transaction in question.

Proposed section 2510.3-18(b)(4)(ii) establishes additional content requirements for written documentation of valuation when the asset being appraised is a security other than a security for which there is a generally recognized market. The proposed regulations modeled this proposed special rule after Rev. Rul. 59-60, 1959-1 C.B. 237, and provide that the valuation report must include, in addition to an assessment of all other relevant factors, an assessment of the factors listed below:

(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 securities 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) The market price of securities of corporations engaged in the same or a similar line of business, which are actively traded in a free and open market, either on an exchange or over-the-counter;

(H) The marketability, or lack thereof, of the securities. Where the plan is the purchaser of securities that are subject to "put" rights and such rights are taken into account in reducing the discount for lack of marketability, such assessment shall include consideration of the extent to which such rights are enforceable, as well as the company's ability to meet its obligations with respect to the "put" rights (taking into account the company's financial strength and liquidity);

(I) Whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued, provided that in cases where a control premium is taken into account:

> (1) Actual control (both in form and in substance) is passed to the purchaser with the sale, or will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the sale, and

(2) It is reasonable to assume that the purchaser's control will not be dissipated within a short period of time subsequent to acquisition.

Proposed section 2510.3-18(b) (3) (ii) focuses on two factors which must be present in order for the DOL to be satisfied that the fiduciary has acted in good faith. First, this section would require a fiduciary to apply sound business principles of evaluation and to conduct a prudent investigation of the circumstances prevailing at the time of the valuation; and second, this section states that either 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 appraiser who is independent of all the parties to the transaction (other than the plan).

The DOL proposed regulations (copy attached) dealing with adequate consideration came out in 1988. Also, see Donovan v. Cunningham, 716 F.2d 1455 (5th Cir. 1983) (copy attached) in which the proposed regulations cite. Take note of a comment made by the court in Donovan v. Cunnigham at page 1468:

"A court reviewing the adequacy of consideration under Section 3(18) is to ask if the price paid is "the fair market value of the asset *as determined in good faith by the . . . . fiduciary;"* it is not to redetermine the appropriate amount for itself *de novo.* Contrary to the appellees' contentions, this is not a search for subjective good faith -- a pure heart and an empty head are not enough. The statutory reference to good faith in Section 3(18) must be read in light of the overriding duties of Section 404. Doing so, we hold that the ESOP fiduciaries will carry their burden to prove that adequate consideration was paid . . . by showing that they arrived at their determination of fair market value by way of a **prudent investigation in the circumstances then prevailing." (emphasis added)**

Proposed regulations section 2510.3-18(b)(3)(ii) focuses on two factors which must be present in order for the Department of Labor to be satisfied that the fiduciary has acted in good faith. First, this section would require a fiduciary to apply sound business principles of evaluation and to conduct a prudent investigation of the circumstances prevailing at the time of the valuation. This requirement reflects the Cunningham court's emphasis on the use of prudent business practices in valuing plan assets.

Second, this section states that either 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 appraiser who is independent of all the parties to the transaction (other than the plan). As noted above, under ERISA, the determination of **adequate consideration** is a central safeguard in many statutory exemptions applicable to plan transactions with the plan sponsor. The close relationship between the plan and the plan sponsor in such situations raises a significant potential for conflicts of interest as the fiduciary values assets which are the subject of transactions between the plan and the plan sponsor. In light of this possibility, the Department believes that good faith may only be demonstrated when the valuation is made by persons independent of the parties to the transaction (other than the plan), i.e., a valuation made by an independent fiduciary or by a fiduciary acting pursuant to the report of an independent appraiser.

Note, while the proposed DOL regulations has yet to be approved for publication in the Code of Federal Register, most courts have embraced the two-part test for adequate consideration enunciated therein, as well as most of the principles relevant to the two parts. See footnotes 7 and 8 in Henry v. Champlain Enterprises, Inc., 334 F. Supp. 2d 252, at 269-270 (N.D.N.Y. 2004) (copy attached). Also, take a look at the attached tax case Eyler v. Commissioner, 88 F.3rd 445 (7th Cir. 1996).

The valuation issues invariably comes down to a battle of experts who speak language that judges may find difficult to penetrate. The technical nature of these discussions may create sympathy for trustees who claim to have followed expert advice in an arcane field. Thus, it becomes imperative that we dissect how the taxpayer reached its valuation and whether it was prudent.