HUSCH BLACKWELL

Anatomy of an ESOP

Employee Stock Ownership Plans From the Perspective of the Business Owner

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1. Why Form an ESOP?

1.01 ESOPs can pay fair market value for the stock. Stock purchased by an ESOP must be appraised by an independent third-party expert working with a trustee for the ESOP who must also be independent from the seller. The ESOP is permitted to pay a negotiated price that is up to full fair market value. If 100 percent were sold to the ESOP, the seller would typically not bear the company's expenses related to the ESOP transaction. Also, no business brokerage or similar fees are typically paid.

1.02 An ESOP provides a seller with an opportunity to keep the profits of the business in the community and benefit the workers who helped build its value. By transferring ownership to employees, those employees will earn the value of the stock over time. (This is explained below.) Also, sale to a third party might result in the employees not being treated in the manner preferred by the seller.

1.03 ESOP companies typically pay either no or less corporate level tax due to the ESOP.

a. If the corporation is or becomes an S corporation, to the extent the income of the corporation is allocable to the ESOP, no income taxes would be owed by either the corporation or the ESOP on that income. Therefore, if the ESOP were to own 100 percent of the corporation, no corporate income taxes would be paid.

b. The corporation may deduct (within certain limits described below) both the principal and interest payments on ESOP debt used to fund the ESOP's stock purchase. Depending on the amount of stock purchased by the ESOP, this can substantially reduce the taxable income of the corporation. Such deductible loan repayments can be made from employer contributions to the ESOP, as well as from dividends on ESOP stock acquired with the loan. It should be noted, however, that only C corporations may deduct dividends used for this purpose, although both C and S corporations may deduct contributions (up to certain limits).

1.04 Sellers can avoid a layer of tax by selling to an ESOP. Most private companies are sold via asset sales. If the company is a C corporation or has been an S corporation for less than 10 years, two levels of tax would apply to an asset sale: one at the corporate level and one at the shareholder level. An ESOP sale is a stock sale, which results in one level of tax or no current tax (if tax deferral is used).

1.05 Sellers can defer tax on gain from sales to an ESOP. Normally, sellers must pay tax on any gain on sale of their stock. However, if they sell to an ESOP, and if the proceeds are invested in qualified replacement securities, and if certain technical requirements are met, they may defer the tax until they sell the replacement securities. If the individual dies holding the replacement securities, income taxes will be avoided altogether. This sounds very attractive, but the fees, other expenses and risks involved result in many sellers deciding not to pursue this.

a. The seller must invest the proceeds in "qualified replacement property." This must be completed within 12 months of the sale to the ESOP. This means securities issued by a U.S. operating company. This does not include mutual fund shares or government securities. It does, however, include bonds and other debt securities. For example, one technique is to invest in high-quality, variable interest corporate debt that trades at or near par. The investment in that security defers tax on the gain on the sale to the ESOP for so long as that security is held. This type of security, used for this purpose, often has a long maturity date, so that the tax will be deferred for a very long time.

This type of debt security is sometimes used because it can be leveraged and the loan proceeds can be used to buy and sell any securities without triggering tax on the gain on the sale to the ESOP. It is usually possible to leverage the debt security at near par for a very small incremental interest cost above the interest income associated with the security. That interest cost should be tax-deductible as investment expense.

b. The following are some of the technical requirements to defer tax:

   (i) The employer must be a C corporation at the time of sale. The corporation may elect S status, effective for the next tax year. If the corporation converts from S to C status in order for tax deferral to be available, it is generally not permitted to go back to S status without IRS permission for five years. However, it may be possible to structure the transaction to permit re-election of S status for the following year.

   (ii) The seller must not be a corporation. It may, however, be a trust for the benefit of individuals.

   (iii) After the sale, the ESOP must own at least 30 percent of the company.

   (iv) The seller must not have acquired the stock in a compensatory transaction (such as pursuant to an employer-issued stock option, restricted stock grant or a bargain purchase of stock).

   (v) The seller must have held the stock for at least three years.

   (vi) If the seller were to sell the stock to a buyer other than an ESOP, the gain must qualify as capital gain.

   (vii) Any stock sold to the ESOP with respect to which this treatment is elected by any seller must not be allocated under the ESOP to certain ESOP participants. Those include anyone who sells to the ESOP and elects to defer tax, certain family members of such individuals, and anyone who owns 25 percent or more of the company's outstanding stock, taking into account stock owned by or for each person (and certain relatives) inside and outside the ESOP.

   (viii) The company must agree to be subject to a 10 percent excise tax if the ESOP disposes of the property within three years of acquisition, or if an allocation is made in violation of the foregoing requirement.

   (ix) The seller must elect this treatment on a form filed with the IRS.

   (x) The seller must obtain a notarized statement identifying the replacement securities within 30 days following acquisition of such securities.

1.06 Sellers can sell part of the business by using an ESOP. It is often difficult to find a buyer for less than all of a private business. If the corporation redeems a shareholder, the redemption payment cannot be deducted. An ESOP can solve these problems in situations such as the following:

a. Less than all current owners want to sell.

b. One or more current owners want to diversify without selling all of their stock.

c. Divorce.

1.07 Sellers may keep an interest in some of the upside value potential of the business. Many transactions involve the seller receiving both cash and company notes for the stock sale to the ESOP. Sellers often accept a low interest rate on the note, with the remaining fair return provided through the company issuing to the seller an option or "warrant" to acquire a set number of shares of its stock at a price equal to the price paid. Such option or warrant provides the seller with some continuing interest in the "upside" of the business.

1.08 An ESOP transaction can provide an excellent estate planning opportunity for the seller. As mentioned above, sellers often receive options or “warrants” on the company’s stock, which give them the right to receive some of any increase in value of the company’s stock. Since this would be based only upon appreciation over the current value, and could have other features that diminish its value upon issuance, the options/warrants could be worth relatively little for gift tax purposes so that substantial future company value could be transferred to one or more children with the payment of little or no gift tax. This can work well as a gift to a child who is involved in the business, whereas cash sale proceeds may be gifted to other children. Further, capital gain is generally paid upon sale of the option/warrant to the company.

1.09 An ESOP can be used to facilitate a sale to a third party. Without an ESOP, the only way a seller may defer tax on sale to a third party is if the company to be sold engages in a tax-free reorganization for stock of the acquiring corporation. If the acquiring corporation is not publicly traded, that may leave the owner as a minority shareholder in a closely held corporation, which is often not a desirable position. If the purchaser is a public company, tax can be deferred, but only for so long as the seller continues to own the stock of the public company, and that usually leaves the seller in an undesirable position of not being diversified.

How can the seller have the best of both worlds: sell to a third party, but defer tax and be diversified? This can be accomplished if the company owned by the seller establishes an ESOP and the seller sells to the ESOP in a transaction financed or arranged by the third-party buyer. The third-party buyer then merges the sold company’s ESOP into an existing or newly formed ESOP of the purchasing corporation. After these transactions are accomplished, the resulting ESOP must own at least 30 percent of the surviving corporation.

1.10 An ESOP can increase productivity. Studies have shown that if a business successfully instills an ownership culture in employees, the employees will be more productive and likely to remain with the company. According to a Hewitt Associates study reported in *Time* magazine, 1,000 public companies and 9,000 private companies have ESOPs. Total shareholder return for companies with an ESOP was reported at 26 percent, whereas total shareholder return for companies without an ESOP was 19 percent.

1.11 An ESOP provides limited deferred compensation to the company’s employees. In a typical setting, it is expensive for an employer to offer nonqualified deferred compensation to its employees for two reasons. First, the corporation does not get a deduction for the deferral until the employee is taxed on the income. The time value of the loss of that deduction in comparison to the value of a current deduction if the compensation had not been deferred can be material. Second, the company must pay tax on the investment income pending payment to the employee, unless a nontaxable investment such as life insurance is used.

If the company is owned by an ESOP and elects S status, it does not owe any income taxes. Therefore, it may offer some deferred compensation to its executives without incurring either of these disadvantages, although there are some limits on this.

2. How Is an ESOP Established?

2.01 An ESOP is a type of qualified retirement plan and must conform with most of the rules applicable to such plans, such as 401(k) plans. However, additional special rules apply to ESOPs. Unlike the typical 401(k) plan, ESOPs are designed to be primarily invested in employer stock and generally do not permit employee contributions.

2.02 Governing documents are required. Like most qualified retirement plans such as 401(k) plans, an ESOP is adopted by the company executing a plan document and a trust document. The trust document must also be executed by the trustee. The document must be executed by the last day of the first plan year for which the ESOP is to be effective. That will be the first year for which a deductible contribution may be made to the ESOP.

2.03 The board of directors of the employer should approve adoption of the plan and trust. This can take the form of a ratification of an officer's execution of the document.

2.04 The employer must be a corporation. Only corporations may sponsor ESOPs. All of the employees covered by the plan must be employed by a corporation. Employees of a partnership, LLC, LLP or similar entity may not participate. The corporation may be either a C corporation or an S corporation for tax purposes.

3. What Is the Process to Determine Whether to Implement and Then to Implement an ESOP?

3.01 The first step is for the seller(s) and company to become thoroughly educated on ESOPs and how a transaction may be done, including the pros and cons. If it is decided to pursue an ESOP, the next step would be to engage an independent trustee.

3.02 Unless the company simply contributes stock, an independent trustee will be needed to negotiate on behalf of the ESOP terms under which the ESOP will acquire company stock. The seller(s) should anticipate an arm's-length negotiation over price and financing terms. The U.S. Department of Labor has indicated that the seller(s) should not be involved in selecting and retaining the trustee, although that can be difficult to arrange.

3.03 The appraiser is required to act as the financial advisor to the trustee and not to the company or seller. The trustee will not share the appraisal with the seller. The Department of Labor has indicated that the appraiser should be engaged by and monitored by the trustee. If the seller wants a preliminary view re the potential price range, other advisors can usually provide it.

3.04 Once the trustee's valuation process is complete, the trustee and seller will negotiate the terms of sale, which will then dictate the next steps.

3.05 The other critical step is arranging any needed third-party financing. That is usually pursued while the trustee is considering the transaction and then factored into the final transaction terms.

3.06 Although not required, in the right case it can be helpful to engage a financial advisor to the company and/or seller to provide advice on valuation, run projections and help arrange financing.

4. How Does an ESOP Acquire Stock?

4.01 Purchase from an existing shareholder. This is the most common method of acquisition. Typically, the purchase is leveraged.

4.02 Purchase of newly issued or treasury stock from the corporation.

4.03 Company contribution to the plan of newly issued or treasury stock.

5. What Is the ESOP's Source of Funds to Acquire Stock?

5.01 Debt. This is the most common method.

5.02 Conversion of an existing retirement plan into an ESOP. Although participants may be unhappy with converting diversified investments into an investment in company stock, this is legally permissible.

5.03 Accumulation of cash in an ESOP. An ESOP can accumulate cash contributions from the employer for the purpose of a future purchase of stock.

6. How Is ESOP Debt Structured to Acquire Stock From an Existing Shareholder or the Company?

Typically, the lender is a third-party lending institution such as a bank. If the company has available cash, the company could lend the amount to the ESOP. The seller could finance the transaction by taking back a note from the ESOP or the company. There are two ways to structure third-party debt:

a. Back-to-back loan. This is the most common form of transaction. The bank lends to the company, the company pledges collateral for the loan, the company lends the same amount to the ESOP, the ESOP issues a note, the ESOP pledges the stock it purchases as security for the loan from the company, and the ESOP uses the loan proceeds to purchase stock from the seller.

b. Direct ESOP loan guaranteed by the company. In this transaction, the third-party lender loans directly to the ESOP in exchange for a note and a pledge of the stock to be purchased with the loan proceeds. The ESOP uses the loan proceeds to purchase the stock, and the company guarantees the ESOP's debt and pledges collateral on the guarantee.

6.01 Company financing is another option. The company lends excess cash to the ESOP in exchange for an ESOP note and a pledge of the stock to be purchased by the ESOP with the loan proceeds. The ESOP uses the loan proceeds to purchase stock. This may be used in combination with either of the foregoing forms of third-party debt.

6.02 Seller financing is another option. To the extent tax deferral is not going to be sought, the company purchases stock from the seller. The ESOP acquires the stock from the company in exchange for a note owed to the company. At the end of the transaction, the company owes the seller and pledges its assets as security (to the extent permitted pursuant to the company's other debt facilities) and the ESOP owns the stock and owes the company for the stock. This form of financing may also be used in conjunction with either form of third-party financing or company financing. Even if tax deferral is to be sought, there is a way for the seller to sell directly to the ESOP and still achieve a similar result.

a. Collateral. A convenient way to pledge collateral is to establish a holding company structure. The seller would sell holding company stock to the ESOP. The holding company would borrow from the seller and pledge stock of the operating subsidiary as collateral. This might not work if there are shareholders other than the ESOP and the seller.

b. Effect on tax deferrals. It was noted above that one of the attractions of an ESOP transaction is deferral of tax on the gain from the sale to the ESOP. To take advantage of that deferral, the seller must invest in qualified replacement property within 12 months of the sale. To the extent the seller receives a note, he or she will not have cash from the sale to purchase the qualified replacement property. If the seller cannot otherwise raise the cash needed to do so, the seller would forgo the tax deferral treatment. Generally, the necessary cash can be raised through a margin loan, but that would involve additional risk, complexity and expense.

c. Installment method of paying tax. An individual seller should be able to pay tax on the installment method as payments are received from the ESOP or company. Furthermore, if the seller otherwise qualifies for capital gain treatment, the tax owed in installments should be capital gain taxes. However, if the note exceeds $5 million, the seller will owe interest to the IRS on a portion of deferred gain.

d. Acceleration upon default. Although the ESOP's debt to the seller may be accelerated upon default, the seller may collect only the payment in default. However, acceleration can be created by the company guaranteeing the ESOP's notes.

6.03 The law does not impose a maximum term on the loan. However, it is uncommon for ESOP loans to extend beyond 20 to 30 years.

6.04 The ESOP may not pay more than a fair market rate of interest. Typically, interest can be either fixed or variable. A typical interest rate would be fixed at the "applicable federal rate" announced by the IRS every month.

6.05 Are participants liable for the loan? No. ESOP loans must be nonrecourse. Only the following assets may be drawn upon to repay any ESOP debt: stock purchased with the loan proceeds, contributions made by the employer to repay the loan and earnings on both of those amounts. The lender to the ESOP (whether it is a third party, the company or the seller) has no other recourse against the ESOP.

6.06 What happens as the loan payments become due? Assuming a third party has loaned the amount in a back-to-back loan, which is the usual case, the employer transfers cash to the ESOP as a contribution or dividend. The ESOP transfers the cash back to the company as a loan repayment. The company transfers the cash to the third-party lender as a loan repayment. The company releases a portion of that collateral each year in accordance with one of the release formulas set forth elsewhere in this outline. There are limits on the use of dividends to repay debt to the extent the dividends are paid on shares that have already been allocated to participants.

6.07 How can the transaction be done if the company does not have adequate collateral? Typically, the seller will carry some of the debt him/herself in the form of a note from the company as described above. Alternatively, if the seller has used tax deferral, then the seller will pledge all or part of the qualified replacement property purchased with the ESOP sale proceeds. If the seller is particularly important to the success of the business, it is possible that the lender will request that life insurance on the life of the seller be obtained in order to insure repayment of the loan in the event of the death of the seller prior to repayment.

6.08 If a seller to an ESOP must take back a note or pledge the qualified replacement property as collateral on the debt, why should the seller engage in the sale? At first blush, pledging the qualified replacement property seems to mean that the seller really has not sold the business and the transaction is somewhat pointless. However, in our experience, sales can make sense even if the seller must take a note or pledge all of the qualified replacement property in order to obtain the necessary financing for the ESOP purchase.

Of course, assuming the company performs sufficiently well to discharge the debt to the third-party lender, the seller will receive all of the intended benefits of the transaction: The seller will receive the entire purchase price and will receive the entire benefit of the qualified replacement property, including investment income and earnings thereon. If the ESOP were to own 100 percent of the company and the company were an S corporation, then the corporation would not pay any federal income tax (subject to the built-in gain tax rules applicable to recently converted S corporations) and would have more cash flow available to repay debt, which makes the debt less risky than ownership in the company without an ESOP. It should be noted that the key is that the company's debt to the seller or third-party lender be paid. If the seller were to pledge collateral to the lender, it would be to only the third-party lender, and as long as the third-party lender is paid, the seller receives the benefits of the deal. The company's debt to the third-party lender may be repaid more quickly than the ESOP's debt to the company is repaid.

However, what happens if the company defaults on its debt to the third-party lender? In this case, the lender could call upon the collateral pledged by the seller and the seller would step into the shoes of the lender. This would give the seller the ability to exercise all rights that a third-party lender could exercise. That would include selling company assets to repay the seller to the extent the seller's proceeds were used to pay the lender. That effectively means that the seller could instigate an asset sale and not currently pay the double taxes that would otherwise apply to an asset sale. In other words, if the seller never did the ESOP transaction and sold the business by selling assets (most buyers of nonpublic companies strongly prefer to buy assets rather than stock), a corporate level tax would be due on the asset sale and the seller would also pay individual income taxes on the proceeds distributed by the corporation to the shareholder. However, the ESOP sale permits the seller to defer the individual tax. That result would not be changed by the seller stepping into the shoes of the third-party lender and receiving payments from the corporation, even if the corporation had to sell assets to pay back the seller.

Finally, it should be noted that the seller can stay active in the business if desired to ensure the performance necessary to repay the debt and the seller can continue to receive compensation for services rendered. Therefore, in determining whether to sell to an ESOP, the seller should compare the sum of the anticipated investment return on the seller note and investment of sale proceeds, and any continuing compensation from the company, to the return that would be received on the company's stock and compensation from the company if the ESOP sale were not made. Typically, a seller can afford to accept a somewhat lower rate of return on investments of sale proceeds than his or her company stock because the investments will involve better diversification and less risk.

7. What Happens to the Employer's 401(k) or Other Retirement Plan If an ESOP Is Adopted?

There are four basic alternatives for dealing with the 401(k) plan. One criterion for determining which alternative to adopt is that employer (but not employee pretax) contributions to the 401(k) plan will count against the maximum amounts that may be contributed to the ESOP (see "How Much Can the ESOP Purchase?" below).

a. Freeze the 401(k) plan. The 401(k) plan may be amended to stop all employee and employer contributions. If the only plan maintained on an ongoing basis will be the ESOP, then it may even be possible to terminate the 401(k) plan and permit distribution from the plan.

b. Stop the match to the 401(k) plan. You could allow employees to continue to make their own contributions, but stop the match. Employees should be notified before the match is stopped so they can change their own rate of contribution in response to elimination of the match. It is also possible to reduce the match rather than eliminate it.

c. Use the 401(k) match to service ESOP debt. Employee contributions are not used to service the debt due to securities law and ERISA restrictions. However, it is possible to use the employer match to service the debt.

d. Continue the 401(k) plan without change.

8. How Are Shares Allocated to Participants Within the ESOP?

8.01 Allocations occur according to the following steps:

a. Determine the total number of shares to be allocated under the plan for the year. This would be the sum of any shares contributed by the employer, any shares purchased with existing cash in the plan and shares released from the suspense account due to loan repayments occurring during the year.

b. Allocate any stock purchased with existing participants' account balances pro rata to those account balances.

c. Determine participants who are eligible to receive an allocation of stock attributable to both matching and nonmatching employer contributions:

(i) Certain participants are not eligible to receive an allocation of any stock that was sold to the plan with respect to which the seller elected tax deferral under Code § 1042. Those participants include the seller, certain members of the seller's family and any 25 percent or more shareholders. For purposes of the 25 percent shareholder restriction, shares owned both inside and outside the plan are counted. For example, if a shareholder owns 20 percent of the company outside the plan, and if all the shares owned by the ESOP were shares with respect to which a seller elected tax deferral, that shareholder may participate in the ESOP and receive an allocation of up to 5 percent of the outstanding stock through the ESOP.

(ii) If the company is an S corporation, certain ESOP participants may not receive an allocation of ESOP stock if they and their "family" own in the aggregate 50 percent or more of the company's stock inside and outside the ESOP.

(iii) The ESOP may require that participants be employed on the last day of the year and/or work up to the 1,000 hours during the year to receive an allocation.

d. If stock were contributed as a matching contribution or if matching contributions in the form of cash were used to repay ESOP debt, then a portion of the shares to be allocated for the year will be allocated as a matching contribution, in proportion to each participant's share of the match.

e. Stock contributed as a nonmatching employer contribution and stock released from the suspense account due to using nonmatching employer contributions to repay an ESOP loan are allocated among eligible participants in proportion to compensation, or on a per head basis.

f. The stock released from the suspense account due to ESOP loan repayments is determined in one of two ways:

(i) Principal and interest method. The shares in the suspense account at the beginning of the year are multiplied by a fraction, the numerator of which is the principal and interest payments during the year and the denominator of which is the sum of the principal and interest payments during the year, plus principal and interest payments to be made in the future.

(ii) Principal only method. This method may be used if the ESOP loan amortization schedule provides for equal payments over a period of no more than 10 years. The shares to be released equal the stock in the suspense account at the beginning of the year multiplied by a fraction, the numerator of which is the principal payments during the year and the denominator of which is the sum of the principal payments during the year, plus principal payments to be made in the future.

8.02 As is the case with all qualified retirement plans, a vesting schedule may be imposed. The maximum vesting schedules are either (i) a three-year "cliff" schedule pursuant to which participants are 0 percent vested until they have three years of service, after which they are 100 percent vested; or (ii) a vesting schedule that provides 20 percent vesting after two years and 20 percent per year thereafter until the participant is 100 percent vested after six years of service. Regardless of the schedule adopted, the plan may credit all years of service of the individual or may credit only service after the effective date of the plan.

The same eligibility rules apply to ESOPs that apply to other qualified retirement plans. The plan may require that an employee work up to 1,000 hours during a period of up to a year before becoming eligible. The employee may then enter on the next semiannual entry date following satisfaction of that service requirement. Alternatively, if the plan provides for immediate 100 percent vesting, it can require two years of service prior to an employee becoming eligible for the plan. Typically, if an ESOP is highly leveraged, the employer wants to promote eligibility in order to have the maximum amount of compensation includable under the plan in order to support deductible contributions to the plan to repay the debt.

9. How Much Can the ESOP Purchase?

9.01 The ESOP must pay no more than fair market value for the stock. The law requires that the trustee hire an independent appraiser to determine the value of the stock for purposes of the transaction, and the price negotiated by the trustee must not exceed that amount. The appraisal must be dated as of the date of the transaction.

9.02 How much cash can be put in the ESOP each year to repay the debt?

a. Contributions:

(i) C corporation employers may contribute up to 25 percent of compensation paid to eligible participants to repay principal and an unlimited amount to pay interest.

(ii) S corporations may contribute up to 25 percent of compensation paid to eligible participants for both principal and interest.

(iii) Other qualified retirement plan contributions will reduce the foregoing amounts that may be contributed to the ESOP. For example, if the company maintains a 401(k) plan, the foregoing contribution limits will be reduced.

b. Dividends on both allocated and unallocated stock in the ESOP may be used to repay debt, subject to certain limitations. The dividend must be "reasonable." Dividends paid by an S corporation are not deductible. Dividends paid by a C corporation are generally deductible, but for taxpayers that are subject to the alternative minimum tax, this could give rise to a tax preference item.

c. If these limits are problematic, then the value of the stock purchased by the ESOP can be reduced by coupling the ESOP sale with redemption by the company.

9.03 Internal Revenue Code Section 415 imposes limits on the maximum amount that may be allocated to a participant's account over and above the limits set forth in the preceding section. In general, the amount allocated to a participant's account for a year may not exceed the lesser of 100 percent of that participant's compensation or $53,000 (for 2016). Certain special rules apply in the case of an ESOP. First, in the case of a leveraged ESOP, the amount considered to be allocated to the account for the year is the lesser of the fair market value of the stock, or the dollar amount of contribution allocable to the participant that was used to repay the debt. Assuming the value of the stock increases from its original purchase price, this is beneficial. The following additional rules apply depending on the taxable tax status of the corporation.

a. C corporation: If no more than one-third of the allocations under the ESOP are to highly compensated employees, neither forfeitures allocated to a participant's account nor the interest payments on the debt count as allocations to the participant's account for purposes of this limitation. The IRS has informally taken the position that this is the case only for so long as the debt is outstanding. Forfeitures that are allocated after repayment of the debt do count against this limit according to the IRS.

b. S corporation: The IRS has informally stated at seminars that both forfeitures and interest count toward this limit.

10. How Is an ESOP Company Managed? Can the Seller Retain Control?

10.01 The ESOP trustee is the owner of the ESOP's stock. This means that the trustee has all rights of a stockholder. However, shareholder votes that relate to merger of the company, sale of substantially all the assets of the company, recapitalization or other changes to the form of the company are passed through to participants to direct the trustee. Any individual, including one employed by the company, may be the trustee. There are also professional trustees such as banks and trust companies. The seller should not be a trustee with respect to the initial sale due to the obvious conflict of interest, but may be the trustee on an ongoing basis.

10.02 It is possible for the seller to retain control of the company even if a majority of the stock is sold, if such control is pursuant to commercially reasonable contract provisions. For example, a seller may be required to guarantee company debt or to take a note from the company. It would often be reasonable for the seller to require, in exchange for such a guarantee, that the shareholders agree to elect the seller to be the sole voting director with respect to all matters other than a corporate matter that would result in the seller being fully paid and taken off any guaranty. As to matters that would result in the seller being fully repaid, other directors should have the sole vote, that would permit a refinancing of any seller debt at any time. The seller could also enter into an employment agreement providing that he shall be the chief executive officer and that termination would result in certain commercially reasonable severance benefits.

10.03 Regarding executive compensation, it is permissible for an ESOP company to issue stock options, phantom stock, stock appreciation rights or other forms of incentive compensation, although there are some limits if the company is an S corporation. Bonus programs for executives and other employees are also permissible. It should be noted that the ESOP is an independent shareholder and has the right to demand that executives not be overpaid. Therefore, it is important to discuss executive compensation policy before entering into an ESOP transaction. However, company lenders and ESOP trustees generally favor reasonable management incentives that are tied to repayment of company debt.

11. What Happens When an ESOP Participant Terminates Employment?

Ultimately, ESOP participants are entitled to the vested retirement benefit allocated to their account.

11.01 When must distribution be made?

a. If a participant owns 5 percent or more of the company stock, distribution must be made by April 1 of the year following the year in which the individual attains age 70½, even though the individual has not terminated employment.

b. When the participant dies, becomes disabled or reaches the normal retirement age specified in the plan (which may not be later than age 65 and five years of service), distribution must be made no later than one year following the plan year during which such event occurred.

c. Other terminations of employment:

(i) Distribution must be made available no later than the end of the sixth plan year following the year in which termination of employment occurs. Although distribution must be made available by this date, a participant may not be required to take distribution until following attainment of normal retirement age.

(ii) Exception: The plan may be drafted to prohibit distributions until all ESOP debt is repaid. This permits the company to avoid having to provide liquidity for distributions until after the debt has been paid. Plans usually require this delay in distribution but may permit small accounts to be paid on a current basis without waiting for the debt to be paid.

11.02 What is the medium of payment (stock or cash)? The ESOP must offer the participant the opportunity to receive a distribution of stock unless one of two exceptions is applicable. One exception is that S corporations need not offer stock distributions. The other exception is that a stock distribution need not be offered if the charter or bylaws of the corporation restrict ownership of substantially all of the company's stock to the ESOP and employees. If stock distributions are not permitted, cash distributions must be provided. Cash can come from the ESOP selling stock to the company for fair market value, or the company contributing to the ESOP so that the stock remains in the plan.

If stock distributions are permitted and made, the participant has the right to put the stock back to the company for 60 days following the distribution and for another 60-day period the following year. The company must pay fair market value for the stock and may pay for it over a period of up to five years with reasonable interest, and commercially reasonable collateral must be pledged.

11.03 How and when is the stock valued for distribution? The value of the stock for purposes of distribution to a participant is normally described in the plan document as the appraised value as of the most recent valuation date preceding the date of distribution. Valuation must occur at least once per year. All appraisals of the stock must be done by an independent appraiser. The valuation date for distribution purposes almost always precedes the date of actual sale of the stock to provide cash for distribution and also precedes the distribution date. A second, or updated, appraisal must be done for the sale of stock to fund a cash distribution, if the sale is by the ESOP to the company or another party in interest. The purchaser of the stock is typically one of two parties: the company or the ESOP.

a. Why might it be desirable for the ESOP to be the purchaser? If the ESOP is the purchaser, company contributions to the ESOP to repurchase the stock would be deductible if they are within the limitations for deductible contributions. Furthermore, the ESOP can pay the appraised amount as of the last valuation date without needing an updated appraisal to the date of the actual repurchase. Finally, repurchase by the ESOP could avoid the ESOP being diluted. If the ESOP paid a control premium for its stock, it should not allow itself to be diluted below control by redemptions of distributees by the company.

b. Why might the company be the purchaser? If the company does not want to create additional benefits for participants by continuing to make contributions to the ESOP, the company could repurchase the stock. If the company is the purchaser, and if it is buying the stock from the ESOP, it must pay fair market value based upon an appraisal that is dated on the date of the repurchase. On the other hand, if the company purchases shares that have been distributed to a distributee, it may pay the appraised value as of the most recent valuation date (which is the same amount as the distributee would receive if he or she were to receive a cash distribution from the ESOP, as described above).

11.04 What forms of distribution are permitted? Distributions may be made in a lump sum or in installments over up to five years. (A longer period is permitted for large balances.) If installment distributions are made, the aforementioned "put" option must be paid by the company promptly in a lump sum as each installment is put back to the company. Repayment over five years may occur only in the case of a lump sum distribution. If installments are permitted, that has the effect of the participant continuing to participate in any increase in the value of the stock until distribution of the installment.

12. What Cash Outlays Will be Required by an Employer That Adopts an ESOP?

12.01 Funding repayment of ESOP debt: As was noted above, the most common method of an ESOP acquiring stock is to borrow the necessary funds. The employer must pay sufficient amounts to the ESOP to permit the ESOP to make loan repayments as they become due. Those payments can take the form of contributions and dividends on the stock owned by the ESOP. If structured properly, such payments would be deductible to the company as noted elsewhere in the outline.

12.02 Repurchase of stock from terminated participants who are to receive distribution: As was noted above, each participant receives an allocation under the plan of shares of company stock. Vested shares must eventually be converted to cash for the benefit of the participant. Cash need not be provided until on or after the date distribution is to be made from the ESOP to a participant.

12.03 The company must also provide liquidity for "ESOP diversification" elections. Participants who have been in the plan for 10 years (that is not the same as having 10 years of service, if years of service prior to the effective date of the plan are counted) and who have attained age 55, have the right to elect to diversify their ESOP account in 25 percent increments. This diversification must take one of two forms: (1) selling the stock to the company or other participants in the plan and investing the cash proceeds in other diversified investments within the plan, or (2) distributing the cash to the participant. We generally draft our plan documents to use the former option because we believe it minimizes the number of diversification elections that are made. If distribution is made as a result of a diversification election, it is more likely that participants will make the election to get their hands on the cash. If the cash remains in the plan, our experience is that it makes it less likely that the participant will make the diversification election.

The cash for the diversification can come from the ESOP selling stock to the company, the ESOP borrowing the cash from the company or another lender, or the company contributing cash to the plan that is allocated among the participants' (pro rata to compensation) and that cash can be used to purchase the stock from the diversifying participant's account.

12.04 The following costs are normally involved in initiating an ESOP. Since the alternative is generally for the seller to sell to a third party, these expenses can be less than the expenses that would be incurred for legal, accounting and brokerage fees associated with the sale of a business to a third party.

a. Legal fees

(i) ESOP documents

a) Plan documents:

- We will review your existing 401(k) or other retirement plan, summarize its principal terms (eligibility, counting hours of service, vesting, forfeitures, etc.), and create a three-column chart. Column one is the type of plan provision, column two is what the current retirement plan provides and column three will be blank to fill in for what the ESOP will provide.

- We will meet with the client to go through the chart and complete a “recipe” for what the plan should provide.

- We will then prepare a draft plan document for review by the client.

b) Trust document

c) Summary plan description

d) Distribution election form

e) Beneficiary designation form

f) Qualified domestic relations order procedures

g) Determination letter application for filing the plan and trust with the IRS (the IRS charges a fee for this, which is an additional expense)

(ii) Tax planning. There are opportunities for tax savings for both the company and seller.

(iii) Corporate documents. Generally, the following corporate documents must be addressed:

a) Articles of incorporation

- C corporation. It is usually desirable to amend the articles to restrict ownership of substantially all of the company’ stock to the ESOP and employees. This way, the ESOP need not offer distributions of stock in kind.

- S corporation. It is important to incorporate the restrictions on share ownership in order to preserve S status in the articles of incorporation, rather than simply relying on the shareholder’s agreement. Putting the restrictions in the articles of incorporation better protects against inadvertent loss of S corporation status.

b) Shareholder agreement. If there will be shareholders other than the ESOP, the shareholders agreement usually must be amended. Many shareholder agreements provide for redemption of a shareholder’s stock in the event of termination of employment, death or disability based upon the book value of the company. A leveraged ESOP transaction creates a “contra-equity” account on the books of the company in the amount of the ESOP debt. This often creates negative equity and would result in a buyout under the shareholder’s agreement being for a negative sum. Usually the shareholder’s agreement is amended to provide for buyout of other shareholders at the ESOP appraised value, unless control premiums or minority discounts are a consideration.

c) Loan documents. Typically there will be a loan agreement, note and pledge agreement between the company and a third-party lender, as well as a loan agreement, note and pledge agreement between the company and the ESOP. There will sometimes also be a guaranty by the seller to the lender. Generally, the third-party lender prepares the first draft of these documents and we review.

d) Employment agreement for key management. To the extent the ESOP trustee becomes a controlling shareholder in the company, it will control the board of directors, which will in turn control company management. To retain existing company management, it may be appropriate to execute employment agreements setting forth the desired terms of their employment and severance pay in the event of severance. This can also be helpful if the trustee(s) will be executive(s). If the employment terms are not set in advance, such executive(s) will face a conflict in his or her duties to the participants and the corporation, versus his or her personal interest.

e) Bonus plan. Whether or not an employment agreement is included, it may be desirable to adopt a formal written bonus plan for management. If executives are involved in being trustees of the ESOP, it could be argued that there would be some conflict of interest in paying bonuses for themselves. If a bonus plan were put in place prior to doing the ESOP deal, it would make it easier to pay bonuses to management.

f) Option agreements. It is often desired to motivate management to cause the company to earn enough to repay the ESOP debt by offering stock appreciation rights that mature after the company's debt is repaid. The exercise price is usually the price paid by the ESOP.

g) Other corporate documents possibly affected. Collective bargaining agreement (any union participation in ESOP must be negotiated with the union); surety bonds (due to the negative impact on the company's equity, an ESOP transaction must be discussed with the company's surety); other loan documents (loan documents may contain covenants prohibiting the company from engaging in certain activities required by an ESOP transaction); and deferred compensation (it is often desirable to offer deferred compensation following an ESOP transaction). Deferred compensation is an added benefit to employees who desire to save more for retirement than is available through the ESOP and for employees who are restricted from getting a full allocation under the ESOP due to the restrictions on allocation associated with the tax deferral treatment discussed elsewhere in the outline.

h) Design, consulting and tax advice. We will assist in determining that the ESOP transaction is feasible from a legal standpoint. We generally review projections prepared by others regarding whether the design of the projections accurately reflects applicable law, and help the company determine the best transaction structure to achieve its objectives. We often consult with the company on issues such as the effective date of the plan and use of existing plan assets to help fund an ESOP. We educate the client on how an ESOP works and what to expect after the ESOP is implemented.

(iv) Estate planning for the individual(s) who sell to the ESOP.

(v) Total initial legal costs. Obviously, most of the foregoing services will vary in degree, depending on the complexity of the transaction and the needs of the client. Therefore, it is difficult to predict the total fees, but the fees generally fall within a range of $30,000 to $300,000.

b. Appraisal. The stock must be appraised by an independent appraiser. Generally, a preliminary appraisal will cost at least $8,000 and perhaps more if multiple corporations or complex financial arrangements are involved.

   (i) The assumptions underlying the appraisal must be understood to ensure that the corporate documents are designed to assure that those assumptions should be realized. For example, if the appraisal assumes a certain level of executive compensation, then the documents should provide for no more than that level.

c. Financial advice

   (i) Projections should be developed to demonstrate the following:

      a) Cash flow will be sufficient to meet the loan covenants that the lender will require.

      b) Cash flow will be sufficient to maintain and replace property, plant and equipment after servicing ESOP debt.

      c) The ESOP debt can be served within the limitations applicable to deductible contributions and reasonable dividends.

      d) The ESOP debt can be serviced without causing any one participant's account to exceed the limits on annual additions.

      e) An optional service would be projecting anticipated repurchase liability relating to distributions to terminated participants.

   (ii) Third-party debt financing must usually be arranged.

d. Fiduciary liability insurance. The main purpose of this insurance is to pay defense costs in the event an individual fiduciary or the company is sued, and the company is insolvent and unable to pay the individual's defense costs, even though the company will have agreed to indemnify the individual. The terms of these policies vary, so the policy should be reviewed to determine that the extent of coverage is appropriate to the circumstances.

e. Independent trustee. This generally costs at least $25,000 per year, and could be much more for large transactions. Furthermore, because the ESOP trustee and the employer and sellers to the ESOP all have different interests, they should not have the same counsel. Generally, an attorney will represent the company to help establish a plan and sometimes may also represent the seller. That attorney should not act as attorney for the ESOP trustee. The ESOP trustee will engage its own counsel whose fees could be $30,000 or more depending on the complexity of the transaction.

f. Life insurance. Lenders will often require that that the corporation be the beneficiary of term life insurance policies on the lives of the key managers, and that such policies be collaterally assigned to the lender.

12.05 What are the ongoing costs of maintaining an ESOP?

a. Recordkeeping. There are many technical rules that apply to ESOPs. It is necessary to hire an expert recordkeeper to help assure compliance with all of the applicable rules.

b. Annual appraisal. The stock of the ESOP must be independent appraised at least annually.

c. Audit fees. If there are more than 100 participants in the ESOP, the ESOP records must be audited annually.

d. IRS reporting. A form 5500 must be filed with the IRS each year for the ESOP. Generally, the recordkeeper will prepare that form.

e. Independent trustee. See discussion of initial costs above.

f. Fidelity bond. This is required by ERISA and is different from fiduciary liability insurance.

13. May An Employer Get Back Contributions Made to an ESOP?

13.01 The general rule is that all amounts contributed to an ESOP must be retained in the ESOP for the exclusive benefit of participants. (Obviously, however, employer contributions made to enable the ESOP to repay a loan from the employer will be received by the employer as a loan repayment.) There are three exceptions:

a. Contributions that are expressly conditioned upon the initial qualification of the plan may be returned if the IRS does not approve the plan as being qualified.

b. Contributions expressly conditioned upon the contributions being deductible may be returned to the employer within a certain period following a determination by the IRS that such amounts are not deductible.

c. Contributions made to the plan due to a mistake of fact may be returned to the employer. Mistakes of fact do not include mistakes of law, such as misinterpreting the maximum permissible contribution under the law. Mistakes of fact cover things such as transposing numbers on a check or putting the decimal point in the wrong place.

14. What Fiduciary Duties Apply to an ESOP?

14.01 Fiduciaries of an ESOP include any party who has any discretionary authority, control or responsibility with respect to administration of the plan, the trust or investment of plan assets. Administration of the plan includes determining eligible participants, their vesting and their entitlement to distribution. Administration of the trust includes voting the stock held by the ESOP and deciding whether to purchase or sell stock for the trust.

The employer should not be considered a fiduciary with respect the act of establishing the plan. In other words, deciding upon the terms of the plan and establishing the plan are generally not fiduciary acts. However, the selection of the plan administrator and the trustee can be considered fiduciary acts.

14.02 What fiduciary duties apply to fiduciary acts?

a. Exclusive best interest of participants. All fiduciaries owe a duty to act in the exclusive best interests of participants and beneficiaries of the ESOP. While engaging in a fiduciary act, a fiduciary may not consider any factors other than the best interests of the participants as participants in the plan. Generally, this means that they may not consider the interest of participants outside their interest in the plan, including the interest of participants in retaining their jobs. For example, if the trustee of the ESOP receives an offer to purchase stock in the ESOP, the trustee generally should not consider whether the buyer would terminate some or all of the ESOP participants' employment. The sole consideration should be whether the offer is sufficiently financially attractive that the stock should be sold.

b. Prudence. A fiduciary must act prudently and in the manner that a reasonable and prudent expert would act. A fiduciary is expected to be an expert with respect to all of his, her or its fiduciary acts. To the extent the fiduciary is not an expert, the fiduciary is required to hire and monitor experts to provide advice to the fiduciary.

c. Loyalty. Each ESOP fiduciary owes an absolute duty of loyalty to all participants and beneficiaries of the ESOP. An ESOP fiduciary may not disclose any information relating to the ESOP that is confidential and may not use any ESOP information for non-ESOP purposes. For example, if a participant seeks to exercise a right under the ESOP, the ESOP fiduciary cannot use that information to take adverse action with respect to the individual's employment. If an ESOP participant is to direct the trustee concerning any company stock vote, anyone who becomes knowledgeable of such direction should agree in writing to keep the direction confidential, including from company management.

14.03 Are a fiduciary's consultations with legal counsel privileged? It should be assumed that any legal advice given to an ESOP fiduciary with respect to a fiduciary act will not be privileged. There is a "fiduciary exception" to the normal attorney-client privilege. Under this exception, the law considers the ultimate client of the attorney to be the participants and beneficiaries of the ESOP, and not the ESOP fiduciary. Therefore, in a suit by ESOP participants or beneficiaries, those participants or beneficiaries can waive the privilege and require the attorney to testify and disclose communications, with limited exceptions.

14.04 Who is the ESOP trustee? The ESOP trustee is generally appointed by the board of directors of the employer that establishes the ESOP. The trustee can be an individual (including an employee) or an institution such as a bank or trust company. If the individual is an employee, he or she may not receive compensation from the ESOP for serving as trustee. However, the employer may pay compensation to any ESOP trustee.

14.05 Who is the plan administrator? The plan administrator can be the employer corporation. However, that subjects all officers of the corporation to risk that they will be acting in a fiduciary capacity with respect to the ESOP. Generally, it is preferable for the board of directors of the employer to name an "administrative committee" that will be the administrator of the plan. Again, any members of the administrative committee who are employees may not receive compensation from the ESOP for their plan administration services. They may, however, receive compensation from the employer.

14.06 How is ESOP stock voted? For nonpublic companies, the trustee may vote the stock as to all matters (including election of the board), except for a merger or similar reorganization or a sale of substantially all of the assets. The ESOP trust document may, however, subject the trustee to direction on any voting matter by participants, the company, the administrative committee or other fiduciary.

14.07 How is an ESOP company governed? The board of directors appoints the ESOP trustee. The shareholders (including the ESOP trustee) appoint the board. The board appoints the officers and sets compensation.
