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ESOPS: WHY AREN'T THERE MORE?

Understanding the Benefits & Addressing the Barriers

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INTRODUCTION

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ESOPs: Why Aren't There More?

INTRODUCTION – WHY NOW?

- ***President Biden's Tax Plan***
- ***Appointment and confirmation of ESOP proponents***
- ***Viable exit planning option***

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ESOPs: Why Aren't There More?

INTRODUCTION – WHAT IS AN EMPLOYEE STOCK OWNERSHIP PLAN

- ***Qualified retirement plan***
- ***Invests primarily in the stock of the companies adopting and sponsoring them***
- ***Governed by ERISA and IRC***
  - Regulated by DOL and IRS
- ***Employees share in capital appreciation of the company***

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ESOPs: Why Aren't There More?

INTRODUCTION – ESOP FACTS

- ***There are roughly 6,600 ESOPs covering more than 14 million participants***
- ***Two-thirds of ESOPs are used to provide a market for the shares of a departing owner***
- ***Less than 10% of plans are in public companies***
- ***55% of ESOPs are in S corporations***

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ESOPs: Why Aren't There More?

INTRODUCTION – ESOP FACTS

- ***Industries of ESOP Sponsors***
  - Manufacturing – 22%
  - Professional/Sci./Tech. – 19%
  - Finance/Insurance/Real Estate – 15%
  - Construction – 13%

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ESOPs: Why Aren't There More?

TOPICS TO BE COVERED IN THIS PRESENTATION

- ***ESOP Roots***
- ***Misconceptions, Benefits and Alternatives***
- ***Vetting an ESOP – Feasibility***
- ***Repurchase Obligation Liability***
- ***Basic Leveraged ESOP Transaction***
- ***Tax Considerations***
- ***Valuation Considerations***
- ***ESOP Challenges in Court***

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ESOP ROOTS

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ESOP ROOTS

- ***Economist Louis O. Kelso created the first ESOP in 1956 as a means to transition ownership of Peninsula Newspapers, Inc. from its two founders to their chosen successors***
- ***Kelso's unique idea:***
  – Instead of having the company borrow the funds and repay with after-tax dollars, the Company's profit sharing plan would borrow the funds and repay both principal and interest out of the annual contributions the Company was already making to the plan

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ESOP ROOTS

- ***At such time, nothing in the Internal Revenue Code authorized leveraging of an IRS tax-qualified retirement plan as it was a prohibited transaction***
- ***The exception was that the transaction had to be arms-length and in the best interest of the plan participants – the exception was granted by the IRS***
- ***Kelso originated the strategy of using an IRS tax-qualified plan as a tool for succession***

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ESOP ROOTS

- ***The concept of an ESOP was formally signed into law in 1974 when the Senate passed its version of the Employee Retirement and Security Act of 1974 (ERISA)***
- ***For a decade, ESOP activity remained dormant pending issuance of IRS regulations defining parameters of the ESOP exemption***
- ***Starting in 1979, ESOPs were used to save failing companies – employees were given stock in exchange for negotiated salary reductions***
  - Weirton Steel, Chrysler Corporation and United Airlines

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ESOP ROOTS

- ***In 1984, Senator Russell Long (D-LA) was the catalyst for four provisions of the Tax Reform Act of 1984 relating to ESOPs:***
  1. Tax-free roll over treatment
  2. 50% interest inclusion
  3. ESOP estate tax assumption
  4. Deductible dividends

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ESOP ROOTS

- ***From the 1970s to 1990s, ESOPs were used for the following purposes:***
  – To facilitate divestitures
  – In defense of hostile takeovers
  – For "going private" transactions

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ESOP ROOTS

- ***Since the 1980s, ESOPs are used as a business succession tool***
  - Passage of Economic Recovery Act of 1981
  - Transitioning from a manufacturing-based to a service-based economy
  - Gradual erosion of union membership
- ***ESOPs have played many roles since 1956; however, they have reverted back to their roots***

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MISCONCEPTIONS, BENEFITS AND ALTERNATIVES

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COMMON MISCONCEPTIONS

- ***ESOP is primarily an employee benefit plan***
- ***Selling shareholder must sell 100% of his/her stock***
- ***Shareholder can get a higher price selling to a third party***
- ***Sensitive information must be shared***
- ***Selling stock to an ESOP results in loss of control by owner***
- ***Can only be established for a C corporation***

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COMMON MISCONCEPTIONS

- ***Must be 100% invested in shares of the Company***
- ***ESOP participants are able to exercise voting rights***
- ***ESOPs make sales difficult to a third party in the future***
- ***Creates a repurchase liability that may harm the future of the Company***
- ***Too costly to implement and administer***

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ESOPs: Why Aren't There More?

ESOP BENEFITS

- ***Selling Owners***
  - Provides ready market to sell shares at fair market value
  - Effective means for exiting the Company for controlling shareholders
  - Significant tax benefits to selling owners; potentially tax-free sale
  - Allows selling shareholders to retain voting control

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ESOP BENEFITS

- ***Company***
  - Effective means for succession – continuity of management team
  - Incentive for recruiting/retaining employees and a way to increase employee morale and productivity
  - Reduction of corporate taxes and increase in cash flow
  - Pre-tax dollars to finance repayment of debt
  - Finance corporate acquisitions

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ESOPs: Why Aren't There More?

ESOP BENEFITS

- ***Employees***
  - Employees acquire beneficial ownership in the Company without having to invest their own money
  - Employees are able to acquire ESOP stock without paying current income tax on the stock
  - Growth of employees' interest not subject to tax until distribution
  - Employees share in current and future economic rewards of Company ownership
  - Builds loyalty and motivates performance

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ESOP ALTERNATIVES

- ***Sell or transition to family members***
- ***Sell to management or key employee***
- ***Sell or merge with a third party***
  - Financial or strategic/investment buyer
- ***Liquidate the business***
- ***Do nothing***

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VETTING AN ESOP – FEASIBILITY

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VETTING AN ESOP – FEASIBILITY

- ***Critical first step in the determination to move forward***
- ***Conducted to determine whether ESOP will achieve goals of owners, management team and employees***
  - Ultimate goal is to prevent expensive errors and ensure long-term success
- ***Provides analysis of impact to sponsor company***
- ***Facilitating debt service requirements is critical***

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ESOPs: Why Aren't There More?

VETTING AN ESOP – FEASIBILITY

- ***Primary aspects of a full feasibility study:***
  - Preliminary valuation of the company
  - Analysis of impact on existing shareholders and the company's financial performance
  - Plan design study
  - Repurchase obligation liability impact

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VETTING AN ESOP – FEASIBILITY

- ***The formality of a feasibility study will vary as some companies may need approval from board of directors***
- ***Evaluation of feasibility is ongoing as circumstances change, updates are required, and other opportunities are considered***

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REPURCHASE OBLIGATION LIABILITY

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REPURCHASE OBLIGATION LIABILITY

- ***IRC and DOL Regulations***
- ***Require sponsor Company to repurchase shares of stock from participants receiving distributions – through a "put" option***
  - Participants can put shares back to sponsor company in exchange for cash consideration
  - Right to sell is guaranteed to participant but not required
- ***Also provide opportunity for participants to diversify***

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ESOPs: Why Aren't There More?

REPURCHASE OBLIGATION LIABILITY

- ***These put and diversity rules, referred to together as the "repurchase obligation liability," reduce Company cash flow***
- ***Considered "off balance sheet" liability that changes over time***
- ***Must consider future cash flow requirements and their impact on future Company performance***

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REPURCHASE OBLIGATION LIABILITY

- ***Magnitude of the liability is impacted by:***
  - Sponsor Company's employee census
  - Size and timing of repurchases/distributions
  - Fair market value of stock (must be valued annually)
  - Speed with which sponsor Company turns stock over
  - Manner in which the "put" is handled by sponsor Company

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REPURCHASE OBLIGATION LIABILITY

- ***Liability study can be done internally or by an independent consultant/expert***
- ***Process will generally include the following steps:***
  - Gather data on plan participants and review demographics
  - Identify and develop certain financial assumptions
  - Run repurchase obligation liability at "base case" level
  - Additional alternative scenarios can also be calculated

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BASIC LEVERAGED ESOP TRANSACTION

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BASIC LEVERAGED ESOP TRANSACTION

- ***Transaction advisors***
  - Company legal counsel
  - Third-party administration firm
  - Shareholder financial advisor
  - Communications firm

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ESOPs: Why Aren't There More?

BASIC LEVERAGED ESOP TRANSACTION

- ***Transaction advisors***
  - Trustee
  - ESOP law firm
  - ESOP financial advisor

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BASIC LEVERAGED ESOP TRANSACTION

- ***Company (ESOP sponsor) sets up a trust to purchase the stock of the Company from the owners***
  - ESOP trustee can be an individual or institution
- ***Can purchase all or a portion of outstanding stock***
- ***Purchase price of the stock must not exceed its fair market value***
  - No less favorable to the ESOP than "adequate consideration"

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ESOPs: Why Aren't There More?

BASIC LEVERAGED ESOP TRANSACTION

- ***Financing comes from external loan***
- ***Internal loan is designed to be repaid through annual deductible contributions to ESOP and dividends paid on stock purchased by ESOP***
  - Results in a tax deduction for funds used by ESOP to repay internal loan
- ***Amortization on internal and external loans do not have to match***

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BASIC LEVERAGED ESOP TRANSACTION

- ***Participants are allocated shares annually as the internal loan is repaid***
- ***Allocations are subject to vesting requirements***
- ***Employees given options to diversify at specified times***
- ***Various options for distributions***

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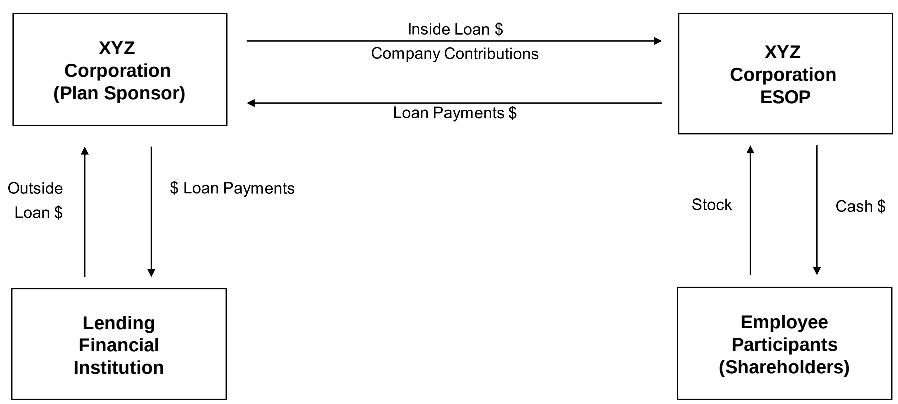
BASIC LEVERAGED ESOP TRANSACTION



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TAX CONSIDERATIONS

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TAX CONSIDERATIONS

- ***Benefits to Shareholder A***
  - Can sell any % of the Company to the ESOP for "adequate consideration"
  - Will defer tax as long the ESOP owns at least 30% of the Company after the sale (IRC section 1042)
    - Must invest the proceeds in qualified domestic replacement securities (can choose amount to be taxed)

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TAX CONSIDERATIONS

- ***Benefits to Shareholder A***
  - Can maintain control of the Company and continued equity in the Company
  - Can continue to receive salary
  - Will receive greater investment income since no tax will be paid and more will be invested
  - Immediately achieves a more diversified portfolio

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TAX CONSIDERATIONS

- ***ESOP with ESOT***
  - Company establishes Employer Stock Ownership Trust (ESOT) with the ESOP, which is a qualified, defined contribution, employee benefit plan
  - ESOT holds shares as beneficial owner for the employees' retirement account, to be allocated to the employees over time
  - Contributions are allocated to individual employee accounts
  - Diversification for employees can be achieved at a certain age

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TAX CONSIDERATIONS

- ***Tax Benefits to Company***
  - XYZ Corp can take federal and PA corporate tax deductions for both the interest and principal payments on loans borrowed to fund the purchase of A's shares
  - Annual contributions to the plan are tax-deductible
  - Cash contributions are deductible
  - Dividends paid in cash on shares held by an ESOP can be tax deductible by sponsoring corporation

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TAX CONSIDERATIONS

- ***Tax Benefits to Company***
  - Cash dividends passed through to ESOP employees are tax deductible for the Company
  - ESOPs can qualify as shareholders in an S corporation
  - In an S corporation, percentage of ownership held by ESOP is not subject to income tax at the federal level

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ESOPs: Why Aren't There More?

TAX CONSIDERATIONS

- ***Tax Benefits to Employees***
  - Employees acquire beneficial ownership in the Company without having to invest their own money
  - Employees are able to acquire ESOP stock without paying current income tax on the stock
  - Growth of employees' interest not subject to tax until distribution
  - Employees share in current and future economic rewards of Company ownership

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TAX CONSIDERATIONS

- ***C Corporations vs. S Corporations***
  - Attributes of C corporations
  - Attributes of S Corporations
  - Tax incentives differ for each

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ESOPs: Why Aren't There More?

TAX CONSIDERATIONS

- ***Tax Incentives Related to ESOPs***
  - Non-taxable income related to ESOP stock for S corporations
    - S corporation is a "pass-through" entity
    - ESOP, as qualified retirement plan, has no Federal income tax liability – participants pay income tax on distributions
    - S corp that is 100%-owned by ESOP pays no Federal income tax
    - Assets in ESOP increase free of income taxes until withdrawal

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TAX CONSIDERATIONS

- ***Comparing a C Corp and S Corp (100% ESOP)***

	C Corporation	*S Corporation*
Pretax income before ESOP payment	$ 1,200,000	$ 1,200,000
Less: ESOP contribution	200,000	200,000
Pre-tax income	$ 1,000,000	$ 1,000,000
Federal income taxes (at 21%)	210,000	0
Net income to Retained Earnings	$ 790,000	$ 1,000,000
Distribution to all shareholders – None	0	0
Retained by Company	$ 790,000	$ 1,000,000

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VALUATION CONSIDERATIONS

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ESOP VALUATION CONSIDERATIONS

- ***ESOP trustees/fiduciaries should appoint valuators that:***
  - Are qualified,
  - Are independent, and
  - Meet requirements of both IRS and ERISA

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ESOPs: Why Aren't There More?

ESOP VALUATION CONSIDERATIONS

- ***ESOP Valuation Fundamentals***
  - DOL requires "adequate consideration"
  - Valuator must consider factors that are specifically applicable to ESOPs

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ESOP VALUATION CONSIDERATIONS

- ***ESOP Valuation Fundamentals***
  - Identification of valuation subject
    - Total of all stock held by ESOP
    - Can have a control interest valuation

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ESOP VALUATION CONSIDERATIONS

- ***ESOP Valuation Fundamentals***
  - Level of value
    - **Liquidity** – how quickly and easily the appraisal subject can be converted to cash?
    - **Ownership control** – can the owner of the subject influence employer corporation's policies and operations?

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ESOP VALUATION CONSIDERATIONS

- ***ESOP Valuation Fundamentals***
  - Standard of value
    - Under DOL rules and ERISA, standard of value is "adequate consideration"
    - Fair market value

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ESOP VALUATION CONSIDERATIONS

- ***ESOP Valuation Fundamentals***
  - Premise of value
    - Value in continued use, as a going concern
    - Value in place, but not in current use, in the production of income
    - Value in exchange – orderly disposition, voluntary and involuntary liquidation

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ESOP VALUATION CONSIDERATIONS

- ***ESOP Valuation Fundamentals***
  - Valuation date
    - "As of" date
      - Transaction date
    - Value can change materially over time due to internal and external influences

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ESOP VALUATION CONSIDERATIONS

- ***ESOP Valuation Fundamentals***
  - Analyze forecasts provided by management of sponsor company
  - Valuator should consider all approaches
  - Perform an analysis of transaction to determine sponsor company's ability to service debt associated with transaction

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ESOP VALUATION CONSIDERATIONS

- ***ESOP Valuation Fundamentals***
  - Issues fairness opinion relative to:
    - Transaction price not greater than fair market value
    - Reasonableness of interest rates
    - Terms of transaction are fair and reasonable to ESOP from a financial point of view

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ESOPS CHALLENGES IN COURT

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ESOPS CHALLENGES IN COURT

- ***GreatBanc – 2014***
  - Institutional Trustee found liable after allowing an ESOP to overpay for the stock of the sponsor company (Sierra Aluminum Company)
  - Process agreement entered into between the DOL and the GreatBanc Trust Company
  - Agreement sets forth policies and procedures the Trustee must follow when engaging in an ESOP transaction
    - Selecting and overseeing valuation advisor, fiduciary process review, financial statement analysis, among others

Thomas E. Perez v. GreatBanc Trust Company, Sierra Aluminum Company, and the Sierra Aluminum Company Employee Stock Ownership Plan, U.S. District Ct., CDCA, Case 5-12-cv-01648-R-DTB (June 2, 2014)

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ESOPS CHALLENGES IN COURT

- ***Vinoskey – 2018/2019***
  - Sale of majority ownership to an ESOP which resulted in ESOP owning 100% of Company
  - Transaction Price far exceeded (over 50%) recent valuations of Company Stock
  - DOL issue with "sizable increase in value"
  - Independent Trustee and Selling Shareholder each targeted for engaging in transaction

Pizzella v. Vinoskey (earlier *Acosta v. Vinoskey*), 2019 U.S. Dist. LEXIS 129579 (Aug. 2, 2019), and *Pizzella v. Vinoskey* (II), 2020 U.S. Dist. LEXIS 15464; 2020 WL 476669 (Jan. 29, 2020)

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ESOPS CHALLENGES IN COURT

- ***Perez v. First Bankers Trust Services – 2017***
  - Trustee under fire for failing to scrutinize valuation prepared by independent valuation advisor
  - Court ruled Trustee did not make honest, objective effort to understand and question the valuation report
  - Ruling that ESOP overpaid for the shares of the Company (SJP Group, Inc.) by more than double, holding the Trustee responsible for the overpayment

Perez v. First Bankers Tr. Servs., Inc., Civil Action No. 12-4450 (MAS) (DEA) (D.N.J. Mar. 31, 2017)

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ESOPS CHALLENGES IN COURT

- ***Brundle v. Wilmington Trust – 2017***
  - ESOP purchased controlling interest in the Company (Constellis Group, Inc.) for approximately $310 million
  - The Company was sold to a third party seven months later for $281 million
  - Trustee overseeing the ESOP transaction was determined to be liable as a result of failure to critically analyze the independent valuation

Brundle v. Wilmington Trust, N.A., 258 F. Supp. 3d 647 (E.D. Va. 2017)

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ESOPS CHALLENGES IN COURT

- ***Bowers – 2021***
  - DOL alleged that ESOP and selling shareholders of the Company (Bowers + Kubota) along with Company's Board of Directors overpaid for the Company stock in a 2012 transaction
  - A district court ruled that the DOL failed to follow standard valuation practices and that no ERISA violations had been established by DOL
  - District Court ruled in September 2021, the case is expected to continue

Walsh v. Bowers, 2021 U.S. Dist. LEXIS 177184 (Sept. 17, 2021)

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CLOSING COMMENTS

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ESOPs: Why Aren't There More?

CLOSING COMMENTS

- ***ESOPs provide many tax and economic benefits to companies, owners and employees***
- ***Use of an ESOP should not be dismissed without proper education and examining feasibility***
- ***The value provided can justify the cost to implement and administer an ESOP***