

# **Selling an ESOP-Owned Company: A List of Business and Legal Issues**

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Presentation for:

Hunton's Executive Compensation Webinar Series  
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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:
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  - 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

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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.)

- 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

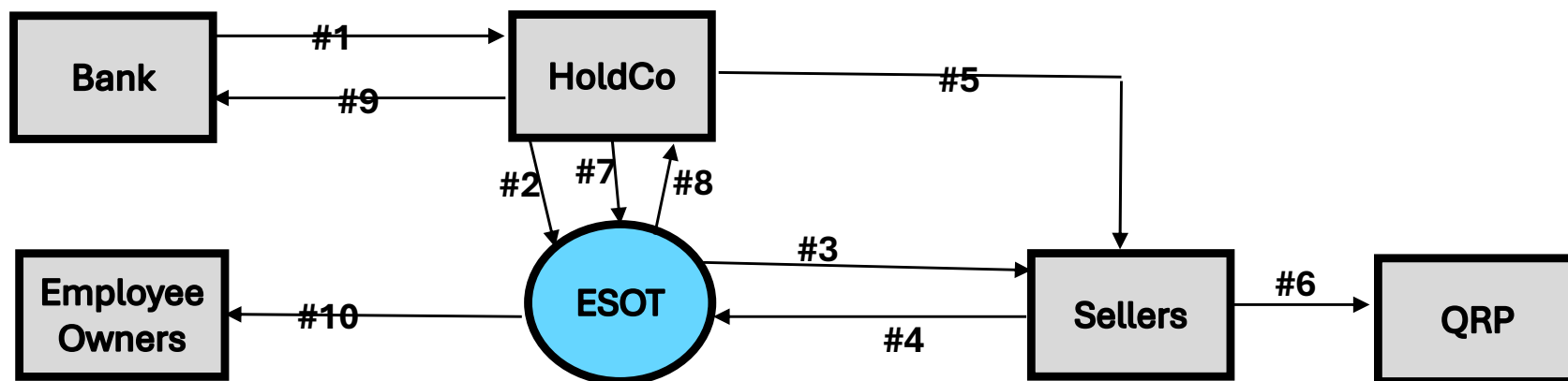
# Introduction

- The purpose of this presentation is to discuss the legal and business issues associated with selling a company that is 100% owned or majority owned by an employee stock ownership trust
  - As background, an employee stock ownership plan (the “**ESOP**”) is a qualified retirement plan under ERISA and its funding mechanism is the employee stock ownership trust (the “**ESOT**”)
  - The ESOT, via the trustee, is the legal owner of the shares
  - The Trustee is a single owner for S corporation shareholder purposes, even if the ESOP has 100s of participants
  
- This presentation is broken into the following subparts:
  - **Part 1:** Describe the transaction that gave rise to the ESOP, which needs to be discussed to provide background and clarity to the various issues that can arise when the ESOT-owned company is later being sold to a third-party buyer
  
  - **Part 2:** Describe the inner-workings of the ESOP from the perspective of all the parties (*i.e.*, the participants, the Trustee, HoldCo, etc.), set forth for the same reasons as stated above
  
  - **Part 3:** Describe how to structure the transaction and address various issues when the ESOT-owned company is later sold to an independent third-party buyer

## Part 1: 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 the legacy they built within the company
  - To a **company**, an ESOP is a corporate finance vehicle that can create tax benefits not available anywhere else in the Internal Revenue Code
  - From an **employee** perspective, an ESOP is a defined contribution retirement plan designed to provide eligible employees with beneficial ownership of shares of company stock

## Part 1: Overview of a Typical ESOP Transaction



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 now 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 design

## Part 1: Pre-Transaction Conversion

- Prior to the ESOP transaction, the entity in question is typically an LLC taxed as partnership or an S corporation (or operating as an LLC who checked-the-box to be taxed as a corporation and then made an S election). As a result:
  - Immediately prior to implementing the ESOP transaction, the entity is 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 to the third-party bank, and after such is repaid, then to the debt obligations under any seller notes)
  - The foregoing restructuring has a detailed tax analysis to overcome certain issues, but generally such issues can be favorably resolved

## Part 1: Seller Viewpoint

- Sellers have a number of alternatives, including one or more of the following:
  - Pay capital gains tax on otherwise low-basis common stock, OR
  - Tax deferral under Section 1042
- If more than 30% is sold to an ESOT, then a selling shareholder could elect to defer gain on the sale of HoldCo stock 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 in situations where seller notes are involved)
  - 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

## Part 2: Employee/HoldCo View – Participation & Allocation

- 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, so long as the inside note exists between the ESOT and HoldCo, shares pledged as security on such inside note are held in a suspense account and are allocated in accordance with the above only to the extent the inside note is repaid
  - Further keep in mind that even if the outside note with the Bank is 5 years, it is common for the inside note to be 20 to 40 years in length because:
    - Such was required due to annual allocation and annual contribution limits, and/or
    - Such was desired to help manage the repurchase liability

## Part 2: Employee/HoldCo Viewpoint – Participant Vesting

- 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:

<u>Years of Service</u>	<u>Nonforfeitable %</u>
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

## Part 2: Employee/HoldCo Viewpoint – Voting Rights

- With respect to private companies and 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,” such matters including (such voting right being, the “pass-through vote”):
  - Corporate mergers,
  - Consolidations,
  - Sales of all or substantially all of HoldCo’s assets,
  - Recapitalizations,
  - Reclassifications,
  - Liquidations,
  - Dissolutions, and
  - Similar matters
- With respect to the above, the ESOP participants do not actually vote, instead, they instruct the Trustee how to vote; otherwise, the Trustee votes the allocated shares
- And too, a pass-through vote is not required if the ESOP-owned company is being sold pursuant to a stock sale (a function of 409(e)(3) and state law and ESOP plan document)
- Unallocated shares 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

## Part 2: Employee/HoldCo Viewpoint – Diversification

- 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

## Part 2: Employee/HoldCo Viewpoint – Distributions

- Generally, a participant's vested account balance would begin to be distributed to him or her 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
  - Keep in mind though, that this rule does not apply while 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

## Part 2: Employee/HoldCo Viewpoint – Distributions (cont.)

- A participant may rollover his or her distribution from an ESOT to an IRA or a qualified retirement plan
- For privately-held companies, a participant must generally be given the right to put the HoldCo stock back to HoldCo or the ESOT
  - Such right requires the repurchase price to be at the then fair market value
  - 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 a participant never has the right to take a stock distribution, instead, all distributions must be in the form of cash

## Part 2: 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

## Part 2: Governance – Board of Directors

- 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 creating the ESOP, 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

## Part 2: Governance – Trustee(s)

- 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
  - In more recent years, the common practice within the transaction creating the ESOP, is that the trustee is a discretionary trustee
  - As a result, most third-party trustees operate as discretionary trustees
  
- 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
  - Votes all shares not subject to a pass-through vote
  - And as a technical matter, even when a pass-through vote is required, the trustee (as the technical owner of the ESOT's shares) is the actual one submitting the vote

## Part 3: Sale to Strategic Buyer – Typical Background Facts

- Warrants might exist (depending upon how long it has been since the transaction giving rise to the ESOP closed)
  - At the time the ESOP was created, the sellers likely sold their interest in HoldCo and received cash and “**Seller Notes**” as consideration
  - In consideration of the Seller Notes being subordinated to the external bank loan and thus having a subordinated interest rate of 11% to 14%, sellers will often take a low stated interest rate (e.g., 5%) and receive the remainder of the interest in the form of warrants
  - Such warrants are priced immediately after the ESOP transaction (the “**Warrants**”)
- An “**Inside Note**” might exist
  - To help facilitate the ESOT’s purchase of the selling shareholders’ shares, HoldCo loaned money to the ESOT
  - And too, immediately after the ESOP transaction, the Seller Notes were likely assumed by HoldCo pursuant to a loan whereby the ESOT promises to repay HoldCo
  - Either or both of the foregoing could still exist
- Finally, in connection with the ESOP transaction, HoldCo will often adopt a management incentive plan in the form of stock appreciation rights (the “**SAR Plan**”)
  - Such typically has both time-based awards and performance-based awards
  - A pool equal to a contemplated amount of economic dilution would be set up (e.g., 10-12% of the fair market value of HoldCo)

## Part 3: Notice to Trustee of Intent to Explore a Sale Transaction

- An ESOT agreement will require that HoldCo provide the Trustee notice of certain action items, including the possibility of selling HoldCo or its assets to a strategic buyer will (or should) trigger such notice, with such notice to include:
  - A general notice that no strategic buyer has yet been identified, and that HoldCo is within the beginning stages of hiring an investment banker, etc.
  - Such notice should include the Board’s belief that pursuing a sale opportunity could be in the best interests of the ESOP participants due to any of the following reasons (not exhaustive):
    - A purpose of the ESOP was to gain a competitive advantage in hiring and retaining employees, however, the Board has found that the employees assign little value to it;
    - The costs associated with administering the ESOP are more expensive than anticipated, especially since such cash outlay does not result in an increase in employee attraction, incentive and retention;
    - The costs associated with administering the ESOP (e.g., repaying acquisition indebtedness) effectively reduces HoldCo’s ability to provide more attractive incentives to key employees;
    - Providing incentives to key employees are necessary, however, HoldCo is constrained due to 409(p) limitations under the Code;
    - It is anticipated that a sale of HoldCo could result in a significant increase in value of HoldCo’s stock;
    - A strategic buyer could provide HoldCo with capabilities that were not otherwise available to HoldCo, thus helping to ensure worker longevity and stability of employment for the ESOP participants who are active employees; and
    - The Board believes that an industry trend exists towards consolidation, and as a result, the value of HoldCo may be optimum for a sale, while at the same time, the Board fears that if HoldCo’s competitors become acquired by a strategic buyer, then such competitors could have a competitive advantage over HoldCo in the market

## Part 3: Possible Structures for Sale to Buyer – Stock Sale – Timing

- If avoiding a pass-through vote is preferred, then the sale transaction to a strategic buyer must be structured as a sale of HoldCo's stock. As a result:
  - All actions will be taken to terminate the ESOT as of the closing, however under ERISA rules, the ESOT is not terminated until the last dollar is distributed
  - If there is a purchase price earnout or holdback, or if the ESOT desires a determination letter from the IRS as to the qualified status of the ESOP as of its termination date, then time will elapse from Closing until the ESOT is fully terminated when the last dollar can be distributed from the ESOT (*i.e.*, about 12-18 months for the determination letter from the IRS)
  - Thus, the stock sale format results with the strategic buyer having to finalize the wind-up of the ESOT, which often is not preferred by strategic buyers
- If no determination letter is sought AND an earnout or holdback applies AND the desire is to have the last dollar in the ESOT distributed as close as possible to the closing of the sale transaction, then an “earnout certificate” or “holdback certificate” (representing the value to be paid out pursuant to such earnout or holdback) can act as an eligible rollover distribution to an IRA, thus fully distributing the ESOT's assets near the closing (as opposed to delay)
- Alternatively, it might be possible to have a sale of HoldCo stock to the buyer, and immediately prior to consummating such, take actions to freeze and terminate the ESOP and then transfer such sponsorship (along with the ESOT) to a newly-created entity for the sole purpose of winding down the ESOT
  - Legal counsel will need to vet whether such design would trigger the pass-through vote requirement

## Part 3: Possible Structures for Sale to Buyer – Other Sale

- A buyer's preferred structure would be a transaction where it does not end up sponsoring the ESOT during its winding up and termination. An example of the structure of such a transaction is set forth below, and assumes that the ESOT-owned company has no subsidiaries immediately prior to the sale to a strategic buyer:
  - Current structure is that the company is owned by the ESOT
  - ESOT creates a holding entity that elects S corporation status, and the ESOT contributes all of its shares in the company to holdings
  - After a Q-sub election and converting the company to an LLC, the result is that ESOT owns holdings, and holdings owns all of the company
  - The membership interests of the company are then sold by holdco to the buyer, or the company is merged into one of buyer's entities, and post-transaction, holdco remains the plan sponsor of the ESOT with the responsibility of winding up its assets
- The foregoing would require a pass-through vote

## Part 3: Treatment of Outstanding SARs

- Typically, the SAR Plan or the award agreement would require full accelerated vesting immediately prior to the sale transaction to a strategic buyer
- The SAR Plan will have to be vetted to determine whether the SARs are cashed out based upon the price per share “before” or “after” resolution of the issue relating to the unallocated shares in the suspense account of the ESOP (*i.e.*, are such shares outstanding or are they redeemed by HoldCo in satisfaction of the Inside Note)

## Part 3: Leveraging the Unallocated Pool of the SAR Plan

- Consider whether to have the economics of the unallocated pool of the SAR Plan available to fund a transaction bonus structure
  - The economics associated with the remaining pool of SARs could be converted into a sale transaction bonus pool based on the value of the unallocated SARs
  - Such transaction bonuses would be paid in cash (and/or equity of HoldCo) and could be made to certain key individuals determined by HoldCo, with the purpose of rewarding those who contributed significantly to the growth in the value of HoldCo since the original sale to the ESOT, and additionally reward such key employees to run full speed into a possible job elimination
- Supporting this idea are the following:
  - Doing nothing results with inequities between HoldCo's longest serving employees and the newest employees. Reason is that their allocations would be relatively similar (assuming allocations of suspense account based on compensation). In contrast, HoldCo should be rewarding its longest serving employees more
  - 409(p) issues could be navigated if the strategic buyer assumes the bonus, with a present to win concept (with exceptions for termination without Cause, quitting for Good Reason, death, Disability, subsequent change in control, etc.)
  - A strategic buyer could fund this with a downward purchase price adjustment, which also provides buyer with a compensatory deduction because the related services are provided post-transaction
  - Therefore, the value of such compensatory deduction could cause an upward adjustment to the purchase price
  - Finally, the monies to fund the payment can be secured within an escrow (business issue as to whether forfeitures benefit buyer or sellers or participants)

## Part 3: Treatment of the Warrants

- Generally, warrants are cashed out based upon a price per share that assumes all of the unallocated shares in the ESOT are fully allocated
- Resolution of this issue should be addressed in the warrant agreement

## Part 3: Treatment of Unallocated Shares in the ESOP

- The ESOP plan document will govern whether allocation of the unallocated shares in the suspense account is required or whether the unallocated shares could be used to pay the remaining principal on the Inside Note
- Using the unallocated shares to payoff the Inside Note could maximize shareholder value as follows:
  - An open issue is whether to use the (i) price per share in the M&A transaction or (ii) the price per share in the most recent ESOP valuation, each of which could be a reasonable price per share subject to Trustee input
  - Market practice varies on what price per share is used in the sale of unallocated shares to HoldCo, thus, absent a contractual provision, the Board would have the discretion to determine a reasonable price per share to be used to repay the Inside Note
  - Using a lower price results in less unallocated shares, and using the higher price results in more unallocated shares
  - Such directly impacts the overall price per share in the M&A transaction, which impacts SAR value, etc.

## Part 3: Treatment of Unallocated Shares in the ESOP (cont.)

- If after full payment on the Inside Note there remains unallocated shares, then the Board must decide what happens to the remaining unallocated shares
  - Often, the ESOP Plan (or the stock purchase agreement and ancillary documents signed when the ESOP was created) does not require that unallocated shares be fully allocated to the ESOP participant in connection with the M&A sale or termination of the ESOT
  - Market practice varies on whether unallocated shares (following payoff of the Inside Note) are then allocated to participants or whether such are simply cancelled
  - Such a decision would be for the Board to decide, subject to Trustee input

## Part 3: Strategic Buyer Requires Rollover Investment

- It is common for a strategic buyer to require key executives to rollover sale proceeds into the buyer
  - But in the ESOP context, the only sale proceeds an executive will receive at closing is the payment on SARs and ESOP distributions
  - SARs are subject to ordinary income tax, so any rollover would have to be on an after-tax basis
  - A required rollover, after paying taxes, could substantially diminish the “dream” associated with the SAR payout since the net payout (after taxes and rollover) to the executive is smaller than expected
  - Such is not ideal
- Alternatively, the key executive could take his or her ESOP distribution, roll such into a self-directed IRA, and then direct the IRA to invest in the buyer
  - Prohibited transaction traps need to be vetted, but can be solved
  - To reduce risk, the key executive could rollover into two IRAs, the larger portion of his or her ESOP balance into a traditional IRA custodian and the distribution such to reinvestment could be rolled into a self-directed IRA

## Don't Forget Next Month's Webinar

- Title:
  - Designing Employee Stock Purchase Plans
- When:
  - 10:00 am to 11:00 am Central
  - July 9, 2026