Unique ESOP Structure Considerations

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Circular 230

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Overview/Summary

- Review Development of Transaction Goals
- Summary of Regulatory/Litigation Environment
- Financial Structuring Alternatives
- Post Transaction Price Adjustments
- Designing Incentive Arrangements
- Transaction Provisions/Considerations

Transaction Goals – Feasibility Process

- First (and most important) step: identify seller and company objectives and proceed with an ESOP if the identified objectives are achieved with an ESOP
- More "pre-planning" occurs than ever before
    - Protects against unnecessary costs
    - Results in achievement of desired goals
    - Allows shareholders to understand appropriate transaction structure(s) and alternatives
- Post-closing audits and investigations can be expected
    - A well executed transaction "process" (including independence of parties, documentation, etc.) is a protection against arguments from reviewing entities

Transaction Goals – ESOP Objectives

- Common objectives supporting the creation of an ESOP include:
  - Creating and realizing employee retirement benefits, cultural improvements, and tax/operational efficiencies
  - Protecting the shareholders' legacy and Company heritage while realizing liquidity and an effective ownership transition
  - An ability to utilize corporate tax savings to increase growth and accelerate debt repayment
  - Enable the shareholders to defer capital gains taxation via a 1042 election
  - Facilitates an efficient means of delivering broader employee ownership and fostering retention/recruitment activities

Transaction Goals – Shareholder Objectives

- Typical shareholder objectives:
  - Valuation expectations
  - Liquidity objectives
  - Post-closing governance
  - Preservation:
    - ✓ Shareholders' legacy
    - ✓ Company jobs and community involvement/support
    - ✓ Continued partnership with customers/suppliers

Regulatory Concerns

Evolving DOL Guidance

- DOL skepticism regarding valuations undertaken in connection with the establishment of an ESOP has led to significant oversight and articulated "requirements"
  - Continued development of the "Fiduciary Process Agreement" (FPA)
    - ✓ Four (4) fiduciaries under such agreements (both institutional and individual fiduciary impact)
- Evolving landscape regarding the feasibility analysis has changed both the players involved in this process and the methods by which information is reviewed for these purposes

Regulatory Concerns

Plaintiff Counsel Targeting ESOPs (?)

- Decline in value post transaction
- Seeking court sanctioned review of
    - Projections
    - Control
    - Debt structure

Financial Structuring Considerations

Seller Debt Structure

- Understand debt capacity
  - Utilize an appropriate capital structure where lower cost debt is maximized before higher cost debt is employed
  - Stress test projections to ensure that the capital structure is sound and that unreasonable levels of risk are avoided
- Interest structure
  - Current/cash pay
    - ✓ Senior Debt restrictions, general affordability and prudence
    - ✓ Cash interest rates should be market based
  - "PIK" Interest
    - ✓ PIK interest rates should be market based
    - ✓ Tax considerations can make high levels of PIK unacceptable to shareholders and other investors

Financial Structuring Considerations

Seller Debt Structure (continued)

- Warrant structure
  - Aligns the shareholders' interests with the ESOP's, whereby ultimate warrant value is determined based on the company's future success
  - Allows for market level returns to shareholders (without hindering cash flow) in consideration for their financing of the transaction
  - Warrant allocation and strike price determination must reflect market returns given the future equity value projections
    - ✓ If an S Corp, the strike price cannot be lower than 90% of fair market value as of the date of issuance
  - Event projection?
    - ✓ How treat in an "early" ESOP transaction (if occurs)
  - Corporate Governance Issues

Financial Structuring Considerations

Real Estate Sale Leaseback ("SLB")

- Real estate used in the operation of the business can be sold to financial investors (REITs, etc.) and then leased back by the business
  - SLBs can help finance transactions and ensure that the shareholders receive full and fair value for the real estate
    - ✓ Determined by a full market process with 3rd party investors
  - However, the cost for the future lease must be included in the company's projections for enterprise valuation purposes
- While lease costs reduce enterprise value, real estate generally commands higher multiples than operating businesses, thus providing an attractive arbitrage for shareholders
  - Long term leases ensure undisturbed operations and predictable cash flows for the ESOP
  - Be aware of potential tax implications and consider completing the SLB after the sale to the ESOP (particularly if 100% S Corp ESOP)

Financial Structuring Considerations

Purchase Warrants

- Warrants may be purchased directly by management team members and investors (e.g., current shareholder group)
  - Allows equity ownership among a broader group than only the current shareholders
    - ✓ Remains targeted ownership that is aligned with the company and ESOP
  - Opportunity to participate in equity with capital gains/loss tax vs. ordinary income tax characteristics
  - Fair market value purchase of warrants provides an influx of capital/equity financing that might not otherwise be available
  - Purchase price considerations….
    - ✓ Determination of the purchase price and strike price is highly negotiated
  - Securities law and S-Corp. structuring considerations need to be navigated
    - ✓ May require offering documentation/memorandum

Financial Structuring Considerations

401(k) Plan Rollover

- 401(k) Plan participants (broad-based offer) may elect to transfer funds from an existing employer retirement plan to the ESOP to provide cash proceeds to purchase company stock
  - Enhanced and self-selected participation in company ownership
  - ESOP tax deferral opportunities
  - Broad-based offering requirements
  - One time transfer to ESOP, most often irrevocable
    - ✓ Vesting/benefit transfer
  - Provides the company (and ESOP) with access to equity financing that might not otherwise be available
  - Securities law structuring considerations need to be navigated

Post-Transaction Price Adjustment

- Clawback requirements
  - FPA (DOL):
    - ✓ *In evaluating proposed stock transactions, the Trustee will consider whether it is appropriate to request a claw-back arrangement or other purchase price adjustment(s) to protect the ESOP against the possibility of adverse consequences in the event of significant corporate events or changed circumstances. The Trustee will document in writing its consideration of the appropriateness of a claw-back or other purchase price adjustment(s)*
  - Designed to protect against:
    - ✓ Customer concentration
    - ✓ New lines of business included in projections
    - ✓ Acquisitions or "untried" changes included in projections
  - Not a simple guarantee of future performance
    - ✓ Intended to be a targeted protection for specific risk factors
    - ✓ Sellers (rightfully) are very sensitive to this issue as clawbacks are nearly unheard of in private equity and/or other acquisitions

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Post-Transaction Price Adjustment

- Earn-outs in ESOP transactions
  - An earn-out is the right to a future upward purchase price adjustment upon the attainment of predetermined goals
  - Not contemplated in DOL guidance, but economically the same as a clawback similarly structured
    - ✓ Can an ESOP pay? Require redemption transaction or company contract for amounts?
    - ✓ Appropriate targets?
    - ✓ If the shareholders will continued to be employed, can an equity incentive plan (properly structured) encourage the same behavior?
  - ESOP/company considerations:
    - ✓ Establishing proper targets and structure
    - ✓ Future payment obligations (paid in cash, added to seller notes, etc.)
  - Selling shareholder considerations:
    - ✓ Generally, not attractive particularly where shareholders will not be in control of, and/or employed by, the business post-closing
    - ✓ If paid as an increase to seller notes, consider the impact to interest rate/warrants (i.e., are additional warrants also granted, is interest paid back to the initial closing date, etc.)

Targeted/Well-Designed Incentive Arrangements

- Management incentive plans are not unique to ESOP companies
  - These incentive plans can meet a variety of goals:
    - ✓ Retention of key employees and contributors
    - ✓ Alignment of interests between management and shareholders
    - ✓ Provides performance incentives
  - However, such plans must be properly structured to achieve their goals while not over compensating employees or unfairly burdening companies
- Can – and should – be used in 100% ESOP-owned companies
- Incentive plans can take numerous forms:
  - Profit sharing plans (qualified or nonqualified)
  - Discretionary bonuses
  - Deferred compensation plans
  - Equity based compensation (SARs, phantom stock, etc.)

Targeted/Well-Designed Incentive Arrangements

Incentive Plan Benefits:

- Retention
- Recruitment
- Alignment of management interest with the shareholder(s), such as an ESOP
- Motivates performance to achieve targeted financial objectives
- Wealth accumulation based on the financial performance of the company helps prevent overly burdening the business
- Targeted to key employees

Targeted/Well-Designed Incentive Arrangements

Understanding Goals of the Plan

- Full value awards vs performance awards
- Common equity awards
    - Performance awards (based on future equity appreciation):
        - ✓ SARs, profits interests in LLCs/partnerships, etc.
    - Full value awards (economically equivalent to a share of stock):
        - ✓ Phantom Stock, restricted stock grants, separate class of preferred/common shares, etc.
- Unique plan structures
    - Recognize management/long term employees who may or may not participate in the ESOP transaction, but are key to the business and operations
    - Vesting (vs grant) based on performance
    - Mix of performance and full value awards
    - Cash component
    - Payments mid-employment (do not encourage attrition)

Unique ESOP Transaction Provisions

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<u>These are NOT Best Practices and may not be appropriate in every transaction</u>

- Event protection for the ESOP
- Corporate governance structure – nomination committee
- Adjustments included in the projections – covenants to maintain status
- Related party contracts (e.g., leases/captive insurance, etc.)
- Compensation limits for shareholders
- Restrictive covenants

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Questions ?

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Allison Wilkerson is a partner at McDermott Will & Emery in Dallas, TX. She focuses her law practice on employee benefits matters. She has extensive experience handling issues pertaining to the Employee Retirement Income Security Act of 1974 (ERISA) and employee stock ownership plans (ESOPs).

Allison focuses her ESOP practice on the design and implementation of ESOP transactions and provides ongoing legal counsel to ESOP-owned companies. She has been involved in hundreds of transactions, including leveraged buyouts, mergers, acquisitions, and the structuring and financing of ESOPs using private equity. She has advised employers on the implementation of nonqualified plans and executive compensation arrangements that complement the employee ownership structure and culture inherent in an ESOP-owned company. Allison also represents independent fiduciaries in their role as purchaser in an ESOP transaction as to their legal duties with respect to their representation of ESOP participants and beneficiaries.

Allison further focuses her practice on compliance issues and the Internal Revenue Code related to employee benefits, including qualified plans, nonqualified plans, and executive and deferred compensation. Allison provides relevant guidance as to administrative and operational matters, and assists clients with various benefit plan correction programs offered by the Department of Labor (DOL) and Internal Revenue Service (IRS).

Allison received her legal degree from the University of Texas at Austin, graduating with honors in 2002.

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PRESENT POSITION

Ted is a member of Chartwell's Corporate Finance practice, where he focuses on providing ownership transition strategies, including the execution of ESOP transactions and/or traditional sell-side M&A processes with strategic and private equity buyers. His combination of industry experience, transaction analysis, execution expertise, and a practical, solutions-focused legal perspective provide Ted with a unique skillset to advise clients in a comprehensive, holistic fashion.

MEMBERSHIPS AND DESIGNATIONS

Ted holds the FINRA Series 63 and 79 licenses, as well as licenses to practice law in Minnesota and North Dakota. He is admitted to practice before the North Dakota Federal District Court, the United States Tax Court, and the U.S. 8th Circuit Court of Appeals. Additionally, Ted is a member of the Legislative and Regulatory Advisory Committee of The ESOP Association and frequently speaks at The ESOP Association and National Center for Employee Ownership conferences. In 2017, Ted received The M&A Advisor's Emerging Leaders Award in recognition of his expertise and professional accomplishments.

PRIOR EXPERIENCE AND EDUCATION

Prior to joining Chartwell, Ted was an investment banker in the Consumer Group at Harris Williams & Company, a preeminent sell-side M&A advisor to the middle market where he advised companies in the consumer products and services, food and beverage, and restaurant and retail sectors. Prior to Harris Williams & Co., Ted began his investment banking career in the Middle Market M&A Group at Lazard, Ltd., a leading global investment banking services provider. Preceding his investment banking career, Ted practiced law in the areas of M&A and tax, with a particular emphasis on the creation, maintenance, and termination of ESOPs. Included in his ESOP practice were transactions involving both the purchase and sale of sponsoring employers, as well as general ESOP operational issues, IRS/DOL compliance reviews and corrective actions, and plan document drafting.

Ted earned his Masters of Business Administration in Corporate Finance and Real Estate from the University of North Carolina's Kenan-Flagler Business School, a Juris Doctor from the University of St. Thomas School of Law, and a Bachelor of Business Administration in Aviation Management from the University of North Dakota, where he also received his Commercial Pilot license.

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Fred Kaseff currently serves as Senior Vice President in the Employee Stock Ownership Plans (ESOP) Client Services group, focusing on managing client relationships and ESOP transactions.

Mr. Kaseff joined GreatBanc Trust Company in 2011. Prior to joining GreatBanc, Mr. Kaseff had more than 20 years of experience as Chief Financial Officer for both publicly traded and privately held companies, primarily with a marketing services firm partially owned by its ESOP. Mr. Kaseff initially served as that company's internal ESOP trustee, and later managed the firm's sale to a publicly traded company, ultimately overseeing the plan's termination and final distributions.

As an attorney, Mr. Kaseff practiced law at the New York office of Weil, Gotshal & Manges LLP, where he focused on public and private debt and equity offerings, and mergers and acquisitions. Prior to his legal career, Mr. Kaseff successfully completed the Uniform Certified Public Accountants examination and worked as a staff accountant in the Indianapolis office of KPMG.

Mr. Kaseff received a bachelor of science in accounting from Indiana University, and a juris doctor from New York University School of Law, and is admitted to the New York State Bar. He is a member of the ESOP Association's Finance Advisory Committee, and is a frequent speaker at ESOP conferences nationwide.

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