ABCs of Private Company ESOP Transactions

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About Anthony “Tony” Eppert

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- Tony practices in the areas of executive compensation and employee benefits

- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Upcoming 2024 Webinars

- 2024 webinars:
  - Compensatory Thoughts on Navigating Blackout Periods (8/8/24)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/12/24)
  - Governance: Properly Hiring and Terminating an Executive Officer (10/10/24)
  - Introduction Course on Employment Taxes (11/14/24)
  - What Happened in 2024: Year-End Review of Compensatory Items(12/12/24)

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Our Compensation Practice – What Sets Us Apart

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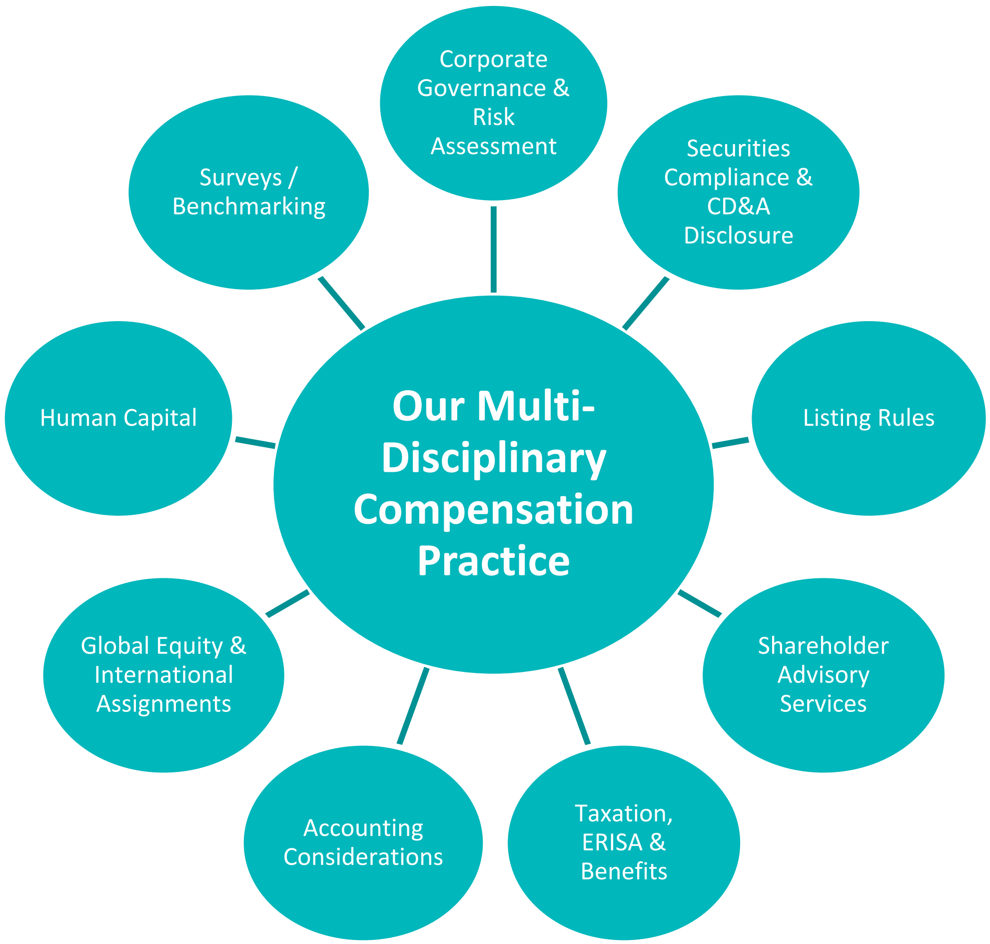
- Compensation issues are complex, especially for publicly-traded companies, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



Our Compensation Practice – What Sets Us Apart (cont.)

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- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement "best practices"
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose

- The purpose of this slide deck is to outline the sale of stock from equity holders to a newly-formed employee stock ownership trust (the "ESOT") and its related employee stock ownership plan (the "ESOP"). To that end, this slide deck covers:
  - Quick thoughts,
  - What is an ESOP,
  - Overview of a typical ESOP transaction,
  - Feasibility study,
  - Pre-transaction conversion to C corp structure,
  - Bank-loan financing,
  - Possible structure of the ESOP transaction,
  - Seller viewpoint,
  - Employee & HoldCo viewpoint, and
  - Post-transaction governance

Quick ESOP Thoughts

- Tax Efficiency
  - There are unique provisions in the tax code applicable only to ESOPs, which can result in higher after-tax proceeds with an ESOP sale compared to those of a typical M&A transaction
- Liquidity and Diversification
  - ESOPs allow for partial or full liquidity by enabling selling shareholders to diversify their holdings while participating in future increases in company value
- Control
  - In contrast to a strategic sale, shareholders can maintain operating control of the company after ESOP implementation. As a result, ESOPs are a very popular liquidity option for private-held companies
- Estate Planning
  - An ESOP creates an opportunity to reduce estate taxes as the equity value is temporarily decreased immediately following the transaction
- Legacy
  - ESOPs provide business and employee continuity. Through selling to an ESOP, companies can maintain independence, ultimately perpetuating company legacies and protecting employee jobs

What Is an ESOP

- An ESOP is a qualified retirement plan designed to invest primarily in the stock of the sponsoring employer
  - For **owners** of closely-held companies, an ESOP is a succession planning tool that allows them to transition ownership of their companies to employees on a tax-advantaged basis while continuing their legacy
  - To a **company**, an ESOP is a corporate finance vehicle that can create tax benefits not available anywhere else in the Internal Revenue Code
  - Form an **employee** perspective, an ESOP is a defined contribution retirement plan designed to provide eligible employees with beneficial ownership of shares of company stock

Overview of a Typical ESOP Transaction

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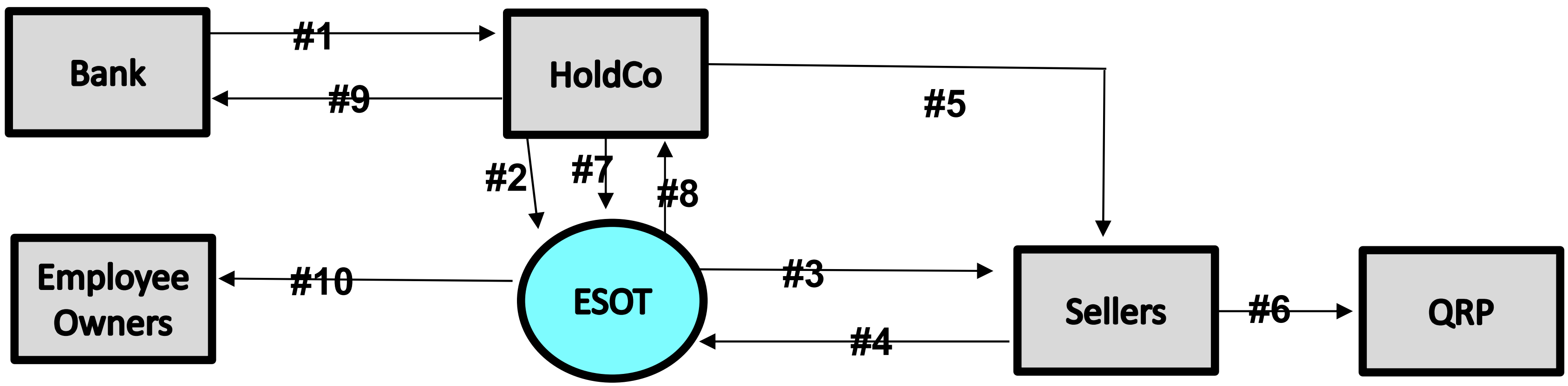

Description of Steps	Notes & Comments
1. Bank loans $ to HoldCo	Tax-efficient means to borrow $
2. HoldCo loans bank $ + balance sheet $ to ESOT	Secured by the shares ESOT receives
3. ESOT uses $ + Seller Notes to buy Stock	High interest rate or warrants to Sellers
4. Sellers convey shares to ESOT	Stock pledged as collateral to Sellers
5. HoldCo assumes ESOT debt obligations on Seller Notes	Debt obligation outside of ERISA
6. Sellers purchase QRP to defer taxation on sale proceeds	Variety of means exist to facilitate
7. HoldCo contributes $ annually to ESOT (tax deductible)	Tax deduction increases cash flow
8. ESOT immediately repays $ to HoldCo	HoldCo is cash flow positive
9. HoldCo utilizes increase cash flow to repay Bank	Debt typically paid faster than normal
10. Employees have <u>beneficial</u> ownership of shares	ESOT controlled by governance

Feasibility Study

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- An advisor should be retained to perform a feasibility study

- A purpose of the feasibility study is to model different sale transactions, with:
  - 30% of HoldCo stock being sold to the ESOT;
  - 51% of HoldCo stock being sold to the ESOT (thus avoiding minority discounts); and
  - 100% of HoldCo stock being sold to the ESOT

- Additionally, and depending upon the outcome of how the current entities are converted within the pre-transaction rollup to a HoldCo structure (if applicable), the ESOP transaction could be set up so that only certain entities are sold to the ESOT with such sold entities being outside of the HoldCo structure

- The feasibility should address:
  - Impact of outside bank note on HoldCo's ability to satisfy the debt obligation, helping to address the question "how much can HoldCo afford to borrow";
  - What cash on hand could be used to pay Sellers in addition to bank monies;
  - Impact of subordinated Seller Note;
  - Impact of warrants;
  - Impact of SARs;
  - Structure of the inside note between HoldCo and the ESOT; and
  - Projected repurchase liability relative to assumed growth rate of HoldCo

Pre-Transaction Conversion to C Corp Structure

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- Many times the entity or entities in question are either LLCs taxed as partnerships or are operating as S corporations (or LLCs taxed as S corporations). As a result:
  - Immediately prior to implementing the ESOP transaction, the entities are typically reorganized into a HoldCo structure;
  - The HoldCo will be taxed as a C corporation immediately prior to implementing the ESOP transaction, thus allowing Sellers to take advantage of the 1042 deferral;
  - Assuming the ESOT will own 100% of HoldCo, the ESOT will immediately after the transaction elect S corporation status (i.e., if HoldCo is 100% owned by a tax-exempt entity, then no tax distributions would be required, and as a result, the tax savings can be used to help facilitate repayment of the debt obligations)

Bank Loan Financing

- There are a number of banks who compete for ESOP financing, however, typically the primary goal of the bank is to take over the credit facility/revolver

- The process starts with:
  - Informing the incumbent banker that an ESOP transaction could occur, and gauge their level of interest
  - Simultaneously, start interviewing 3 other banks

Seller Viewpoint

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- Sellers have a number of alternatives, including one or more of the following:
  - Pay capital gains tax on otherwise low-basis common stock,
  - Tax deferral under Section 1042
- A selling shareholder could (but is not required) elect to defer gain on the sale of HoldCo stock sold to an ESOT by reinvesting all or any portion of the sale proceeds in "qualified replacement property"
  - Generally, replacement securities are stock or debt instruments of a domestic operating corporation (though other products exist that satisfy this requirement)
  - Replacement securities must be acquired within 12 months following the sale transaction to the ESOT (this is where a "floating rate note" can come into play to protect 100% of the sale proceeds, even sale proceeds received after such 12-month period)
  - Holder could margin the account and immediately have access to cash while maintaining tax deferral
  - If the selling shareholder dies while holding the qualified replacement property, his or her heirs would get a step-up in basis similar to what would have happened had the selling shareholder held HoldCo shares at the time of his or her death (but in the interim, the selling shareholder had diversification of wealth and access to cash)
- Other rules include:
  - To elect deferral, the selling shareholder must have owned the shares at least 3 years prior to selling such to the ESOT (tacking rules apply)
  - To elect deferral, the selling shareholder and certain relatives cannot participate in ESOP allocations

Employee/HoldCo Viewpoint – Participation & Allocation

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- Generally, all full-time employees over the age of 21 with one year of service would be eligible to participate in the ESOP, however HoldCo may exclude:
  - Independent contractors,
  - Non-resident aliens,
  - Employees participating in collective bargaining units, and
  - Certain others (provided applicable testing is satisfied)

- Allocations to individual employee accounts are generally made on the basis of relative pay or some more equal formula
  - But keep in mind, that so long as the inside note exists between the ESOT and HoldCo, shares are held in a suspense account and are allocated in accordance with the above only to the extent the inside note is paid

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Employee/HoldCo Viewpoint – Participant Vesting

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- A participant becomes 100% vested in his or her account upon attaining normal retirement age (e.g., age 65) or upon a partial or complete termination of the ESOT
  - Also, HoldCo could design the ESOP to accelerate vesting upon a participant's disability or death (and possibly upon a change in control transaction)
- For all other instances, a vesting schedule would apply to individual participant accounts, which could be no more stringent than:
  - No vesting until the participant completes 3 years of service, then 100% vested, or
  - Six-year graded vesting in accordance with the following:

Years of Service	Nonforfeitable %
Less than 2 years	0%
2 years	20%
3 years	40%
4 years	60%
5 years	80%
6 or more years	100%

- Generally, the portion of a participant's account that remains unvested as of his or her termination of employment with HoldCo is forfeited
  - Forfeitures are reallocated among remaining participants in accordance with a set allocation schedule

Employee/HoldCo Viewpoint – Voting Rights

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- As to shares allocated to participant accounts, participants would have full voting rights, but only with respect to corporate matters involving a vote of shares "for" or "against":
  - Corporate mergers,
  - Consolidations,
  - Sales of all or substantially all of HoldCo's assets,
  - Recapitalizations,
  - Reclassifications,
  - Liquidations,
  - Dissolutions, and
  - Similar matters
- Otherwise, the Trustee votes the allocated shares
- Addressing unallocated shares, these are generally voted by the Trustee, though the ESOP document could provide that unallocated shares would be voted by the Trustee proportionate to how participants are directing the vote of allocated shares (*i.e.*, essentially a "mirror provision"), subject to fiduciary restraint

Employee/HoldCo Viewpoint – Diversification

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- Except as provided below, ESOPs must provide "qualified participants" an opportunity to diversify at least 25% of their vested account balance into other investment options within the "qualified election period"
  - A "qualified participant" means one who is at least 55 years old and has at least 10 years of participation in the ESOP
  - The "qualified election period" begins when a participant becomes a qualified participant and lasts for 6 years

- However, in the final year of the qualified election period, the participant must have the opportunity to direct the investment of at least 50% of the balance of his or her account

- Noteworthy is that a definitional prerequisite to becoming a "qualified participant" is at least 10 years of participation in the ESOP
  - Thus, the diversification requirement cannot be triggered in the first 10 years of the life of the ESOP

Employee/HoldCo Viewpoint – Distributions

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- Generally, a participant's vested account balance would begin to be distributed to him no later than one year after the plan year within which the participant terminates his or her employment due to:
  - Retirement on or after "normal retirement age,"
  - Disability, or
  - Death

- However, if a participant's employment is terminated for any other reason, his or her vested account balance would begin to be distributed not later than one year after the end of the fifth plan year following the plan year within which the participant's employment was terminated
  - Though this rule is not triggered to the extent an inside loan balance remains between the ESOT and HoldCo

- Additionally, in instances where a distribution is required, the account balance must be distributed in substantially equal periodic payments (not less frequently than annually) over a period not exceeding 5 years
  - Though a participant may elect otherwise

Employee/HoldCo Viewpoint – Distributions (cont.)

- A participant may rollover his distribution to an IRA or a qualified retirement plan
- For privately-held companies, a participant must generally be given a put option (i.e., right to require HoldCo to repurchase stock at fair market value) as to HoldCo stock distributed to him or her
  - However, if HoldCo is an S corporation or if HoldCo's bylaws or Articles of Incorporation restrict stock ownership to substantially all current employees, then distributions can be set up so that they only take the form of cash (*i.e.*, no stock)

Post-Transaction Governance – Fiduciaries

- Any individual or entity exercising discretion, authority, maintenance or control of ESOT assets is a fiduciary (such includes the trustees, the members of the Board of Directors, and HoldCo's officers)

- Responsibilities of fiduciaries include:
  - To carry out duties in accordance with basic fiduciary principles (*e.g.*, to act solely in the interest of ESOP participants and to act exclusively for their benefit)
  - To act with the "care, skill, prudence, and diligence" under which a prudent individual would act in similar circumstances and situations
  - To act in accordance with applicable ESOP documents and ESOT documents

Post-Transaction Governance – Board of Directors

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- The Board of Directors makes the final decision on whether to create an ESOP (which is NOT a fiduciary act under ERISA)
  - And to avoid becoming the default "named fiduciary," the Board should delegate the named fiduciary position and responsibilities to an ESOP committee
- The Board would pick the trustee
  - For the transaction itself, typically an outside trustee is used so as to help bolster independence and that the transaction represented an arm's-length transaction
  - Immediately after the transaction, a directed or discretionary trustee could be used that is NOT an outside trustee (*i.e.*, an inside trustee could be used)
- As part of the transaction, steps will be taken to ensure D&O liability insurance covers both implementation of the ESOP and operation of the ESOP
- Other than the foregoing, the typical status quo associated with a company's governance remains, that is:
  - Shareholders elect directors (remember most of the shares will be unallocated and will be voted by the Trustee);
  - Directors appoint officers and set policy, including "who" is the trustee; and
  - Officers run the day-to-day operations of HoldCo

Post-Transaction Governance – Trustee(s)

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- The trustee is a fiduciary
  - Outside trustees are either a directed or discretionary trustee, the former of which is subject to direction by the named fiduciary
- The trustee is appointed by the Board and:
  - May be an institution or an individual
  - Is the legal owner of the shares held by the ESOT
  - Is an ESOP fiduciary
  - Votes unallocated shares on all matters otherwise entitled to a shareholder vote, including the election of members of the Board

Don’t Forget Next Month’s Webinar

- Title:
  - Compensatory Thoughts on Navigating Blackout Periods
- When:
  - 10:00 am to 11:00 am Central
  - August 8, 2024