

Structuring Options for ESOP Transactions: Advanced Techniques for ERISA Counsel and Plan Sponsors

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Today's faculty features:

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Structuring Options for ESOP Transactions: Advanced Techniques for ERISA Counsel and Plan Sponsors

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Presentation Overview

- I. Overview of U.S. Department of Labor (“DOL”) Regulations and Other Guidance Concerning ESOP Transactions
- II. Financial Structuring Alternatives for ESOP Transactions
- III. The Use of Clawbacks and Earn-Outs in Post-Transaction Adjustments
- IV. Management Incentive Plan Alternatives
- V. Key Provisions for ESOP Transaction Agreements
- VI. Best Practices for ESOP Transactions

I. Overview of DOL Regulations and Other Guidance

ERISA ENFORCEMENT

- The Employee Retirement Income Security Act of 1974, as amended (“ERISA”) and the Internal Revenue Code of 1986, as amended (the “Code”), are the governing laws regulating an employee stock ownership plan (“ESOP”)
 - This presentation focuses on the ERISA aspects of ESOP Transactions
 - Provisions of the Code that parallel the provisions of ERISA that are applicable to ESOP transactions are omitted in the interest of brevity
- The DOL is charged with enforcement of ERISA and has the authority to promulgate regulations and/or issue other guidance with respect to the enforcement of ERISA.

I. Overview of DOL Regulations and Other Guidance (Continued)

ERISA ENFORCEMENT (Continued)

- Divisions within the DOL that oversee ESOP related matters:
 - Employee Benefits Security Administration (“EBSA”)
 - Fields calls from ESOP participants and beneficiaries regarding their ERISA rights
 - Handles random or targeted plan investigations of ESOPs
 - Refers cases for civil litigation or criminal prosecution (as applicable)
 - Office of the Chief Accountant
 - Primarily handles the Form 5500 filings for ESOPs
 - Office of the Solicitor (“SOL”)
 - Represents the Secretary of the DOL in litigation matters

I. Overview of DOL Regulations and Other Guidance (Continued)

ERISA ENFORCEMENT (Continued)

- DOL Guidance under ERISA:
 - No precedential value but indicative of the DOL's position(s) on the topics
 - Regulations:
 - Final DOL Regulations (including DOL Interpretive Bulletins) codified under Title 29 of the Code of Federal Regulations
 - Proposed DOL Regulations published in the Federal Register
 - Other Guidance published on EBSA's website (www.dol.gov/agencies/ebsa/employers-and-advisers/guidance):
 - Advisory Opinions
 - Information Letters
 - Exemptions
 - Technical Releases
 - Field Assistance Bulletins
 - E.O. 12866 Guidance

I. Overview of DOL Regulations and Other Guidance (Continued)

ERISA ENFORCEMENT (Continued)

- DOL Guidance under ERISA:
 - Correction Programs Are Available
 - Voluntary Fiduciary Correction Program (“VFCP”)
 - Covers 19 listed transactions for breaches of ERISA fiduciary duties
 - Delinquent Filer Voluntary Compliance Program (“DVFCP”)
 - Offers reduced civil penalties for eligible plan sponsors who file the Forms 5500 late or initial fail to file such Forms 5500 for ERISA plans at all

I. Overview of DOL Regulations and Other Guidance (Continued)

ERISA AND ESOP TRANSACTIONS

- Section 404 of ERISA: ERISA Fiduciary Standard of Care
 - **Exclusive benefit rule**
 - A qualified retirement plan is required to be maintained for the exclusive best interests *of the participants and beneficiaries* and payment of reasonable administrative expenses
 - **Prudence**
 - With the care, skill, prudence and diligence under the circumstances then prevailing, that a prudent person, acting in a like capacity and familiar with such matters, would use in the conduct of an enterprise of a like character and with like aims

I. Overview of DOL Regulations and Other Guidance (Continued)

ERISA AND ESOP TRANSACTIONS (Continued)

- Section 405 of ERISA: ERISA Co-Fiduciary Liability
 - Each fiduciary of an ERISA plan shall be liability for any breaches of ERISA by any other fiduciary of the same plan as follows:
 - Knowing participation in or concealment of an ERISA violation;
 - Enabling another fiduciary to commit the breach of ERISA; and/or
 - Has knowledge of another fiduciary's breach of ERISA without reasonable efforts to remedy the breach.

I. Overview of DOL Regulations and Other Guidance (Continued)

ERISA AND ESOP TRANSACTIONS (Continued)

- How the ERISA Fiduciary Standard of Care Applies to ESOP Plan Sponsors
 - As the “Plan Administrator” of ESOPs
 - Not the third-party record keeper who handles the ESOP accounting
 - In the selection, appointment, and monitoring of the trustee or board of trustees of the ESOP (the “ESOP Trustee”)

I. Overview of DOL Regulations and Other Guidance (Continued)

“PROHIBITED TRANSACTIONS”

- Section 406 of ERISA includes the following as “prohibited transactions” unless otherwise exempted:
 - Transactions between a plan and a “party in interest” that involve the direct or indirect:
 - “(A) sale or exchange, or leasing, of any property between the plan and a party in interest;
 - (B) lending of money or other extension of credit between the plan and a party in interest;
 - (C) furnishing of goods, services, or facilities between the plan and a party in interest
 - (D) transfer to, or use by or for the benefit of a party in interest, of any assets of the plan; or
 - (E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of [Section 407 of ERISA].”
 - Fiduciary self-dealing transactions; and
 - Transfers of real or personal property from a plan to a party in interest in a sale or exchange

I. Overview of DOL Regulations and Other Guidance (Continued)

“PROHIBITED TRANSACTIONS” (Continued)

- Section 3(14) of ERISA defines a “party in interest” broadly
 - Some examples:
 - ESOP plan sponsor
 - Named fiduciaries of the ESOP
 - Employee organization whose members are covered under the ESOP
 - Employees, directors, officers, or 10% or more shareholders of any of the foregoing
 - Certain service providers to the ESOP (such as the ESOP Trustee)
 - Family members of individuals who are parties in interest

I. Overview of DOL Regulations and Other Guidance (Continued)

“PROHIBITED TRANSACTIONS” EXEMPTIONS – ESOP TRANSACTIONS

- Section 407(b) of ERISA provides that the 10% limit on a plan’s investment in qualifying employer securities (“Company Stock”) do not apply to individual account plans (which include ESOPs)
- Section 408(a) of ERISA authorizes the DOL to provide administrative exemptions (on a class basis or for any particular applicant)
- Section 408(b)(2) of ERISA permits ESOPs to enter into reasonable contracts or arrangements for necessary plan services

I. Overview of DOL Regulations and Other Guidance (Continued)

“PROHIBITED TRANSACTIONS” EXEMPTIONS – ESOP TRANSACTIONS (Continued)

- Section 408(b)(3) of ERISA permits ESOPs to borrow funds to acquire shares of Company Stock if the loan satisfies the following:
 - The primary benefit requirement;
 - Has a reasonable rate of interest;
 - Limits collateral for the loan to the shares of Company Stock that the ESOP acquires with the loan proceeds, earnings thereon, or contributions made for the purpose of repaying the loan.
- DOL Regulations under 408(b)(3) of ERISA impose additional conditions (e.g., share release formula, put option rights, and accounting requirements).

I. Overview of DOL Regulations and Other Guidance (Continued)

“PROHIBITED TRANSACTIONS” EXEMPTIONS – ESOP TRANSACTIONS (Continued)

- Section 408(e) of ERISA permits employee benefit plans to acquire shares of Company Stock if:
 - Company Stock constitutes “qualifying employer securities” (as defined in Section 407(d)(4) of ERISA);
 - The purchase price is not more than “adequate consideration” (as defined in Section 3(18) of ERISA);
 - No commission is charged with respect to the transaction; and
 - If the plan is an eligible “individual account plan” (as defined in Section 407(d)(3) of ERISA) or otherwise will not acquire more than the limit on investments in Company Stock under Section 407(a) of ERISA.
 - ESOPs constitute individual account plans.

I. Overview of DOL Regulations and Other Guidance (Continued)

“PROHIBITED TRANSACTIONS” EXEMPTIONS – ESOP TRANSACTIONS (Continued)

- **Adequate Consideration**
 - The ESOP cannot pay more than fair market value for the shares of Company Stock that it is acquiring
- **Fairness**
 - The overall transaction must be fair to the ESOP from a financial point of view
 - This includes any other contemporaneous arrangements between the Company and the selling shareholder(s) and/or between the Company and management (such as management incentive plans)

I. Overview of DOL Regulations and Other Guidance (Continued)

DOL “PROCESS AGREEMENTS”

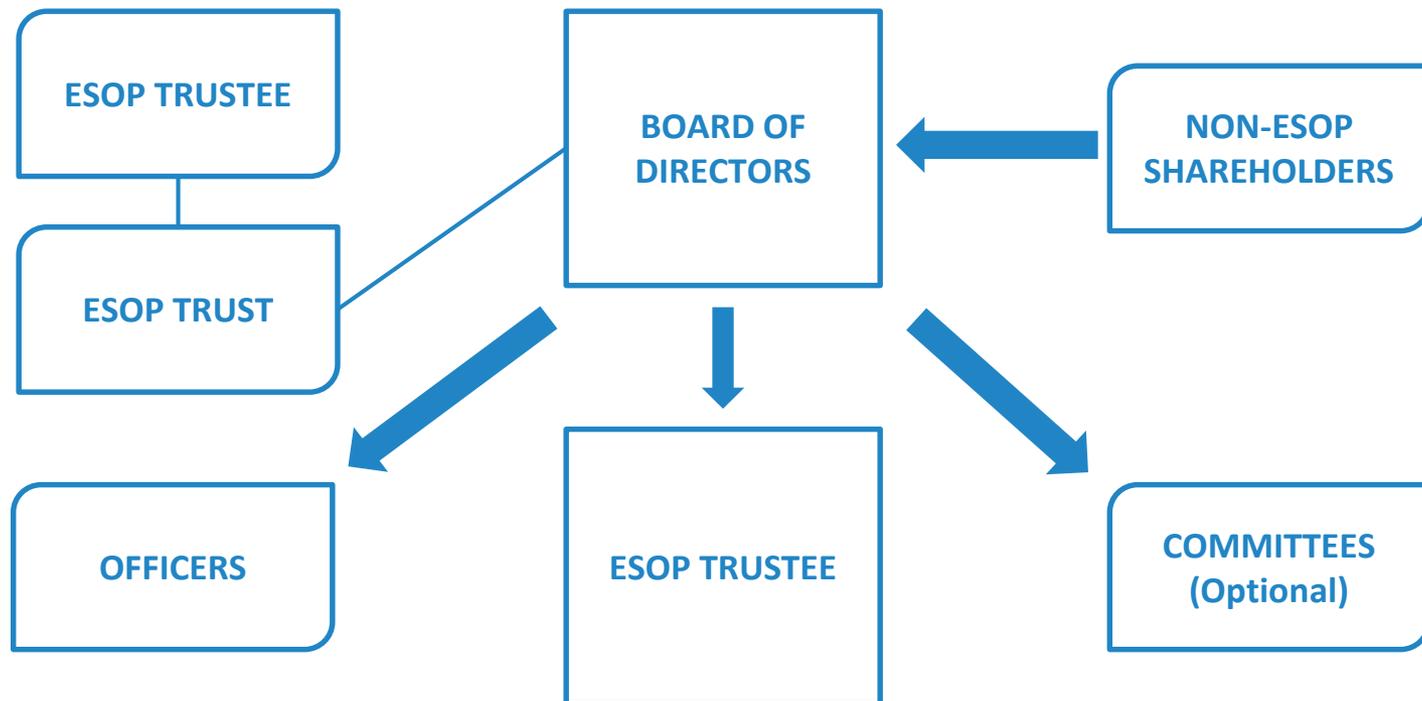
- Settlement agreements between the DOL and three institutional ESOP trustees (and one individual trustee) to date:
 - 2014: GreatBanc Trust Company
 - 2017: First Bankers Trust Services, Inc.
 - 2017: Alpha Investment Consulting Group
- Not binding on other parties, however, indicative of the DOL’s position regarding prudent processes for:
 - Selection of the ESOP’s independent appraiser and financial advisor;
 - Review and acceptance of an independent valuation; and
 - Transaction due diligence and negotiation procedures

I. Overview of DOL Regulations and Other Guidance (Continued)

MANAGING CONFLICTS OF INTEREST

- Establish separate corporate governance bodies
- Each party to a transaction should retain separate advisors
 - At a minimum, the Board of Directors of a Company should engage an experienced, independent trustee to represent the interests of the ESOP participants and beneficiaries; and
 - The ESOP Trustee should engage an independent appraiser and financial advisor for the ESOP *who has not provided any services for the Company or the Board of Directors or the non-ESOP selling shareholder(s).*

Corporate Governance in an ESOP Corporation



- Shareholders elect Board of Directors
- Board of Directors appoints officers, ESOP Trustee (or a Board of Trustees), and committee members

Brief Description of Respective Roles

ESOP Trustee

- Elects and Monitors the Board of Directors
- Votes Shares Owned (if necessary)
- Responsible for ESOP Trust Administration
- Establishes Fair Market Value for Company Stock

Board of Directors

- Responsible for Major Corporate Actions
- Strategic Planning
- Appoints Officers and Trustee (and Optionally Committees)

Corporate Officers

- Responsible for Day-to-Day Management of Corporation

Brief Description of Respective Roles (Continued)

Optional Committees of the Board of Directors

- **Nominating Committee** – Evaluating current directors and identifying and vetting potential new directors
- **ERISA Fiduciary Committee** – Selection and monitoring of ERISA fiduciaries of all employee benefit plans that the Company maintains
- **Audit Committee** – Oversight of the annual audit of the Company’s financial statements (if applicable)
- **Executive Compensation Committee** – Evaluation of the compensation packages awarded to executives (including the engagement of an independent analyst)
- **ESOP Communications Committee** - Responsible for learning how the ESOP functions and communicating that to the Company’s employees

ESOP Corporate Governance

Success in an ESOP-owned corporation encompasses:

- Business survival and growth
- Increase in Company Stock value
- Repurchase of Company Stock from departing employees
- Adequate provision for employee retirement
- Employee fulfillment of operational improvement initiatives to increase, quality, productivity, profitability and value

The ESOP Trust

- The ESOP needs a trust, which is a separate legal entity, to hold title to assets (including shares of Company Stock) and administer plan assets
 - The ESOP Trust will be the legal or record owner of shares of Company Stock
 - Participating employees are beneficial owners of Company Stock and not direct owners
- When the Company establishes an ESOP, the Company must concurrently form a trust and appoint a trustee for the ESOP
- ERISA governs the ESOP Trust
 - The ESOP Trustee is subject to the ERISA prudent person standard, which is the highest standard of care in the country

The ESOP Trustee

Types of ESOP Trustees

- **Inside Trustees**
 - Directors, officers, or employees of the Company
- **Independent Trustee**
 - Institutions (banks, trust companies, etc.)
 - Professional individual service providers

Authority of ESOP Trustees

- **Directed Trustee** (inside or independent): Receives and acts under direction from discretionary fiduciaries
- **Discretionary Trustee** (inside or independent): Has full discretion with regard to voting ESOP-owned shares and investment and management of ESOP assets

Parties and Advisors Involved in an ESOP Transaction

<u>The Company</u>	<u>The ESOP Trust</u>	<u>The Selling Shareholder(s)</u>
<ul style="list-style-type: none"> • <u>Accountant and/or Consultant</u> • <u>Financial Advisor</u> <ul style="list-style-type: none"> • May assist with debt placement • <u>Legal Counsel</u> <ul style="list-style-type: none"> • Assists with ESOP transaction design • Drafts ESOP plan documents • Drafts ESOP transaction documents 	<ul style="list-style-type: none"> • <u>ESOP Trustee</u> • <u>ESOP Independent Appraiser and Financial Advisor</u> <ul style="list-style-type: none"> • Valuation Report and Fairness Opinion Letter • <u>Legal Counsel</u> <ul style="list-style-type: none"> • The ESOP Trust's legal advisor (not corporate counsel) 	<ul style="list-style-type: none"> • <u>Accountant and/or Tax Preparer</u> • <u>Financial Advisor</u> • <u>Separate Legal Counsel</u> <ul style="list-style-type: none"> • Reviews ESOP transaction documents

II. Financial Structuring Alternatives for ESOP Transactions

CAPITAL SOURCES

- Debt
 - Senior Bank
 - 2nd Lien/Junior
 - Structured Equity
 - Seller Financing
- Equity (Less Common)
 - Senior Management
 - Private Equity/Warrants
 - Employees

II. Financial Structuring Alternatives for ESOP Transactions (Continued)

TRADITIONAL LENDER SOURCES

- Importance of:
 - Lender relationship
 - Historical performance of the business
 - Educating lenders regarding ESOPs
 - Tax and other advantages of ESOPs
 - Impact of ESOP transaction on the corporate financial statements (e.g., the contra-equity account)
 - Modeling cash flow (ESOP Feasibility Analysis)

II. Financial Structuring Alternatives for ESOP Transactions (Continued)

COMBINATION OF FINANCING SOURCES

When both Bank and Seller Financing are utilized:

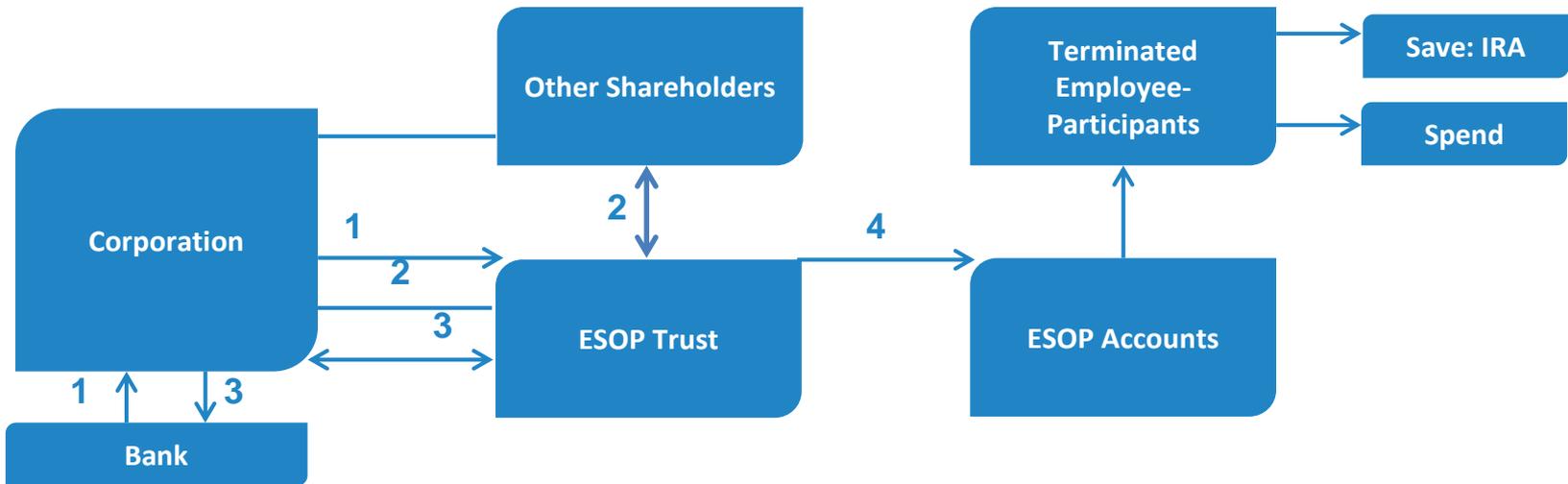
- Statutory and regulatory restrictions on ESOP acquisition loans preclude subordination. However, banks typically do not request subordination if seller-financing structured as two mirror loans:
 - External Loan: Loan from Selling Shareholder(s) to the Company (may be and almost always is subordinated to the Bank)
 - Internal Loan: Company's loan of the External Loan proceeds to the ESOP
 - No net impact on corporate cash flow from servicing the ESOP loan repayments (sourced in tax deductible employer contributions and/or tax deductible dividends or S corporation distributions), so the Bank does not request subordination of the Internal Loan

II. Financial Structuring Alternatives for ESOP Transactions (Continued)

ESOT STOCK ACQUISITION WARRANTS

- A warrant is a security similar to a stock option that entitles the holder to buy the underlying stock of the issuing company at a fixed exercise price for a specified period of time.
- The warrant is additional consideration that would be considered in conjunction with the seller financing.
 - The warrant is priced into the fairness of the transaction.
- The warrant permits the Selling Shareholder to acquire stock at the post-transaction price and appreciation will be taxed on the long-term capital gains rate.
- The ESOT's independent, discretionary, and institutional Trustee and independent appraiser will determine what is fair in this respect.

How Does an ESOP Work? (Leveraged)



1. Bank loans funds to the Corporation, which loans funds to the ESOP Trust.
2. ESOP Trust uses loan proceeds to acquire stock from existing shareholders or the Corporation.
3. Corporation makes annual tax deductible cash contributions to the ESOP Trust; ESOP Trust makes payments on the loan; Corporation makes payments on the Bank loan.
4. ESOP Trust allocates stock to Participant accounts and tells employees how much stock has been allocated to their accounts and how much such stock is worth.
5. Employees receive stock or cash when they leave Corporation and must sell stock back to Corporation, which must purchase such stock.

Code Section 1042 Tax-Deferred ESOP Transaction

- A shareholder of a “closely held” *C corporation* may sell qualified employer securities to an ESOP and defer the taxation of gain upon sale of such employer securities to the extent that he or she reinvests in securities of other corporations (“qualified replacement property” or “QRP”)
- The QRP has a carry-over basis from the shares of Company Stock sold to the ESOP.
- If the seller holds on to the QRP until the seller’s death, the QRP will pass to the seller’s heir(s) with a stepped-up basis for tax purposes.

Code Section 1042 Tax-Deferred ESOP Transaction (Continued)

Qualifying Employer Securities

- Not readily tradable on an established securities market, and:
 - Common stock (best dividend and best voting rights); or
 - Convertible preferred stock (convertible to best dividend/best voting rights common stock)
- Selling shareholder did not receive pursuant to an incentive program
- Long-term capital gain
- Three-year holding period

Code Section 1042 Tax-Deferred ESOP Transaction (Continued)

TRANSACTIONS MUST HAVE 5 CHARACTERISTICS

1

It must be one that would otherwise result in long-term capital gain (LTCG) to the selling shareholder

Code Section 1042 Tax-Deferred ESOP Transaction

TRANSACTIONS MUST HAVE 5 CHARACTERISTICS

2

The selling shareholder's holding period for the stock must be at least 3 years

Code Section 1042 Tax-Deferred ESOP Transaction

TRANSACTIONS MUST HAVE 5 CHARACTERISTICS

3

The selling shareholder must not have received the stock from a qualified employee plan (such as an ESOP), by exercising a stock option or through an employee stock purchase program

Code Section 1042 Tax-Deferred ESOP Transaction

TRANSACTIONS MUST HAVE 5 CHARACTERISTICS

4

After the sale, the ESOP must own (on a fully diluted basis) at least 30% of the Company

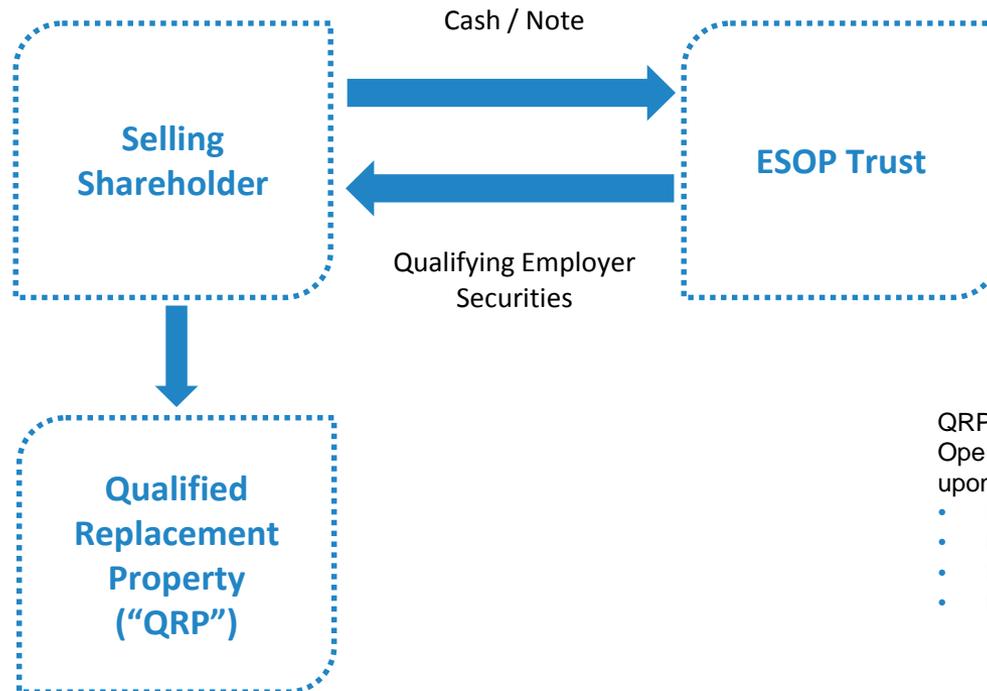
Code Section 1042 Tax-Deferred ESOP Transaction

TRANSACTIONS MUST HAVE 5 CHARACTERISTICS

5

The selling shareholder must purchase the QRP within a 15-month period that begins 3 months before and ends 12 months after the sale of Company Stock to the ESOP

Tax-Deferred Reinvestment under Section 1042 of the IRC C Corporations Only



QRP: Debt or Equity in a Domestic Operating Corporation (Stepped-up basis upon death). QRP Excludes:

- REITs
- Mutual Funds
- Passive Investment Companies
- Municipal Bonds

Qualified Replacement Property

- Generally, “qualified replacement securities” must be securities of U.S. operating companies whose passive investment income does not exceed 25% of gross receipts.
- The replacement securities are defined to include equity (stocks) and debt (bonds) of U.S. corporations, either public or private, including common stock, preferred stock, corporate notes and bonds, convertible bonds and floating rate notes.
- Qualified replacement property does not include U.S. government municipal securities, foreign securities, mutual funds, interests in limited partnerships, REITs, passive investments, or the stock of the corporation (or its affiliates) that is the subject of the ESOP transaction.

Qualified Replacement Property (Continued)

- Some brokerage and investment firms offer products that essentially allow the sellers to borrow against the replacement securities
- Floating rate note QRP securities (“FRNs”) are designed specifically to address this leverage opportunity
- The FRNs are designed specifically to be held until death of the selling shareholder

Prohibited Allocations if Capital Gains Deferred Under Section 1042

50% excise tax if allocation occurs (generally within 10 years of transaction) of company stock acquired from the selling shareholder to:

- Taxpayer who received tax deferral (selling shareholder);
- Individual related to selling shareholder; and
- Any person owning more than 25% of any class of outstanding stock of the sponsoring corporation

* **Note:** Children/Grandchildren of the selling shareholder may receive 5% in the aggregate under certain conditions.

Comparison of Stock Sale Structures

	Sale to ESOP without Code Section 1042 Tax-Deferral	Sale to ESOP with Code Section 1042 Tax-Deferral
Long-Term Capital Gains Tax	Federal: 15% or 20%, depending on the selling shareholder's tax bracket. Plus the long-term capital gains tax rate of the state of residence of the selling shareholder	Deferred until subsequent disposition of QRP
Affordable Care Act Medicare Investment Tax (ACA Tax)	3.8% on the lesser of: (a) Net investment income (mostly passive investments, unless material participation exception applies), or (b) Modified AGI (e.g., amount over \$250,000 for married joint filers)	N/A
Result	Net Proceeds = Purchase Price – Combined Federal and State taxes	Net Proceeds = Purchase Price – QRP Acquisition Cost; QRP Acquisition Cost is invested

Code Section 1042 Tax-Deferred ESOP Transaction – QRP Examples

Filing an election under Section 1042 of the Code after selling shares of Company Stock to an ESOP for \$1,000,000, the seller may invest the \$1,000,000 proceeds in QRP and avoid capital gains taxation.

DIRECT QRP ACQUISITION EXAMPLE

Sale to the ESOP for \$1,000,000 in cash payment

\$1,000,000 in QRP acquired with cash

\$1,000,000 in QRP has carryover basis (often negligible)

If the \$1,000,000 in QRP is sold after the seller's death, the capital gains is measured by the stepped basis or fair market value basis at death

If the value at death is \$1,500,000, the basis is stepped to \$1,500,000 at death and no tax is applied

Code Section 1042 Tax-Deferred ESOP Transaction – QRP Examples

FINANCED QRP ACQUISITION EXAMPLE

Sale to the ESOP for \$1,000,000 in cash payment

\$1,000,000 in QRP acquired as FRNs with \$200,000 in cash and \$800,000 in margin loan proceeds

\$1,000,000 in FRN QRP will generate interest income to pay the margin interest on the \$800,000 margin loan

\$800,000 (net of the \$1,000,000 proceeds from the sale to the ESOP less the \$200,000 cash down payment to acquire QRP) is available for other investments

\$1,000,000 in QRP has carryover basis (often negligible)

If the \$1,000,000 in QRP is sold after the seller's death, the capital gains is measured by the stepped basis or fair market value basis at death

If the value of the FRNS at death is \$1,000,000, the basis is stepped to \$1,000,000 at death and no tax is applied

Installment Sales

- Tax Rates – Notes Regarding Installment Reporting (Internal Revenue Code Section 453):
- Installment reporting is the default method for installment sales.
- Each payment is included in income in the year of receipt.
 - This means that each installment payment is subject to the Federal LTCG rate prevailing for the year of payment.
- The Seller may “opt out” of installment reporting (Schedule D) and pay taxes on the entire purchase price in the year of the sale at the then current rates.
- \$5M caveat

Partial Installment Sale Reporting

A partial Code Section 1042 election and installment sale is permissible; however, the IRS requires the allocation to be based on the entire selling price.

EXAMPLE DIRECT QRP ACQUISITION

\$1,000,000 sale to the ESOP; \$200,000 received in cash and \$800,000 seller note

\$200,000 of QRP acquired with cash under Code Section 1042

The cash received is treated as 20% subject to Code Section 1042 tax-deferral and 80% reportable under the installment method (i.e., no ability to match the cash and the 1042)

Potential Tax Liability

Select Provisions Relevant to Companies:

- Federal corporate tax rate dropped from 35% to 21%
- 20% deduction for qualified pass through entities
- Interest deduction limit of 30% of EBITDA (beginning after 2021, limit becomes 30% of EBIT)
- Immediate expensing of capital expenditures
- Repatriation tax rate of 15.5% for cash and 8.0% for non-cash assets

Potential Tax Liability (Continued)

- Given new corporate tax rates, it is possible that C-Corp structures may be nearly as efficient as alternative structures
- C-Corps provide much more flexibility in sourcing and structuring capital compared to S-Corps
- Tax leakage is significantly lower than before and may justify running a financial analysis to compare alternatives
 - Additional C-Corp tax shields that may be available are abnormally high interest expenses if there was a recent leveraged ESOP transaction, non-cash ESOP benefit expenses, depreciation, etc.
- Strategy may be particularly interesting for partial year S-Corp ESOPs: ability to minimize flow of cash into the ESOP attributable to proportionate S corporation distributions

Potential Tax Liability (Continued)

C-Corp Advantages and Disadvantages	
<u>Advantages</u>	<u>Disadvantages</u>
Do not have second class of stock and other restrictions of an S-Corp	Although tax leakage is less due to lower tax rate, there is still tax leakage compared to S-Corp structures
Ability to efficiently source capital of all types depending on situation	
Recent tax law changes make tax leakage lower	
For partial S-Corp ESOPs, can better control benefit levels realized by ESOP	
Depending on situation, acquisitions as a C-Corp can allow sellers to elect 1042	

Potential Tax Liability (Continued)

Potential Tax Liability Without 1042 Election	
Selling Shareholders' realized gain	\$1,000,000
Highest marginal tax rate for Federal long-term capital gains	\$200,000 (20%)
New York Income Tax	\$88,200 (8.82%)
Federal Excise Taxes under the Affordable Care Act	\$38,000 (3.8%)
Total Taxes (excluding NYC taxes)	\$326,200

III. The Use of Clawbacks and Earn-Outs in Post-Transaction Adjustments

CLAWBACKS AND EARN-OUTS

- A “**clawback**” provision enables the seller of a security to obtain additional consideration from the purchaser, if the purchaser of the security subsequently sells the security at a profit.
- An “**earn-out**” provision enables the seller of a security or asset to obtain additional consideration from a purchaser, based on the future performance of the business sold.
- Neither of these types of provisions appear in Stock Purchase Agreements (“SPAs”) where the ESOT is the purchaser, because the ESOT cannot pay more than “adequate consideration.”

III. The Use of Clawbacks and Earn-Outs in Post-Transaction Adjustments (Continued)

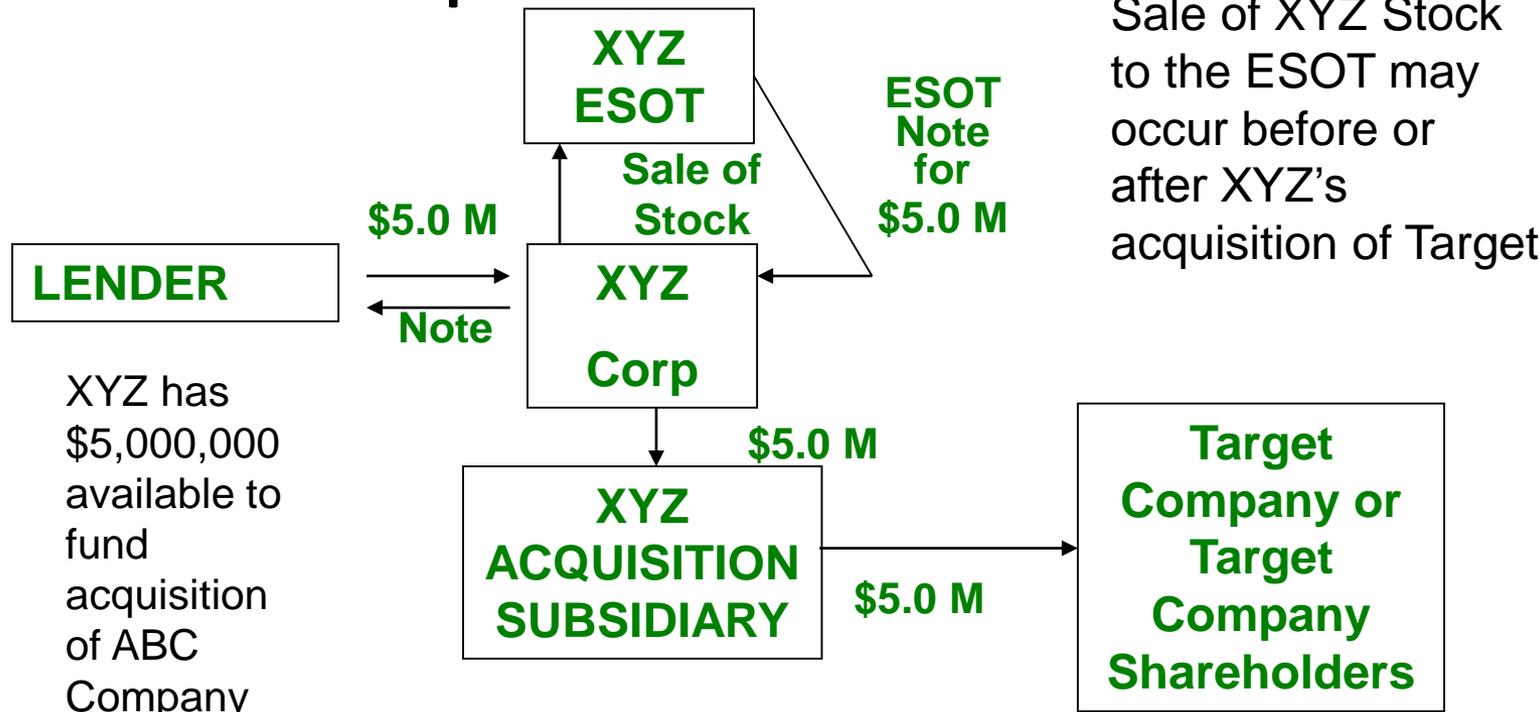
CLAWBACKS AND EARN-OUTS (CONTINUED)

- Clawback and earnout provisions sometimes do appear in SPAs where the ESOT is selling shares of employer securities, depending on the bargaining position of the ESOT Trustee.
- Generally, any clawback or earnout right of the non-ESOP selling shareholder(s) is best addressed in a separate agreement between the company and the non-ESOP selling shareholder(s).
 - DOL Regulations (and U.S. Department of Treasury Regulations) preclude the ESOP from being a party to a buy-sell or similar agreement.

ESOPs as M&A Tools

- Beyond a vehicle for business succession planning purposes, ESOPs can be used to maximize tax advantages in other M&A Structures:
 - ESOP tax savings can help free up available corporate cash flow for servicing corporate debt payments.
 - ESOP's tax-exempt status shelters income stream of target company on a post-acquisition basis.
 - An ESOP-owned company can leverage the tax advantages of ESOPs to be a successful bidder in the acquisition of a target company.

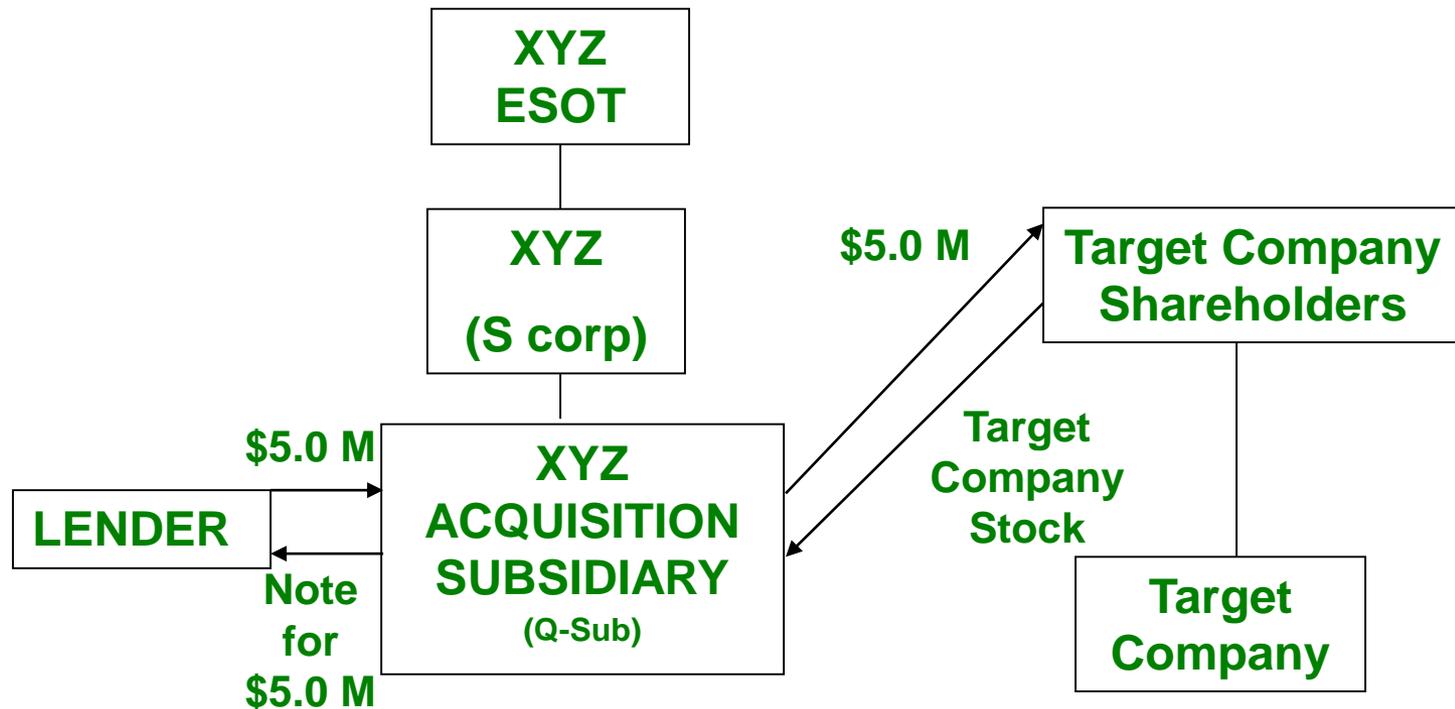
ESOPs as M&A Tools – Transaction Structure Example 1



Post-transactions:

- XYZ Corp's contributions to XYZ ESOT to allow repayment of the ESOT Note generates tax deductions and increases cash flow available to XYZ Corp to make payments on \$5.0 M note from Lender.
- Taxable to Target Company Shareholders

ESOPs as M&A Tools – Transaction Structure Example 2

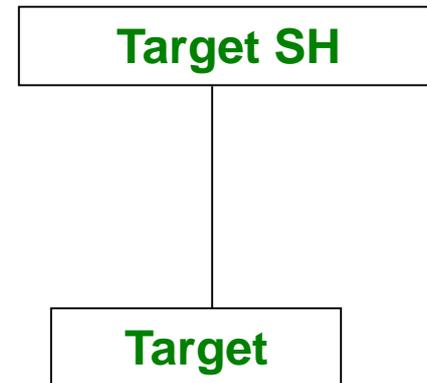
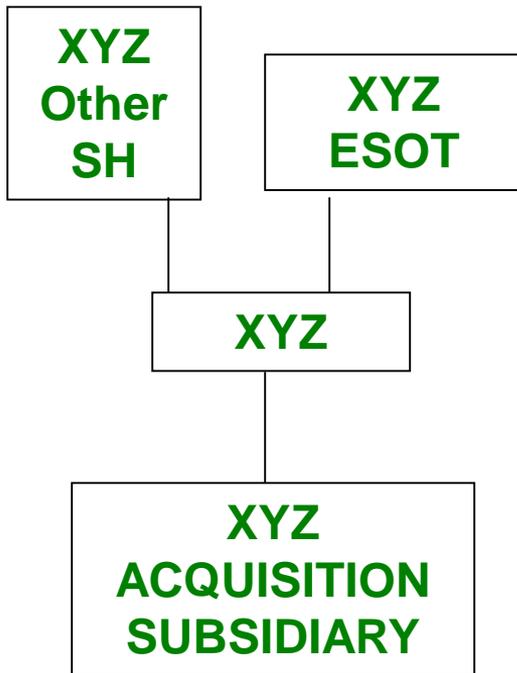


Post-transaction:

- Taxable to Target Company Shareholders
- Target Company's earnings become tax-exempt (following qualified subchapter S subsidiary election for Target Company), and more employees participate in the XYZ ESOP

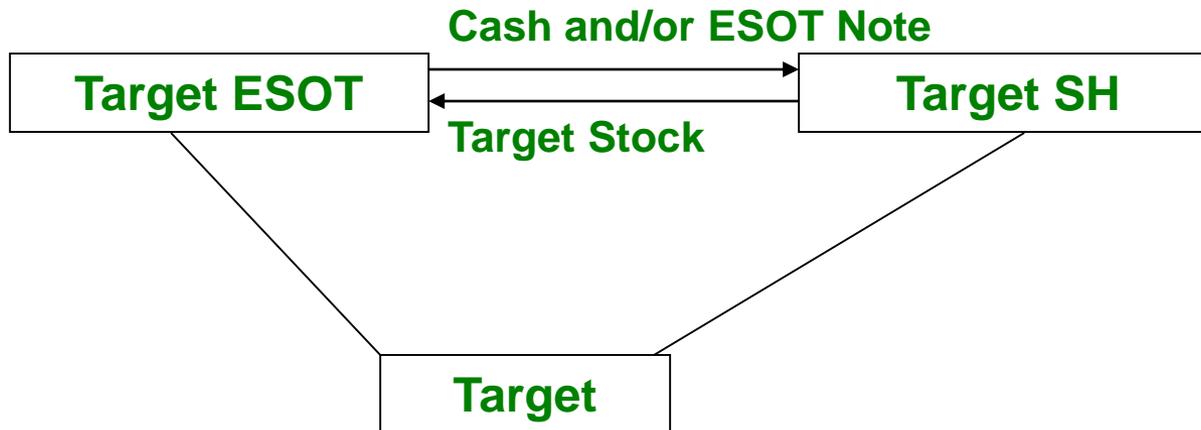
ESOPs as M&A Tools – Transaction Structure Example 3

Pre-Transaction Corporate Entities:



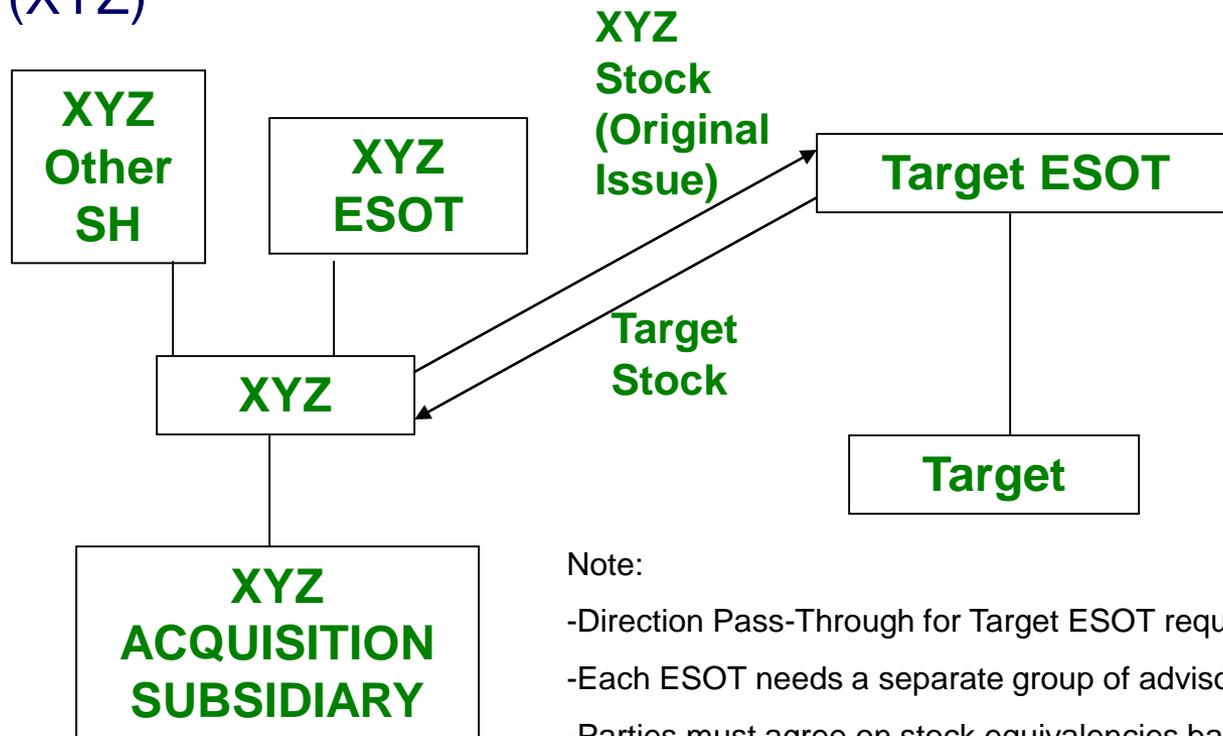
ESOPs as M&A Tools – Transaction Structure Example 3 (Continued)

- Step 1:
 - Target Establishes ESOP and Trust
 - Target SH sells to Target ESOT
 - Target SH (seller) elects to defer recognition of capital gains taxes under Code Section 1042:



ESOPs as M&A Tools – Transaction Structure Example 3 (Continued)

- Step 2: Stock exchange between Target ESOT and Acquirer (XYZ)

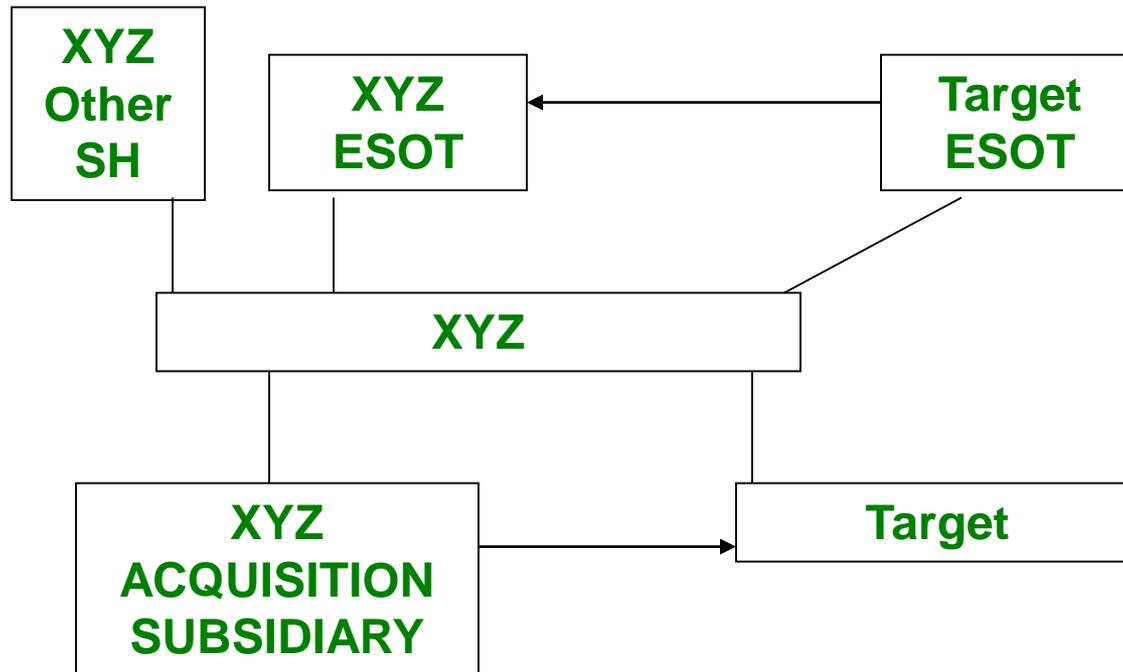


Note:

- Direction Pass-Through for Target ESOT required
- Each ESOT needs a separate group of advisors
- Parties must agree on stock equivalencies based upon separate independent valuations

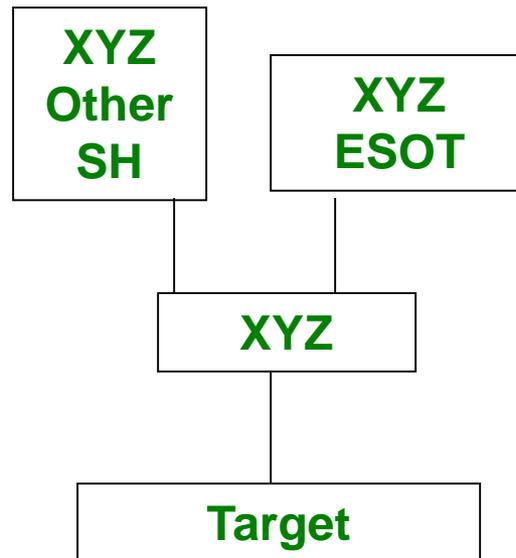
ESOPs as M&A Tools – Transaction Structure Example 3 (Continued)

- Step 3: Merger of ESOPs and Merger of Subsidiaries



ESOPs as M&A Tools – Transaction Structure Example 3 (Continued)

- Post-Transaction:
 - Capital gains tax-deferred for Target SH (seller)
 - Target's eligible employees participate in the XYZ ESOP
 - XYZ acquires Target without need for cash assets or financing (although XYZ assumes Target's liabilities), except for transaction expenses



IV. Management Incentive Plan Alternatives

INTRODUCTION

- Types
 - Cash bonus
 - Equity or Equity-Like Incentives
 - Employee Stock Purchase Plan (“ESPP”)
 - Stock Bonuses or Gifts
 - Restricted Stock
 - Stock Appreciation Rights
 - Phantom Stock
 - Warrants
 - Supplemental Executive Retirement Plans (aka wrap-around plans)

IV. Management Incentive Plan Alternatives (Continued)

INTRODUCTION

- Tax Regulation:
 - Section 423 of the Code for ESPPs;
 - Section 409A of the Code for all non-qualified deferred compensation
 - Excluding “short-term deferrals” where the compensation for services rendered is paid within two and one-half months following the end of the year in which the services are performed
 - Depending on the structure of the Management Incentive Plan, the award recipients may be able to defer income recognition beyond the year of grant.

IV. Management Incentive Plan Alternatives (Continued)

INTRODUCTION

- Factors to Consider from a Corporate Perspective:
 - Eligibility to Participate
 - Vesting
 - 83(b) Election
 - Tax Gross-Up
 - Objective or subjective criteria for evaluation satisfaction of performance conditions

IV. Management Incentive Plan Alternatives (Continued)

IMPORTANCE ON CONTEMPORANEOUS CONSIDERATION WITH AN ESOT TRANSACTION

- Factors to consider from the ESOP's perspective:
 - Potential dilutive impact of the Management Incentive Plan
 - Impact of the Management Incentive Plan on corporate cash flow (and possibly reduction in funds available for contributions to the ESOP to service ESOT debt);
 - Overall Fairness

IV. Management Incentive Plan Alternatives (Continued)

IMPORTANCE ON CONTEMPORANEOUS CONSIDERATION WITH AN ESOT TRANSACTION

- If the Management Incentive Plan is developed and established contemporaneously with the ESOT's stock acquisition transaction, the impact of the Management Incentive Plan will be included in the factors considered for the ESOP's fairness opinion
 - Note: The ESOP's independent appraiser and financial advisor will not issue an opinion on the reasonableness of the Management Incentive Plan.
 - The Company should retain an outside, experienced and qualified executive compensation analyst for such reasonableness opinion.

V. Key Provisions for ESOP Transaction Agreements

STANDARD PROVISIONS WITH ESOP NUANCES

- **Purchase Price and Other Consideration**
 - Emphasis on “adequate consideration”
 - Sources of financing; Deliveries at closing
 - Statement of prohibited transaction exemption conditions for ESOT Transactions
- **Representations and Warranties**
 - If multiple sellers, joint and several representations and warranties
 - If the ESOT will become the sole shareholder, the selling shareholder(s) should make the representations and warranties typically provided by the Company
 - Full disclosure of the Company’s financial health and future business prospects

V. Key Provisions for ESOP Transaction Agreements (Continued)

STANDARD PROVISIONS WITH ESOP NUANCES (CONTINUED)

- Pre-Closing or Closing Conditions
 - The Company should continue operations in the ordinary course of business
 - Memorialize any pre-closing contributions to the ESOP
 - Require the Company to concurrently enter into employment agreements with key management and/or consulting agreements with selling shareholder(s) crucial to a smooth transition in operations
 - Reflect the establishment of any Management Incentive Plan
 - Issuance of the Company's Statement of Consent under Section 1042 of the Code, as applicable

V. Key Provisions for ESOP Transaction Agreements (Continued)

STANDARD PROVISIONS WITH ESOP NUANCES (CONTINUED)

- **Post-Closing Covenants and/or Adjustments**
 - The Company should promise to obtain an IRS favorable determination letter for the ESOP, if it has not already done so.
 - The Parties should set forth the agreement on any post-closing adjustments (which should be in favor of the ESOP), as applicable.
 - Restrictions exist on subsequent disposition of Company Stock by the ESOP (3-year holding requirement), except for ESOP benefit payments under Section 4978(d) of the Code.

V. Key Provisions for ESOP Transaction Agreements (Continued)

STANDARD PROVISIONS WITH ESOP NUANCES (CONTINUED)

- Indemnification
 - Particularly of the ESOT by the selling shareholder(s), especially in transactions that result in the ESOT becoming the sole shareholder of a Company
 - Basket
 - Limit on indemnification
 - Indemnification Procedures

V. Key Provisions for ESOP Transaction Agreements (Continued)

STANDARD PROVISIONS WITH ESOP NUANCES (CONTINUED)

- Dispute Resolution
 - Governing Law
 - Good faith efforts for the Parties to attempt to resolve before resorting to more formal procedures
 - Arbitration or Mediation

VI. Best Practices for ESOP Transactions

- Retain expert legal, tax, and accounting advisors
- Commission an ESOP feasibility analysis
- Confirm available sources of financing as part of the corporate transaction structure planning process
- Design and structure the ESOP Transaction
 - Legal, tax, and accounting advisors should collaborate with the Company for tax planning purposes and to ensure that the future financing repayment obligations will not significantly impair the Company's cash flow

VI. Best Practices for ESOP Transactions (Continued)

- Address conflicts of interest
 - Retain an independent Trustee for the ESOP in conjunction with the establishment of the ESOP
 - The independent Trustee will retain an independent appraiser and financial advisor for the ESOP and may retain separate legal counsel for the ESOP (collectively, the “ESOT Advisory Team”)
 - Appoint one director (a non-selling shareholder if possible) to serve as the Company’s contact person for communications with the ESOT Advisory Team
 - Ensure advisors are not representing more than one party to the transaction

VI. Best Practices for ESOP Transactions (Continued)

- Respond promptly and thoroughly to due diligence request of the ESOT Advisory Team
- Maintain a detailed and written record of the due diligence production and negotiations
 - Ideally, set up an electronic data room
- Develop any new management incentive programs concurrently with the transaction and disclose such plans to the ESOT Advisory Team
 - This ensures the inclusion of future equity or synthetic equity grants to senior management in the ESOP's fairness evaluation at the time of the transaction
- Be patient
 - Lenders and the ESOT Advisory Team will need time to review due diligence documents, financing agreements, and other transaction documents.

VI. Best Practices for ESOP Transactions (Continued)

- Obtain all third-party consents (landlords, vendors, creditors, and/or regulatory agencies, as applicable) well in advance of closing
- Obtain a copy of the ESOP's fairness opinion letter
 - Note only the ESOP Trustee will receive the accompanying valuation report
- Develop and implement a plan for educating employees about the ESOP and fostering an employee-ownership culture
- Retain a robust, detailed record of every step of the ESOP transaction development, negotiation, and closing procedures.



David R. Johanson

Brief Bio

David R. Johanson, the Partner-in-Charge of the Napa office and a Partner in the San Francisco, Los Angeles, and New York offices of Hawkins Parnell Thackston & Young LLP, has helped hundreds of corporations form ESOPs and create effective employee ownership through other equity incentives during the past almost 30 years. Mr. Johanson assists clients in designing ESOP and equity incentive plans and accomplishing ESOP-related transactions, including mergers and acquisitions of all kinds. Mr. Johanson also defends ERISA fiduciary actions in Federal Courts throughout the U.S. and is actively involved in defending regulatory and enforcement actions by the Internal Revenue Service and the U.S. Department of Labor. Recognized nationally for his experience and expertise in the ESOP and executive compensation field, Mr. Johanson is a past chair (1993-1995 and 2005-2007) of the legislative and regulatory advisory committee of The ESOP Association. He also is a past chair of The ESOP Association's advisory committee chairs council and is a former member of its board of directors. Mr. Johanson was honored at the 17th annual conference of The ESOP Association as the outstanding committee chair for 1993-94. Mr. Johanson served for more than ten years as General Counsel to The National Center for Employee Ownership and on its board of directors. Mr. Johanson writes and speaks frequently about employee ownership throughout the U.S.



Roberta Casper Watson

Brief Bio

Roberta Casper Watson, a partner with The Wagner Law Group, has specialized in pension and employee benefit law for over 40 years, with significant emphasis on all aspects of employer-sponsored health and welfare and fringe benefit plans, including significant experience with ESOPs, ESOP-owned companies and employer stock held in non-ESOP ERISA plans, including purchases and sales of employer stock, leveraging ESOPs, obtaining various tax benefits available to ESOPs or those selling stock to ESOPs, and administration of ESOP when subject to restrictions as a result of such tax benefits, and navigation of fiduciary rules for ESOPs, as well as, benefit plan configuration, plan preparation and interpretation, claims handling, ERISA reporting and disclosure, benefit issues in the merger and acquisition context, and SPD compliance.

Ms. Watson has practiced law in Boston and Tampa, and is currently based in the firm's Tampa office. She has been listed in the Best Lawyers in America every year since 1995, for 2012 and 2019 was named by Best Lawyers as the Tampa Bay area's Employee Benefits Lawyer of the Year, and has been selected nearly every year since 2006 as a Florida Super Lawyer. Ms. Watson is a past chair of the American Bar Association Tax Section's Employee Benefits Committee, the American Bar Association Health Law Section's Employee Benefits Interest Group, and the American Bar Association Joint Committee on Employee Benefits. She is a founding member of the American College of Employee Benefits Counsel, a national employee benefits honor society that includes as members many of the leading employee benefit lawyers in the country. She has written and spoken extensively on employee benefits issues.

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