Thought Leadership

Sale of an ESOP Sponsor Company: Questions of Time, Money, People, and the Law

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When a closely held business owner sells his stock to an ESOP, he may believe that this will be his last corporate transaction. Often, however, and particularly with successful ESOP companies, potential buyers come calling. This discussion explores the processes by which ESOP companies manage a possible sale to a third party, including the roles of the board, the ESOP trustee, and company management. It also considers what documents may be involved in such a sale, including the fairness opinion provided by the ESOP's independent financial adviser.

Introduction

You sold your closely held company to an ESOP. Then, a strategic buyer with what appears to be an attractive offer calls. What do you do next?

This discussion addresses questions about selling an ESOP company, with a focus on issues of time, money, people, and the law.

For consistency of business and legal references, this discussion focuses on the closely held, seller-financed ESOP company

How Does the Process Begin?

The president or other officer of the ESOP sponsor company (the "company") often is the first to receive an offer from a strategic buyer (the "buyer").

The president may also (1) be a member of the board of directors, (2) hold a seller note from when he sold his shares to the ESOP, and/or (3) hold warrants attached to the seller note. And, in fact, he may be the ESOP trustee (the "ESOP trustee" or "trustee"). The sponsor company may have transitioned from an independent trustee to an insider trustee after the ESOP stock purchase closed.

When an officer has so many different roles and responsibilities, the purchase offer creates a conflict of interest. Therefore, the officer is left wondering, as he evaluates the offer, in what role he should act and what he should do to avoid a breach of fiduciary duty lawsuit.

Officer First Evaluates Offer

The president first evaluates the offer in his role as an officer of the sponsor company—in order to evaluate whether or not the offer is legitimate and may, in fact, be a bona fide offer.

If the officer determines that the offer is legitimate and may be in the interest of the employer corporation and shareholders, then he should present the offer to the board of directors.

The officers and the board avoid a breach of fiduciary duty by following procedural prudence in their evaluation. This means they should establish a reasonable process for evaluating offers and document their activities as they proceed.

If, for example, the board's decision is challenged and a court determines that the board has followed procedural prudence (thereby preserving the business judgment rule), the court will evaluate the decision-making process, not the actual decision. This will work heavily in the board's favor.

The board should be adequately informed about the economic and legal ramifications of selling the

sponsor company. It should seek counsel from qualified advisers. For example, under Internal Revenue Code ("Code") Section 4978, if (1) the shareholder who sold to the ESOP took Section 1042 treatment on the proceeds in order to defer capital gains tax and (2) the ESOP sells its shares within three years of the ESOP's purchase of the shares, then the sponsor company must pay a 10 percent excise tax on the amount realized on the sale.

There are, however, exceptions to this rule, such as:

1. a sale to satisfy normal plan distribution requirements and
2. a stock-for-stock exchange in a tax-free reorganization with another company.

The Board Evaluates—Is it a Bona Fide Offer?

The board must perform preliminary due diligence to determine if the offer is bona fide. This means that the board has determined (1) that the offer was made in good faith and (2) that the buyer can pay for it (i.e., the buyer has cash).

At this stage, what kind of due diligence does the board perform—financial, legal, or both?

The board (or a committee of the board) first typically performs general financial due diligence on the buyer and meets with the buyer's executives (1) to discuss the two companies' business strategies, vision and goals, and (2) to evaluate mutual interests. The parties usually share financial and other data.

The seller, however, should beware that the buyer may be on a fishing expedition—for example, to learn about the sponsor company's technology or proprietary processes. Therefore, before the parties exchange information, it is prudent to sign a confidentiality agreement.

When and What Do We Tell the ESOP Trustee?

If the ESOP trustee is an inside trustee, the trustee will likely not only be aware of what is happening. In fact, he is likely to be participating in the discussions. At this point, he should be participating only in his capacity as an officer or director.

If the ESOP trustee is an outside trustee, it is good practice to inform the trustee that the sponsor company has been approached by a potential buyer.

Once the board determines that the offer is bona fide, however, it must inform the ESOP trustee of the offer. The trustee then comes to the bargaining table. If there has been an inside trustee up to that point, the inside trustee should resign.

The board should appoint an independent outside discretionary trustee:

1. to evaluate the deal and
2. to serve as the ESOP trustee for the deal.

An ESOP attorney or the ESOP valuation adviser are often good referral sources for an independent trustee.

ESOP sponsor companies that already have an independent trustee often choose to make the ESOP trustee aware of the offer early in the process, so that the trustee is not surprised. Early awareness and open communication often give the ESOP trustee the ability to move faster to the next stage.

Even in a 100 percent ESOP-owned sponsor company, the ESOP trustee will recognize that the initial evaluation of an offer is a board function.

Therefore, while from a fiduciary standpoint the ESOP trustee is not required to be involved with the initial evaluation of the offer, it is good to keep the ESOP trustee informed if it appears to the board that the offer will move to the next stage. The next stage is typically the letter of intent stage.

Who Are the Parties to the Deal?

Buyers unaccustomed to ESOP sponsor companies are often confused when the independent ESOP

trustee arrives at the bargaining table. This is because, to date, the buyer has dealt with, for example, the company's president (who sold his shares to the ESOP in exchange for:

1. a seller note secured by all of the company's assets and
2. a pledge of the ESOP shares and warrants for up to 30 percent of the sponsor company stock).

The president may also have been acting as the inside trustee. Therefore, the uninformed buyer may think that the president controls the company and the ESOP. And, the uninformed buyer may bargain accordingly and ignore the ESOP's interests.

Going into the letter of intent stage, it is important for the buyer to realize that the ESOP is a separate party to the deal. This fact may not be obvious, particularly if the ESOP is relatively new and a substantial portion of the shares have not been allocated to the ESOP participant accounts. Legally, however, the ESOP trustee is the record owner of all allocated and unallocated shares.

If there is a seller note outstanding, effectively, there will be two simultaneous acquisitions:

1. a note acquisition between the buyer and the seller note holder (the "seller note holder"), who holds (a) a security interest in the shares owned by the ESOP and, perhaps, (b) a security interest in all of the assets of the company, as the company's creditor
2. a stock acquisition between the buyer and the ESOP trustee, as the legal owner of the shares

Therefore, it may be appropriate for the seller note holder and the ESOP trustee to enter into separate letters of intent with the buyer. These separate letters of intent will help draw a distinction between the selling constituencies.

The ESOP trustee and its financial adviser and attorney should review and have the opportunity to comment on both the seller note holder letter of intent and the ESOP letter of intent.

While a letter of intent is not required, parties typically enter into them. Note, however, that ESOP trustees typically do not want to sign a letter of intent if the sale is structured as an asset sale.

This is because in an asset sale, the sponsor company—not the ESOP trustee—is actually the seller. Whereas, if it is a stock sale, it makes sense for the ESOP trustee to sign a letter of intent. This is because legally the ESOP trustee owns the shares. Even if the purchase is a asset deal, the ESOP trustee will need to approve the letter of intent.

Stock Sale versus Asset Sale

Purchases of ESOP sponsor companies are often structured as stock sales. This is because if, for example, the ESOP owns 49 percent of the sponsor company shares and an individual owns 51 percent, in an asset sale the individual's proceeds will be double taxed—once at the corporate level and once at the personal level.

Furthermore, if the sale is structured as a sale of substantially all of the company's assets (or a merger, recapitalization, dissolution, or liquidation), the Internal Revenue Code requires "pass-through voting" by ESOP participants.

With pass-through voting, the ESOP participants must instruct the trustee as to how the shares allocated to their accounts are to be voted (the ESOP trustee still votes the unallocated shares). This can increase the expense and time involved in the transaction.

In a stock sale, however, the ESOP trustee typically acts on behalf of the participants, which the parties see as being more cost and time efficient.[1]

The ESOP Trustee's Team—The ESOP Trustee's Valuation Adviser and Attorney

After the board appoints the independent ESOP trustee, the trustee hires a valuation adviser and an attorney. The sponsor company's attorney will want to review and comment on the engagement letters of the ESOP trustee's valuation adviser and the ESOP trustee's attorney.

It is an unusual aspect of the ESOP structure that, while the ESOP trustee and its team must remain independent of the company and the seller note holder, the sponsor company often pays the fees of the ESOP trustee and its professional advisers. Therefore, the sponsor company will be a signatory to those engagement letters.

Even if the company and the seller note holder want the ESOP to pay the fees of the professionals who advise the ESOP, the law limits the kinds of fees that the ESOP can pay.

The ESOP can pay fees for certain typical deal-related actions, such as the negotiation, documentation, and coordination of the purchase of the ESOP's shares.

". . . The ESOP trustee sometimes may choose a different valuation adviser for the transaction from the adviser who has been performing the annual employer stock valuation updates."

And, if the ESOP will be terminated, the ESOP can pay the cost of obtaining an IRS determination letter to the effect that the ESOP's termination does not affect its tax-qualified status.

The ESOP, however, cannot pay fees for what are commonly referred to as "settlor" or company functions.

These functions can include the correction of any operational failures from the ESOP's administration or the termination of the ESOP. The sponsor company, not the ESOP, must pay those fees.

The ESOP trustee's counsel can separate the fees by using matter codes—one for fees the ESOP can pay and one for fees the company must pay.

It is noteworthy that the ESOP trustee sometimes may choose a different valuation adviser for the transaction from the adviser who has been performing the annual employer stock valuation updates.

This procedure is intended to preserve independence and to avoid having an adviser who may be beholden to the value that the adviser opined to the previous year. ESOP counsel typically helps the ESOP trustee navigate fee and conflicts issues.

Typical Provisions of the Seller Note Holder Letter of Intent and the ESOP Letter of Intent

The seller note holder letter of intent and the ESOP letter of intent often set out the time frame in two phases:

1. Phase 1 is a 30-day, nonexclusive phase in which (a) the parties exchange financial information, (b) management meets to discuss in detail the post-transaction picture, and (c) the ESOP trustee's financial adviser does a preliminary review of the fairness of the proposed transaction to the ESOP from a financial point of view.

   This review includes a study of relative fairness (i.e., a comparison of what the ESOP will get to what any other sellers and/or company executives will get).

2. Phase 2 is often a 60-day exclusivity period, during which the parties engage in (a) detailed legal due diligence, (b) detailed financial due diligence, and possibly (c) a site visit to the buyer by the ESOP trustee and its financial adviser and attorney.

   The site visit can include a meeting with buyer's management.

Typical provisions that are at issue in the letters of intent include the following:

1. adjustments to the purchase price
2. taxes
3. indemnification
4. consideration (cash versus stock)
5. time frame

It is helpful to resolve material issues early. However, except for limited provisions (e.g., confidentiality, exclusivity, and a trustee "fiduciary out"), the letter of intent is usually nonbinding.

Letters of intent typically make the deal closing contingent on the completion of certain events:

1. completion of due diligence satisfactory to the buyer and the seller
2. settlement of accounts receivables, notes receivables, accounts payable, distributions payable and notes payable among related parties
3. the sponsor company conducting business in the ordinary course until closing with no material adverse change in business
4. approval by the buyer's board
5. execution of a definitive purchase agreement and related agreements, such as a shareholders agreement

The shareholders agreement may contain customary majority and minority ownership rights, such as tag-along, drag-along and preemptive rights (which, by the way, the ESOP cannot agree to under ERISA) if the provisions require the ESOP to sell stock.

The letters of intent usually state an enterprise value, which is subject to decrease by the amount of third-party debt, notes payable, capital leases, prepayment penalties, debt retirement costs and other adjustments.

The closing will also be contingent on the ESOP trustee receiving a favorable fairness opinion from its financial adviser.

When the ESOP Trustee Won't Agree to Certain Provisions

Because the ESOP trustee has not had, and will not have, operational control over the sponsor company, the trustee typically may not agree to adjustments to the purchase price for working capital or taxes. It will not agree to indemnify the buyer.

The buyer will have to look to the seller note holder or other selling shareholders for any such adjustments and recourse.

The ESOP trustee typically will not agree to enter into a shareholders agreement if the agreement contains drag-along or similar provisions under which the ESOP would be required to sell its shares. This is because such provisions are contrary to ERISA.

There may be pressure for the parties to sign the letter of intent with provisions that the parties would not agree to in the purchase agreement. The argument for this is that the letter of intent is nonbinding, and the parties need to move on to get a deal done. This often simply delays arguments over issues.

While it is true that the letter of intent may not be binding, it may put the sellers in a poor bargaining position. This is because it creates the perception that they have reached an agreement.

Should We Go Exclusive?

Just before the nonexclusivity phase ends, the sponsor company and the buyer may want an oral approval from the ESOP trustee and the ESOP trustee's financial adviser that the deal terms are fair to the ESOP from a financial point of view.

The motivation for this is to get an indication that there is, in fact, a deal before the parties spend the money to do in-depth legal and financial due diligence.

If the deal consideration is cash only (even if the payment of a portion is subject to escrows and/or earnouts), it is a relatively easy exercise for the ESOP trustee's financial adviser to determine if the proposed transaction is fair to the ESOP from a financial point of view.

If, however, the consideration is (1) stock in the buyer corporation or (2) a mix of cash and stock in the buyer corporation, there are usually so many unanswered questions before the in-depth legal and financial analysis stage that it is not possible for the ESOP trustee's financial adviser to make a judgment at that point.

In this case, the financial adviser may give an oral indication that the consideration offered is within a reasonable range, but with many caveats.

Cash or Stock or Both?

If stock, or a mix of cash and stock, is offered to the ESOP as consideration, the ESOP trustee's financial adviser will not only have to value the sponsor company, it will have to value the buyer corporation, which is impossible to do until complete financial and legal due diligence is performed on the buyer.

As a result, there can be a circular dilemma. This is because the buyer will want the ESOP trustee to agree to the consideration offered. But, it is not possible to agree until the ESOP trustee's valuation adviser and legal adviser have completed their work.

The value proposition in buyer corporation stock may not be knowable at this point. However, for cost and timing reasons, it is helpful for the ESOP trustee and its financial adviser to determine sooner rather than later that it may want stock in the buyer corporation.

If the ESOP trustee has the option to choose between cash or stock or a mix, if stock in the buyer corporation is at all compelling (which it may well be if the trustee believes there will be an immediate increase in value post-closing from the combined companies), there may be a strong financial case for taking all stock.

An ESOP trustee may, however, take the view that giving up its relatively secure investment in the company's stock in exchange for stock in the buyer corporation is too risky.

This could be because, for example, there is a fiduciary concern in giving up shares in a solid company with good prospects for shares in an unknown company, and in possibly trading a majority interest for a minority interest.

Often the seller note holder is in a better position to deal with the risk of taking stock in the buyer corporation. This is because he will go on to work at, and possibly have some operational control of, the buyer. Therefore, the ESOP trustee may only take a substantial cash premium for its shares.

The buyer also may come to realize that it does not really want the ESOP or the ESOP participants as shareholders.

Other consideration is often used as "sweeteners" to the ESOP, such as:

1. rights in an earn-out,
2. escrow, or
3. guaranteed 401(k) contributions to former ESOP participants with immediate vesting.

The ESOP trustee's financial adviser, however, typically does not assign any value to these sweeteners because the interests are so contingent.

It is noteworthy that if the ESOP will continue to exist post-closing, in order for the ESOP to take the buyer's corporate stock, the stock must be "qualified employer securities" under Code Sections 4975(e)(8) and 409(l) and Treasury Regulation Section 54.495-12. This is because an ESOP can only invest in "qualified employer securities." This is not the case if the ESOP will be terminated.

Qualified employer securities are defined as stock issued by the employer (or by a sponsor company that is of the same controlled group) that has a combination of voting and dividend rights equal to or greater than the class of stock of the employer (or of any company that is a member of the same controlled group) that has the greatest voting and dividend rights.

Because of the difficulties in using buyer corporation stock as currency for the transaction, ESOP employer corporation shares are sometimes redeemed by the company for a cash premium in a separate transaction immediately before other shareholders sell the remaining shares to the buyer.

The Fairness Opinion

The ESOP trustee's financial adviser will determine:

1. whether or not the consideration to be paid to the ESOP for its shares is equal to or greater than the fair market value of such shares (as such term is used in determining "adequate consideration" under section 3(18) of ERISA) and
2. whether the transaction is fair to the ESOP from a financial point of view.

The fairness determination includes an analysis of the deal's relative fairness (e.g., is the ESOP getting as good a deal as the seller note holder?).

The ESOP trustee's financial adviser will use as a benchmark for its analysis the financial position of the ESOP seven to ten years out assuming that:

1. the company is not purchased,
2. all allocations are made,
3. all participants vest in their shares, and
4. the company meets its projections.2

If the ESOP company is an S corporation, the financial adviser will include in its analysis the value of future S corporation tax deferrals.

The ESOP trustee's financial adviser will then compare this benchmark position to the ESOP's financial position if the ESOP were to take cash in exchange for its shares. Or, if buyer corporation stock is a possibility, then it will compare the benchmark to the projected financial position of the ESOP seven to ten years out if the ESOP were to take stock in the buyer corporation.

The financial adviser will also compare the ESOP's possible financial positions to the financial position of any other selling parties, such as the seller note holder, to determine the relative fairness of the transaction.

From a fiduciary perspective, the ESOP trustee:

1. can only consider the net sale proceeds of the transaction and
2. can only consider the financial aspects of the offer, not what might happen to the employees.

In any case, the ESOP trustee cannot close without a favorable fairness opinion from its financial adviser.[3]

Price Protection

If the ESOP trustee determines that it wants the buyer's stock as consideration, it is important that the ESOP receive contractual "price protection" for the shares. This is because, for example, the ESOP may be trading a majority interest in the company for a minority interest in the buyer. Minority interests are typically subject to a discount in value of up to 30 percent.

The possible result is, therefore, that immediately after the transaction, without price protection, the value of the ESOP's buyer shares could decrease by up to 30 percent.

If the ESOP holds a majority of the sponsor company's stock and it cannot successfully obtain price protection in the buyer's stock, then the ESOP may require additional stock or cash to make up for that significant discount.

The ESOP trustee will argue that price protection will not have a material impact on the buyer. This is because the failure to apply a minority discount is not likely to materially increase the buyer's repurchase obligation.

For example, if the buyer has a $200,000 repurchase obligation, with a minority discount of 20 percent that goes unapplied, that would only translate to an additional $40,000 of repurchase obligation, which is probably not going to be material to the buyer.

On the other hand, a participant who has been terminated will likely view the portion of that $40,000 that he would have received had there been price protection as a material amount.

The buyer's articles of incorporation should be amended to state that any stock held by, or distributed by, the ESOP will not be subject to a discount for lack of control.

What Aspects of the Purchase Agreement Are Important to the ESOP?

With respect to the purchase agreement, the ESOP trustee typically will not agree to any indemnification provisions. Also, the ESOP trustee typically will only give limited representations and warranties (e.g., that it has the power to enter into the agreement and that it has title to the sponsor company stock).

This procedure makes sense when one considers that the ESOP has not and will not have operational control over the sponsor company.

Instead, the buyer must look to the seller note holder or other selling shareholders for any such provisions. It is important to make an uninformed buyer aware early in the transaction that this is the customary position of an ESOP regarding indemnification provisions and representations and warranties.

"If the ESOP trustee will take stock in the buyer corporation, it is noteworthy that the ESOP trustee should require lengthy representations and warranties from the buyer."

If the ESOP trustee will take stock in the buyer corporation, it is noteworthy that the ESOP trustee should require lengthy representations and warranties from the buyer.

These representations can include the following:

1. provisions regarding capitalization
2. clear title to the buyer stock
3. no outstanding litigation
4. validity of financial statements
5. no material adverse changes
6. no unresolved environmental matters
7. no unresolved taxation issues

In this way, the buyer is on the hook for indemnification to the ESOP trustee for a breach of any representation or warranty under the purchase agreement that adversely affects the value of the buyer corporation stock.

The ESOP trustee will usually want to make clear in the purchase agreement that the value of its consideration is not subject to any of the following:

1. working capital adjustments
2. adjustments for taxes
3. third-party debt
4. notes payable
5. capital leases
6. prepayment penalties
7. debt retirement costs
8. other adjustments

"... typically the buyer will choose to terminate the ESOP and transfer the participants' stock accounts from the ESOP to the buyer's 401(k)."

Rather, the buyer will have to look to the seller note holder or other selling shareholders for any such adjustments.

The purchase agreement will direct the flow of the consideration so that, for example, at closing the company will assign to the seller note holder all of the company's rights in the ESOP note and pledge of ESOP shares.

This assignment will constitute payment in full under the seller note. This will cause the seller note holder to cancel the seller note and any security agreement related thereto.

The ESOP will then assign to the seller note holder all of the unallocated shares. In exchange, the seller note holder will assign the ESOP note and pledge of ESOP shares to the ESOP trustee. This assignment will immediately cancel the ESOP note and the pledge of ESOP shares.

After this, the unallocated shares will be unencumbered. The ESOP will then assign all of the allocated shares to the buyer in exchange for stock, cash, and/or other consideration.

And finally, the seller note holder will assign to the buyer all of the unallocated shares in exchange for:

1. a note (possibly with terms more favorable than the seller note),
2. stock,
3. cash, and/or
4. other consideration, subject to any closing or post-closing adjustments.

What Happens to the ESOP?

There are several options of what to do with the ESOP upon the sale of an ESOP sponsor company:

1. freeze it
2. terminate it and transfer stock accounts from the ESOP to buyer's 401(k)
3. if the buyer is an ESOP sponsor company, merge it with the buyer's ESOP

If the ESOP is terminated or frozen, note that the participants automatically vest in all of the shares that have been allocated to their account.

Usually the buyer does not want to inherit the sponsor company's ESOP and the potential liabilities associated with it. Therefore, typically the buyer will choose to terminate the ESOP and transfer the participants' stock accounts from the ESOP to the buyer's 401(k).

However, the buyer may:

1. freeze the ESOP (in the sense that no more contributions will be made to the ESOP) and
2. administer the ESOP post-closing, at which time the ESOP will contain the consideration from the transaction.

Or if the buyer already has an ESOP, the buyer may choose to merge the two ESOPs.

Notes:

1. Note that the ESOP plan document might grant pass-through voting rights in the case of a stock sale, or the ESOP trustee can ask the ESOP participants to vote on a stock sale.
2. There is no rule regarding the use of seven to ten years, but that time frame is often used because it is seen as a reasonable time period. Some valuation advisors might choose to use the term of the ESOP loan instead, but, for example, it may not be practical to try to project forward more than ten years.
3. Recent DOL guidance from the *Johnson v. Couturier* case (DOL Settlement: Civil Action No. 2:08-cv-02732-RRB-GGH) states that an ESOP trustee must make certain that reliance on the financial adviser's opinion is reasonably justified under the circumstances. The ESOP trustee cannot rely on the financial adviser's views unless the ESOP trustee has read and understands the valuation report and fairness opinion and any other supporting documents. The ESOP trustee (a) must have identified, questioned, and tested the financial data and underlying assumptions and (b) must have verified that the conclusions are consistent with the data and analyses and that the valuation report, fairness opinion, or any other requested report or advice is internally consistent and makes sense.

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