PROPERLY STRUCTURING & MAINTAINING AN ESOP

THE ESOP AS A BUSINESS OWNERSHIP TRANSITION OPTION:
PROPER STRUCTURE & MAINTENANCE

Keith D. Butcher
John A. Kober
Jason C. Ray

BUTCHER JOSEPH & CO.
INVESTMENT BANKERS

Keith D. Butcher is managing partner of the investment banking firm ButcherJoseph & Co. in Clayton, Missouri.

KEITH.BUTCHER@BUTCHERJOSEPH.COM

John A. Kober is a partner in Morgan Lewis & Bockius' business and finance practice. He is currently the managing partner of the law firm's Dallas office and the immediate past co-chair of the firm's ESOP practice.

JKOBER@MORGANLEWIS.COM

Jason C. Ray is a senior attorney in Morgan Lewis & Bockius' employee benefits and executive compensation practice in Dallas, Texas.

JRAY@MORGANLEWIS.COM

Butcher Joseph & Co.

In looking at the various ownership transition options available, the business owner needs to examine each option very carefully since each option has pros and cons. An ESOP (Employee Stock Ownership Plan) is technically an employee benefit retirement plan, but if implemented properly it can also serve as a tax-advantaged management buyout and ownership transition vehicle. ESOPs are highly technical, but when the transactions are structured properly, the ESOP can create tremendous value for the seller, company employees and the management team. This article presents how to properly structure and maintain an ESOP as well as key considerations to take into account when evaluating the feasibility of an ESOP as an ownership transition tool.

To properly structure an ESOP, the business owner needs to:

STEP 1: Analyze the financial impact of an ESOP on the business and on him or her personally.

STEP 2: Establish an appropriate corporate governance structure on how the business will operate following the transition to the ESOP (this step is commonly missed).

STEP 3: Design the structure of the ESOP transaction from a financial standpoint (this step is commonly missed), as well as structure the ESOP from a benefit standpoint and corporate cash flow standpoint.

STEP 4: Structure the ESOP transaction so it works within the estate planning structure of the business owner (commonly missed).

STEP 5: Present the structure to the bank and ESOP trustee.

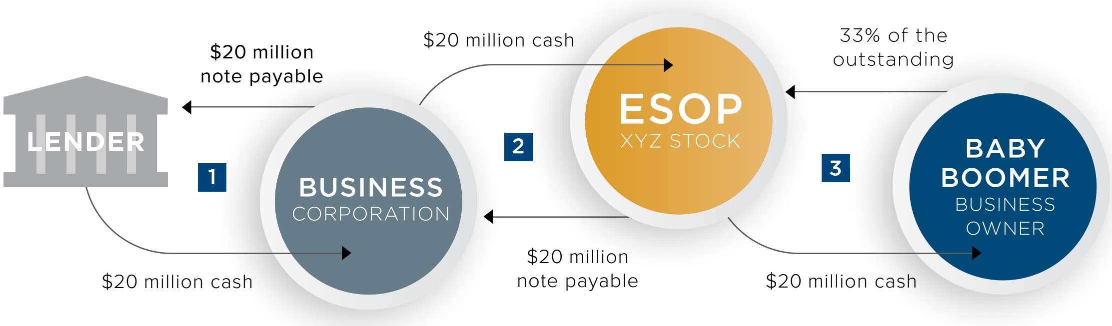
To properly implement an ESOP as part of a capital structure and ownership transition plan of the business, the business owner will be required to spend a significant amount of time on the structure, as well as the full commitment of the business owner's management team. In Step 1, the business owner must consider whether its business is a good candidate for an ESOP. The ideal candidate for an ESOP transaction has: (i) sufficient debt capacity; (ii) sufficient cash flow generated from operations to service the debt; (iii) consistent historical and prospective operating performance (revenue generation and profit margins); and (iv) management in place to run the business, which is commonly absent. If the business in question does not fit this profile then the costs of establishing and maintaining an ESOP will probably outweigh the benefits. However, if the business in question does match this profile then the ESOP may be worth pursuing.

BUTCHER JOSEPH & CO.

a. CREATION.

There are two basic types of ESOP structures: leveraged and non-leveraged. The leveraged ESOP structure is very common because of the favorable tax treatment. In the leveraged ESOP structure, the business creates a trust and establishes an ESOP under the qualified plan rules. Different from other qualified plans, the ESOP trust has special rights given to it under the Code: (i) it can purchase up to 100% of the company's stock; and (ii) borrow money from the company or bank to be used to purchase the company stock.[1] The ESOP trustee has the power to borrow money and purchase up to 100% of the company's stock. In a typical ESOP transaction: (i) the company borrows money from a lender (i.e., a bank); (ii) the company in turn loans the proceeds to the ESOP trust; and (iii) the ESOP trustee uses the proceeds to purchase stock from either the company or from the business owner. For ESOP record keeping purposes, the stock is placed in a suspense account within the ESOP and used to collateralize the loan. After the initial transaction, the company makes annual cash contributions into the ESOP trust. These contributions will be tax deductible if properly structured. The ESOP trust uses the company's contributions to pay off the interest and principal on the loan used to purchase the company stock. The ESOP accounts of participants are allocated company stock according to a formula that releases shares from the suspense account as the ESOP loan is paid off.

LEVERAGED ESOP: BANK FINANCED



[1] The trust document is a legal contract that creates the trust and sets the rules that will govern the trust's affairs. The named trustee is typically a high level executive within the company or a third party institution. Choosing a trustee(s) is a delicate task. As we will discuss later, overlapping responsibilities may cause conflicts of interest that lead to breaches of the trustee's fiduciary duty.

Butcher Joseph & Co.

A non-leveraged ESOP involves a different type of structure. The company creates the ESOP trust and then contributes stock to the ESOP trust. It can also fund the ESOP with cash, which is then used to purchase company stock from the company or a selling shareholder. Just like the leveraged ESOP, the ESOP accounts of participants are credited with stock until retirement. ESOPs generally operate like a profit sharing plan. The participant employees do not pay anything for the stock they receive. They are free to liquidate their stock once they retire, become disabled or otherwise leave the company.

The structure that a company chooses will depend on its reasons for implementing the ESOP. It is important to note that an ESOP structure is an ownership transition tool available to business owners that creates significant benefits for the employees. For purposes of the article, the primary objective is to smoothly transition the business and to keep the business in the community. In this scenario the leveraged ESOP may be the best structure.

As a first step the business owner should work with a valuation firm to confirm the value of the business. The second step in creating a leveraged ESOP is for the board of directors of the Company to select an ESOP trustee (discussed later). The ESOP trustee is subject to specific fiduciary duties. One of those duties is the duty of prudence.[2] The duty of prudence requires the ESOP trustee to: (i) borrow the money and use the proceeds to purchase the stock from the business owner;[3] and (ii) purchase such stock from the business owner for no more than “adequate consideration.” Adequate consideration means the stock’s fair market value.[4] Determining the fair market value of stock that is not publicly traded is very difficult. Even though the company may hire a financial adviser to advise on the fair market value of the company stock, the ESOP trustee must engage an independent appraiser to provide an opinion that the ESOP trustee is not paying more than fair market value for stock.

[2] 29 U.S.C. § 1104(a)(1)(B) (West 2012) (“A fiduciary shall discharge his duties with respect to the plan. . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”).

[3] See Treasury Regulation Section 54.4975-7(b)(4)

[4] See Donovan v. Cunningham, 716 F.2d 1455, 1467-68 (5th. Cir. 1983) (“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.”).

In addition, the ESOP must follow these rules for the ESOP to be considered a tax qualified trust.[5]

The independent appraiser will be responsible for valuing the stock for the ESOP trustee and writing an adequate consideration opinion to the ESOP trustee. The Internal Revenue Service ("IRS") and the Department of Labor ("DOL") frequently review ESOP transactions to ensure that the ESOP trust did not pay more than fair market value for the stock. This tends to be the source of controversy. If more than fair market value is paid for the stock, then the sale is considered a prohibited transaction that is subject to tax penalties and remedial action under the Code and the Employee Retirement Income Security Act ("ERISA"). An ESOP trustee may also be required to make the ESOP whole. If a competent independent appraiser is engaged by the ESOP trustee, the risk of negative consequences is reduced.[6] The independent appraiser will ensure that the stock is properly valued, and the valuation firm's stamp of approval will make the IRS or the DOL less likely to challenge the transaction. It is important that the adequate consideration value be based on information that was collected as close to the date of the sale as possible. If the sale occurs a long time after the valuation report is issued, then it may no longer be considered prudent to rely upon it and the previously mentioned problems may become an issue.[7]

Once the value of the stock is determined, the company needs to implement the changes to its corporate governance structure (i.e., makeup of the directors prior to the time the ESOP is completed). Then, the company will formally execute and adopt the ESOP and restated trust documents along with the corporate documents. The corporate documents will dictate how the business will be governed after the ESOP transaction. The ESOP trust document will outline the duties of the individual(s) who will serve as ESOP's trustee. It is imperative that the named individuals (or entities) are made aware of the responsibilities associated with being a trustee. As discussed in detail in the following section, the trustee owes a fiduciary duty to the ESOP and its beneficiaries.

[5] 26 U.S.C. § 401(a)(28)(C) (West 2010).
[6] See Chesemore v. Alliance Holdings, Inc., 52 EBC 1703 (W.D. Wisconsin, 2011).
[7] See Donovan v. Cunningham, 716 F.2d 1455, 1473-74 (5th Cir. 1983).

b. INITIAL & ONGOING COMPLIANCE & EMPLOYEE COMMUNICATION.

After the ESOP transaction is completed, the final step in the creation process is seeking a determination letter from the IRS that the ESOP is a tax qualified retirement plan. Obtaining a determination letter for a retirement plan is not mandated by law but it is highly recommended. A determination letter is a written statement issued by a district director of the IRS that applies the principles and precedents previously announced by the IRS to the applicant's plan.[8] The applicant can rely on this document for authority if any aspect of its plan is subsequently questioned.[9] To do this, the company must submit the ESOP documents, as well as several standardized application forms to the IRS. The IRS will review the submitted materials and confirm that the company has complied with all the relevant laws and regulations. If all the requirements have been met, the IRS will issue a determination letter stating that the ESOP is a tax qualified plan under the Code. If the IRS believes that certain requirements have not been met, it will issue a determination letter stating that certain aspects of the plan need to be changed. It may also ask for additional information before it will issue a finalized letter. Any changes that the IRS may require can be made by amending the ESOP documents.

Since the ESOP is subject to regulatory oversight, the company will be required to comply with ongoing reporting and legal requirements. Each year, the ESOP trustee will be required to value the company stock held by the ESOP[10] and provide the employees with statements. From time to time, the ESOP will require legal or plan design amendments. In addition, the company may implement a formal employee communications program. The responsibility for regulating the ESOP is divided between the IRS and the DOL. For the purposes of this section of the article, the DOL's regulations are the most important because it administers ERISA's reporting and disclosure requirements.

[8] See Internal Revenue Service, EP Determination Letter Resource Guide: What is a favorable determination letter?, IRS.GOV, http://www.irs.gov/retirement/article/0,,id=128037,00.html (last visited on 8-1-2012).

[9] See Internal Revenue Service, EP Determination Letter Resource Guide: Do I need to file for a determination letter for my retirement plan?, IRS.GOV, http://www.irs.gov/retirement/article/0,,id=128038,00.html (last visited on 8-1-2012).

[10] 401(a)(28).

Butcher Joseph & Co.

One of the primary public policies underlying ERISA is the protection of pension plan participants and beneficiaries. An essential part of protecting plan participants and beneficiaries is notifying them of their rights and benefits under the plan. Therefore, ERISA and the regulations thereunder require the company[11] to annually report certain information to the DOL and disclose certain information to plan participants and beneficiaries.[12] To satisfy the reporting requirement the company must file an "annual report" with the DOL within 210 days after the close of each plan year.[13] An annual report is the plan's financial statements (i.e., detail of the assets and liabilities of the plan, the plan's investment performance, and structure.)[14] The disclosure requirements are less straight forward than the reporting requirements. Plan participants and beneficiaries must receive certain information automatically.[15] However, they are entitled to receive other types of information only upon request.[16]

The company may also be required to make other disclosures in addition to those mandated by ERISA. In the ESOP world, since the ESOP is invested in company stock, the company may possess certain information that is not normally required to be disclosed. However, the information may affect the value of the stock and the decision of a participant if such information was disclosed. For example, the board may be close to completing a transaction that will positively impact the value of the company. At the same time, the company is offering early retirement benefits. In this situation, many employees may prematurely retire due to lack of information about the situation and lose out on a substantial amount of benefits. The courts have attempted to solve this problem by holding plan fiduciaries liable for failing to inform employees of "material changes" to the plan that are under "serious consideration." [17]

[11] For purposes of this article, the company is considered the plan administrator. Under DOL rules, the plan administrator is required to comply with these rules.

[12] See 29 C.F.R. § 2520.104-1(2012).

[13] 29 U.S.C. § 1024(a)(1) (West 2012).

[14] See 29 U.S.C. § 1023 (West 2012).

[15] Pamela Perdue, The Evolving Area of ERISA Disclosure, SG073 ALI-ABA 927, 929 (2002) ("With respect to those documents required to be provided automatically, this category includes. . . (1) summary plan description, (2) summary of material modification, (3) summary of annual report (4) section 204(h) notice (5) statement of deferred vested benefits and (6) notice of failure to meet the minimum funding requirements.").

[16] 29 U.S.C. § 1024(b)(4) (West 2012) ("The administrator shall, upon written request of any participant or beneficiary, furnish a copy of the latest updated summary plan description and the latest annual report, any terminal report, the bargaining agreement, trust agreement, contract, or other instrument under which the plan is established or operated.").

[17] See Fischer v. Philadelphia Elec. Co. (II), 96 F.3d 1533, 1539 (3d Cir. 1996) (Serious consideration means that "(1) a specific proposal (2) is being discussed for purposes of implementation (3) by senior management with the authority to implement the change.").

This means that the ESOP must have a well designed governance structure and employee communication program. Otherwise, the plan fiduciaries (and possibly the company) may face liability for breach of fiduciary duty.[18]

With that said, communications regarding the ESOP should not be limited to what is legally mandated. The board of directors of an ESOP company needs to use wise discretion in what type of information should be given to its employees so they can make informed decisions about their situation since their benefits are tied to the value of the company stock.

Because there is a lot of confusion about employees' rights in an ESOP company, it is important that the employees understand that the company is being run by a board and the type of information to expect (i.e., some companies provide the legal minimum and others are open book). If the initial communications are sloppy or inaccurate, the company will be dealing with employee expectation problems, and employees will be unlikely to be enthusiastic. Even worse, disorganized communication may cause employees to seek information from sources that cast ESOPs in a negative light. The risk that employees will receive overly negative information about ESOPs from news articles or television shows is especially high, given the recent occurrence of several high-profile corporate scandals involving retirement plans. It is the company's responsibility to be truthful with its employees. There are risks associated with forming and investing in an ESOP. However, the horror stories associated with Enron, Tyco, Chicago Tribune, and others are aberrations. If companies follow the law and adhere to proper and best corporate governance practices, there is very little chance that anything improper will occur. It is always the situations that have bad facts that create bad law.[19]

In short, if a company creates an ESOP then it must actively manage its employees' expectations. Many companies, after implementing an ESOP, will hold multiple in-person presentations and meetings with all of the company's employees, followed up with written materials and other communications. Most importantly, the communications are sent out regularly and the overall message is consistent.

[18] See Chesemore v. Alliance Holdings, Inc., 52 EBC 1703 (W.D. Wisconsin 2011); See also complaint titled Wool v. Sitrick, et.al., case no. 2:10-cv-02741-JHN-PJW, filed on April 15, 2010 in the United States District Court, Central District of California (case settled).

[19] See Chesemore v. Alliance Holdings, Inc., 52 EBC 1703 (W.D. Wisconsin 2011).

c. REPURCHASE LIABILITY.

"Repurchase liability" is the legal obligation of the company to purchase back the shares into treasury that have been distributed to participants. Like all privately-held companies, the employees under the ESOP will want to get paid in cash someday. The law requires the company to purchase the stock owned by plan participants and beneficiaries under certain events.[20] Therefore, the company must consistently plan for such events. Some companies set aside money to fund such events so that the company can easily repurchase the stock as employees retire or leave the company.

The size of the repurchase obligation is determined by several interlocking variables. The most important variable is the value of the company's stock. The value of the company stock may substantially increase in value by the time any given participant becomes eligible for a distribution and demands such distribution. Ironically, this means that a successful company may experience some cash flow pressure without proper planning. The size of the obligation is also affected by the size, composition and timing of the allocation of the stock within the ESOP. The more stock that is allocated, the greater the potential repurchase liability. The final variable to consider is the turnover rate. If the company's workforce is very stable and young then the repurchase liability will be low in the short term and high in the long term because of retirement. The reverse is true if the company's workforce is very old.

The company is legally obligated to repurchase the shares that the ESOP distributes to participants and beneficiaries. An ESOP holding company stock that is not readily tradable on an established market must grant its participants and beneficiaries "a right to require that the company repurchase the company stock at fair market value."[21] The Code created this obligation so that employees could seamlessly cash out their retirement accounts without incurring the frictional costs associated with finding a buyer. Few buyers, if any, would be willing to purchase company stock (i.e., a minority interest) that is not publicly traded. The regulations create a legally mandated buyer and establish the value for the shares in a closely-held business.

[20] 29 U.S.C. § 409(h).
[21] 26 U.S.C. § 409(h)(1)(B).

Butcher Joseph & Co.

CONCLUSION

ESOPs are highly technical, but when implemented and maintained properly they can create great value for the seller, employees and management team. When assessing different transition options, it is important for the business owner to seek advice from an ESOP advisor with deep ESOP experience and knowledge that will provide all the necessary information to enable the business owner to make an informed decision that is best for all parties involved.