

ESOP Transaction Insights

SELLING AN ESOP-OWNED EMPLOYER CORPORATION

Michael McGinley

When a sponsor company establishes an employee stock ownership plan (ESOP), the initial plan is usually (1) that the ESOP will stay in place forever and (2) that all of the employees will enjoy the fruits of their labors. This benefit occurs when the sponsor company shares in the employee accounts are put back to the sponsor company at the time of the employee retirement. Sometimes, however, ESOP employer corporations are sold. The existence of an ESOP does add a measure of complication to a sale of the sponsor company. However, with the right advisers, a successful sponsor company sale transaction can be completed for the benefit of all parties. This discussion presents an overview of the process, issues, special considerations, roles, and responsibilities of each party, and distribution rollover options in selling an ESOP-owned employer corporation.

INTRODUCTION

Due to the special nature of ESOPs, the sale of a sponsor company that is either wholly or partially owned by an ESOP is a complex transaction. That transaction requires special procedures and expertise in order to navigate the requirements to effect a successful sale.

In order for a company owned by an ESOP to be sold, it must receive no less than “adequate consideration.” This means that any sale transaction must be considered financially fair and prudent on the behalf of (1) the plan, (2) its participants, and (3) its beneficiaries.

The sale of an ESOP-owned employer corporation requires certain experts, including the ESOP trustee as well as the trustee’s independent financial adviser and legal counsel. The trustee is tasked with acting as a fiduciary for the ESOP. And, the trustee employs these financial and legal advisers:

1. to determine the fairness of any proposed transaction and
2. to ensure that all regulations and statutes are met.

In order to determine if a proposed sale transaction is fair, the trustee and its financial advisers should perform a thorough due diligence of the company. The purpose of this due diligence is to determine the fair market value: (1) of the company, (2) of its equity, and (3) of the equity owned or controlled by the ESOP.

The advisers should then present their findings to the trustee. The ESOP trustee will make a final determination whether (1) to accept a proposed offer or (2) to negotiate different terms and conditions.

THE SALE PROCESS

The sale process typically begins when a potential acquirer submits a letter of intent to the subject sponsor company’s board of directors. Even when an ESOP owns 100 percent of the outstanding stock of the sponsor company, it is usually the board of directors that first receives and considers a proposed transaction.

In other cases, the board may hire an investment banking firm to actively solicit bids to acquire the sponsor company. The reasons for selling a sponsor company can be many. However, whether it is an unsolicited outside offer or a solicited offer, this is usually the first procedure in the sale process.

It is very important that the board of directors notify the ESOP trustee of the potential sponsor company sale transaction at the earliest time possible. The board should look at the ESOP trustee as its partner. And, the board should make sure that the trustee has the information it needs to do its part to conclude a successful transaction.

In a significant recent ESOP transaction, a successful Willamette Management Associates ESOP client was approached by a public company. In this case, the sponsor

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company promptly notified the trustee of the possible sale. The ESOP trustee notified its financial and legal adviser immediately.

The ESOP trustee's advisers advised the sponsor company to hire an investment banker to assist with negotiations with the buyer. The process resulted in a successful transaction in which the ESOP received a substantial premium.

The board has a responsibility:

1. to protect the assets of the company and
2. to ensure that the shareholders receive the highest return on their investment.

In this capacity, the board should evaluate any and all stock purchase offers. Typically, a board will use an outside valuation firm:

1. to act as its financial adviser and
2. to provide a fairness opinion related to the proposed transaction.

This valuation firm may or may not be the same valuation firm that is used by the ESOP trustee for the ESOP annual employer stock valuation.

In circumstances where the board relies on information from the trustee's financial adviser, there is the potential for additional layers of complication. This complication may arise due to the fact that the ESOP trustee's financial adviser is, first and foremost, the adviser of the ESOP trustee. And, to the extent that the board's incentives are aligned with those of the ESOP's, this could be a reasonable arrangement. However, if the two parties' motivations become misaligned, then this arrangement could present a conflict of interest.

In situations where the financial adviser serves two masters by working for both the ESOP trustee and the sponsor company board, there becomes the potential to create:

1. information sharing conflicts or inefficiencies in the negotiation process at best and
2. a failure of fiduciary responsibilities at worst.

Typically, this is not the case. However, all parties should be aware of their responsibilities to maintain their respective fiduciary duties throughout the process.

In most sponsor companies, should the board pursue an offer to sell, the board is tasked with negotiating the terms of the offer. However, the board and the ESOP trustee (and its advisers) should communicate early and often in the negotiation process. This is because, even though the board

may take the lead in the negotiations, the ESOP trustee has the final say in approving a deal on behalf of the ESOP.

Once a bona fide offer is received by the board, it should be submitted to the ESOP trustee for review. The ESOP trustee will then require a legal adviser, competent in ESOP regulations, to approve the terms of the deal.

The ESOP trustee may also require its financial adviser to issue a fairness opinion, stating (1) that no less than "adequate consideration" is being paid for the shares and (2) that the deal is financially fair to the ESOP. Pass-through voting is also typically required to sell the shares held in as ESOP.

TRANSACTION FAIRNESS

The fairness opinion will typically be issued by the valuation adviser as of the date of the company sale transaction. It should include a statement that the transaction is fair to the ESOP from a financial point of view.

In this capacity, fairness is defined as not receiving less than "adequate consideration" under Section 3(18)(B) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

This financial fairness is the absolute fairness of the transaction. However, it is also appropriate to give consideration to the relative fairness of the deal.

In other words, while it is not required that the ESOP receive exactly the same economic return as other parties in the deal, it is prudent to know what that return is relative to all stakeholders and that returns be fair relative to the risks taken.

The issue of relative fairness is particularly important in ESOP employer stock sale transactions where the sponsor company management team is offered incentives to remain in place during the sale transition and beyond. The ESOP trustee should be assured that the terms of such programs:

1. are reasonable and
2. do not unduly impact the proceeds that would be received by the ESOP.

TRANSACTION CONSIDERATIONS

In the evaluation of an employer corporation sale transaction, there are several factors in both the terms and the nature of the transaction that should be given consideration. For example, is it a strategic acquisition, financial acquisition, or manager buy-out (which has its own special considerations)? What are the overall terms and

structure of the transaction? Is it an asset sale or a stock sale (tax impact)? Are there any earn-outs or synthetic equity plans?

What happens to the board or to key employees, that is, are there any noncompete, nonsolicitation agreements, employment agreements, or termination agreements? Is there any outstanding debt in the ESOP and how is that handled?

Are there any unallocated shares and how are they handled (cancel debt in exchange for cancelling shares or allocate shares based on debt payoff source)? What are the voting and disclosure requirements?

ROLES AND RESPONSIBILITIES OF THE VARIOUS PARTIES

Each of the parties involved in an ESOP may play a role in the sale of the subject sponsor company. The best sponsor company sale transactions occur when all of these parties work together cooperatively.

Board of Directors

The board of directors must act to maximize shareholder value, including shares owned by the ESOP. The board should evaluate all offers and decide on which offers to recommend to the shareholders. The board of directors has a fiduciary responsibility to all shareholders of the sponsor company.

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Sponsor Company Management

The management of the sponsor company has a duty to the company and its board of directors. In a sale situation, management will be interviewed extensively and will be called upon to provide due diligence support and information.

Management may also be in a potential conflict of interest position where their own self-interests are perhaps not aligned with the best interest of the ESOP. In these situations, care should be taken to ensure that management fulfills its responsibility to the sponsor company before any personal interests.

In the recent transaction noted in the previous paragraphs, the management team of the selling sponsor company was given substantial synthetic equity that would be fully vested in a company sale. However, the ESOP shares

acquired by the ESOP were not fully allocated. This was because the ESOP had been completed only four years previously.

For this reason, management appeared to be receiving relatively greater benefits from an ESOP sale compared to the ESOP participants. The management team was clearly conflicted. For this reason, significant negotiation was required to realign the sale transaction benefits.

The ESOP Trustee

The ESOP trustee has a fiduciary responsibility to the plan participants and their beneficiaries. Once the board of directors recommends an offer to the shareholders, the ESOP trustee should evaluate the offer to determine:

1. that adequate consideration will be received by the trust and
2. that the offer is fair to the ESOP from a financial point of view.

The ESOP trustee should also determine whether it is prudent for the ESOP to enter into the transaction.

The structure of the transaction may be such that the ESOP trustee is required to accept voting direction from the plan participants with respect to their allocated shares.

In this case, the ESOP trustee will want to assure that the sponsor company makes full disclosure to the participants of all the appropriate information concerning the offer.

The ESOP trustee may also want to arrange for the confidential tallying of the participant directions.

Finally, the ESOP trustee will have to determine that the proposed transaction is prudent. In doing so, the ESOP trustee should determine that a prudent man would sell the sponsor company under the proposed terms.

Prudence is a matter of judgment, but the ESOP trust has a responsibility to ensure that the transaction is fair to (1) the trust, (2) its participants, and (3) its beneficiaries. Special care should be taken to ensure this prudence, as the Department of Labor may require that the trust demonstrate the prudence of the transaction after the fact.

Government-imposed penalties for inadequate prudence can be severe. Therefore, it is especially important for the ESOP trustee to use qualified advisers based on experience, knowledge, and qualifications rather than simply on price.

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The ESOP Trustee's Legal Adviser

The ESOP trustee's legal adviser, or the ESOP lawyer, has a fiduciary responsibility to the trustee. The role of the legal adviser is to determine that the sponsor company sale transaction:

1. doesn't violate company charter documents or any of the terms of ERISA and
2. is structured in an appropriate and legal way.

The ESOP lawyer is also very involved in the negotiation of the terms of stock purchase agreement and other documents. While the sponsor company and the lender attorneys often draft such documents, this adviser has a major role in the outcome of the transaction.

The ESOP trustee legal adviser almost always has deep and specific knowledge of the Employee Retirement Income Security Act (ERISA) and will be very involved in negotiating things such as representations, warranties, and other transaction details.

The ESOP Trustee's Financial Adviser

The ESOP trustee's independent financial adviser may issue an opinion to the ESOP trustee as to whether or not the ESOP trust is receiving no less than adequate consideration and that the transaction is fair to the ESOP from a financial point of view.

This fair market value determination should be done in a good faith process whereby the ESOP trustees and fiduciaries may make a good faith conclusion of what constitutes adequate consideration for the ESOP-held employer corporation stock.

This determination should be in compliance with both Internal Revenue Service and Department of Labor regulations.

The financial adviser in an ESOP employer corporation sale transaction will typically not have access to the acquiring firm so as to understand things like the synergies that will accrue to the buyer. The acquirer usually works directly with the target company or with an investment banker.

However, the ESOP financial adviser will try to get as much information as possible by talking with the sponsor company and investment banker and through independent research.

TRANSACTION VALUATION ISSUES

The valuation adviser should provide the ESOP trustee with enough information to make an informed decision. At the

very least, this valuation analyst's due diligence typically involves an analysis of the following:

- The fair market value of the sponsor company and of its equity; the allocation of the sponsor company equity to the employer stock to be sold by the ESOP.
- The fair market value of the proceeds received by the ESOP if other than cash, especially in the case where the acquiring company's stock will be exchanged for the employer corporation shares held in the ESOP.
- The fair market value determination of both the sold and the acquired stock (if any) should be adjusted to the appropriate level of value (including controlling/non-controlling or marketable/nonmarketable interest levels of value) and all appropriate valuation discounts should be considered with respect to each appropriate level of value.
- Any ESOP debt outstanding and its effect on the employer stock fair market value.
- The capital structure of the acquiring company, and its effect on the ESOP's ownership position.
- Management incentive or employment contracts (or termination arrangements).
- Financial effects of any required escrows or indemnities.
- Any other transaction considerations that may affect value or terms.

In order to estimate the fair market value of the sponsor company's stock, the financial adviser should assess all of the following factors:

- the nature of the subject sponsor company and the history of the business enterprise
- the economic outlook and the condition and outlook of the specific industry
- the book value of the subject securities and the financial condition of the subject sponsor company
- the earnings capacity of the employer corporation
- the dividend-paying capacity of the employer corporation
- whether or not the subject business enterprise has goodwill or other intangible value
- the market price of securities of corporations engaged in the same or a similar line of business that are actively traded in a free and open market
- the marketability, or lack thereof, of the subject securities
- whether or not the seller would be able to obtain an ownership control price premium with regard to the subject employer corporation stock

PLAN TERMINATION

When an ESOP is terminated due to a sale or otherwise, there are several tax advantaged options for how to handle the distributions. And, each of these options has different benefits and considerations based on the desired post-transaction environment.

In the event of plan termination, the ESOP will be wound up and its assets will be distributed (whereby all plan participants become immediately vested). As opposed to simply releasing all of the proceeds in cash, distributions can be rolled over directly into another qualified plan, such as a 401(k) or profit sharing plan.

Plan distributions may also be exchanged for the acquiring company's stock, as long as the acquirer's stock is considered to be a "qualified replacement security."

Finally, if the acquiring company has an ESOP, then the subject sponsor company ESOP can be merged with the acquiring company ESOP. Or, the acquirer company can simply acquire and maintain the subject sponsor company ESOP after the transaction.

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Convert the Plan to a 401(k) or Profit Sharing Plan

In a sponsor company sale transaction, the acquiring company can amend the plan to become a 401(k) or profit sharing plan. Similarly, if the subject sponsor company simply terminates the ESOP, it may rollover the plan into one of these qualified plans. This rollover has the benefits of:

1. maintaining the plan's vesting schedule and
2. encouraging continued employment.

If the amended plan meets the conditions of Internal Revenue Code Section 404(c), then it reduces the fiduciary risk by shifting the investment decision to the plan participant.

The amended plan should abide by Code Section 411(d)(6), which protects certain benefits within the plan. The amended plan should be submitted to the Internal Revenue Service with a Form 5300 for a favorable determination letter.

Merge the ESOP Plan with Another ESOP

This transaction structure is slightly more complex. However, it is still a manageable option. This transaction

structure has synergistic benefits by combining two ESOP-oriented corporate cultures.

However, in this scenario, due diligence should be performed by the valuation adviser on the acquiring company's stock to ensure that the stock offer represents adequate consideration. In addition, shares at the acquiring company should be "qualified employer securities."

Maintain the ESOP Plan as an ESOP at the Acquiring Company

This transaction structure may be an attractive option for the ESOP plan participants to accept. This is because it provides for a smooth transition of benefits through the transaction.

In this transaction structure, the ESOP should receive shares of the new company in the transaction. And, those new company shares should be "qualified employer securities," although vesting and other provisions of the ESOP may be maintained in the transaction.

SUMMARY AND CONCLUSION

Due to the special nature of ESOPs, the sale of a sponsor company that is either wholly or partially owned by an ESOP is a complex transaction. Such a sale transaction requires special procedures and expertise in order to complete a successful sale.

This transaction structuring requires certain advisers to ensure:

1. that the ESOP participants and beneficiaries receive no less than adequate consideration and
2. that the transaction is financially fair to the ESOP.

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Several additional procedures are involved in the sale of an ESOP-owned employer corporation, but with the right advisers, the ESOP-owned sponsor company can achieve a successful sale.

Michael McGinley is an associate in our Atlanta office. Michael can be reached at (404) 475-2309 or mjmcginley@willamette.com.

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