RUTGERS
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Employee Stock Ownership Plans
&
Equity Compensation

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Bringing together the worlds of Research, Policy, and Practice

ESOP LEGAL AND FIDUCIARY RESPONSIBILITIES

Presented by

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Good ESOP Candidates

- Non-cyclical slow to medium growth
- Stable cash flow
- Ownership group interested in remaining involved/participating in the business
- Patient long-time horizon—not seeking immediate cash payment in full
- Ownership group concerned about employees and/or long term future of company/motivated by "legacy" or mission goals in addition to cash
- Lack of cash strategic buyers willing to pay significant premium for the company

Some Core ESOP Advantages and Disadvantages

Advantages

- Tax efficient
- Shareholder directed process
- Control over timing
- Legacy

Disadvantages

- Complex
- Regulated
- Often involve Seller notes

What is an ESOP?

- ESOP = “Employee Stock Ownership Plan”
- Qualified deferred compensation plan under ERISA and Internal Revenue Code
- Similar to Profit Sharing and 401(k) Plans
- Must invest primarily in company stock
- Can be leveraged

Typical Goals of ESOP Transactions

- Shareholder Liquidity
- Long-term succession plan
- Corporate and personal tax planning
- Ownership/Partnership incentive for key employees

Significant ESOP Tax Preferences

- Effective deduction of principal on ESOP loan repayment
- Section 1042 Capital Gains Deferral
- Deduction of dividends paid on ESOP shares
- S Corporation ESOP non-recognition of corporate income

Section 1042 Capital Gains Deferral

- Permits shareholders selling to an ESOP to defer indefinitely capital gains tax on sale of shares
- ESOP must own 30% of value of all company stock after sale
- Selling shareholders must purchase qualified replacement property (“QRP”)—stocks or bonds of any domestic operating corporation

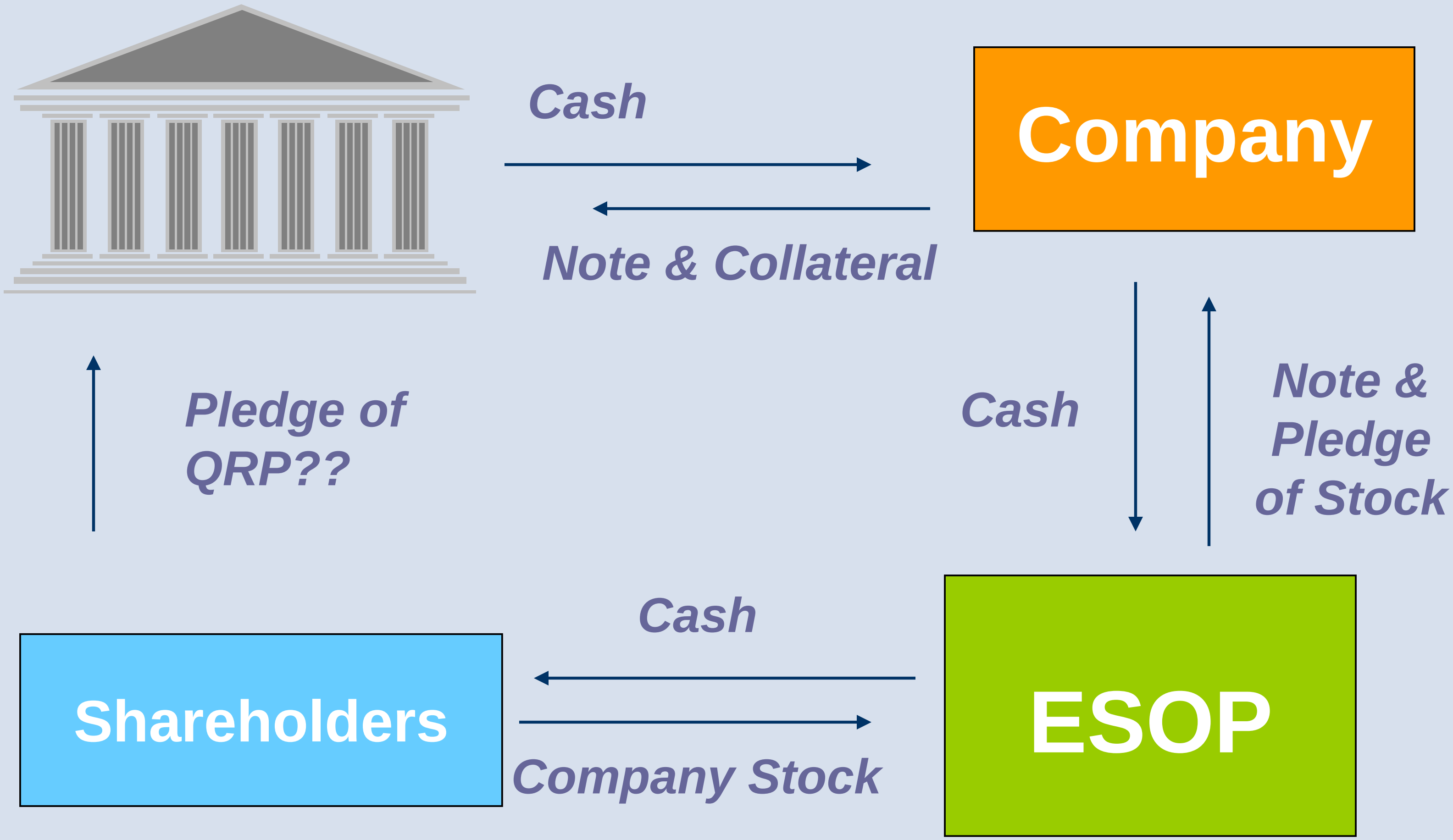
“S” Corporation ESOPs

- “S” Corporation income attributed to shareholders
- ESOP as S Corp shareholder pays no taxes on its share of corporate income
- No section 1042 Capital Gains Deferral

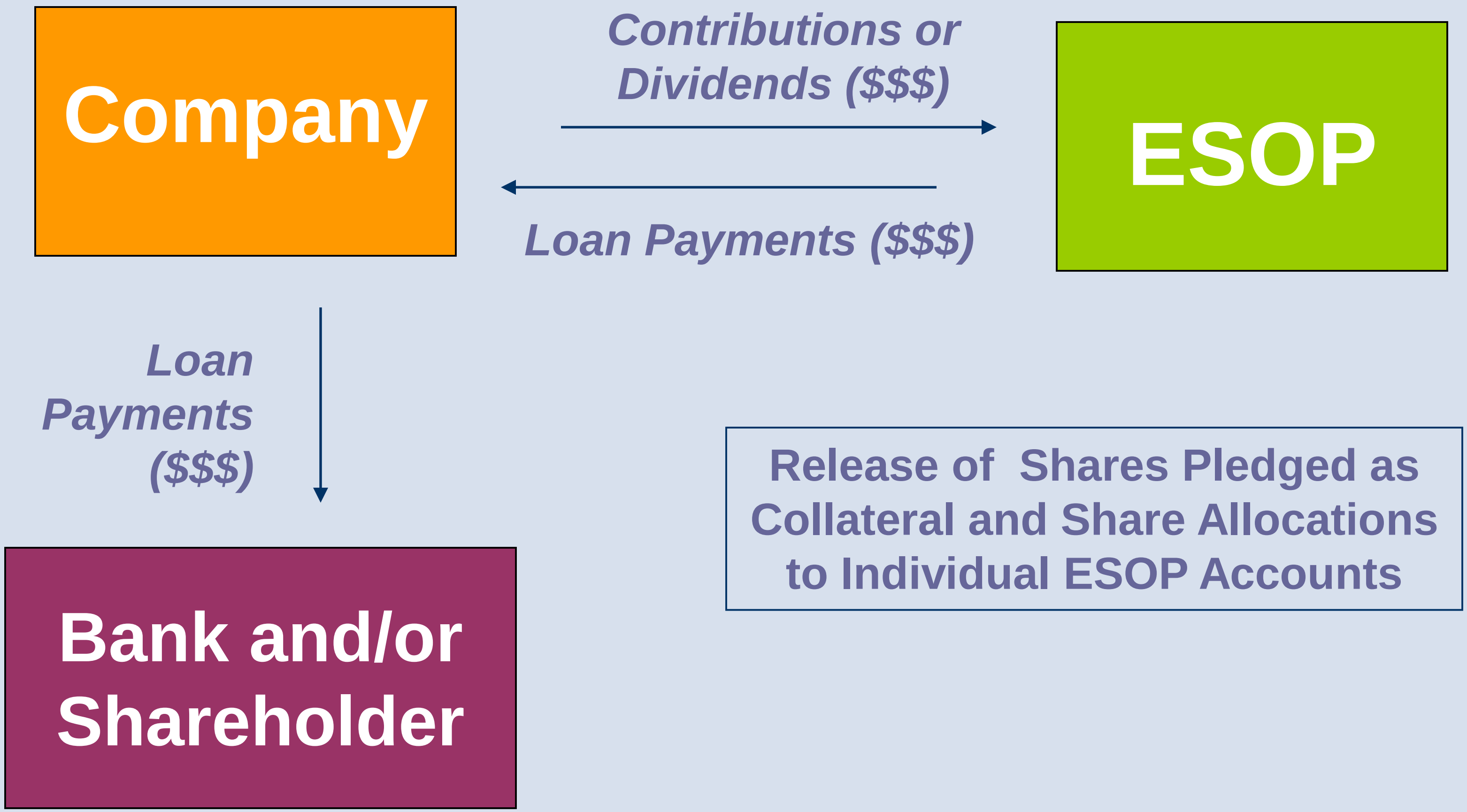
How Does an ESOP Work?

- Company establishes an ESOP Trust
- ESOP Trust purchases company stock from shareholders or company
- Bank or seller provides financing to Company
- Company pays contributions or dividends to ESOP that ESOP uses to repay debt
- Company or ESOP repurchases shares from employees after termination

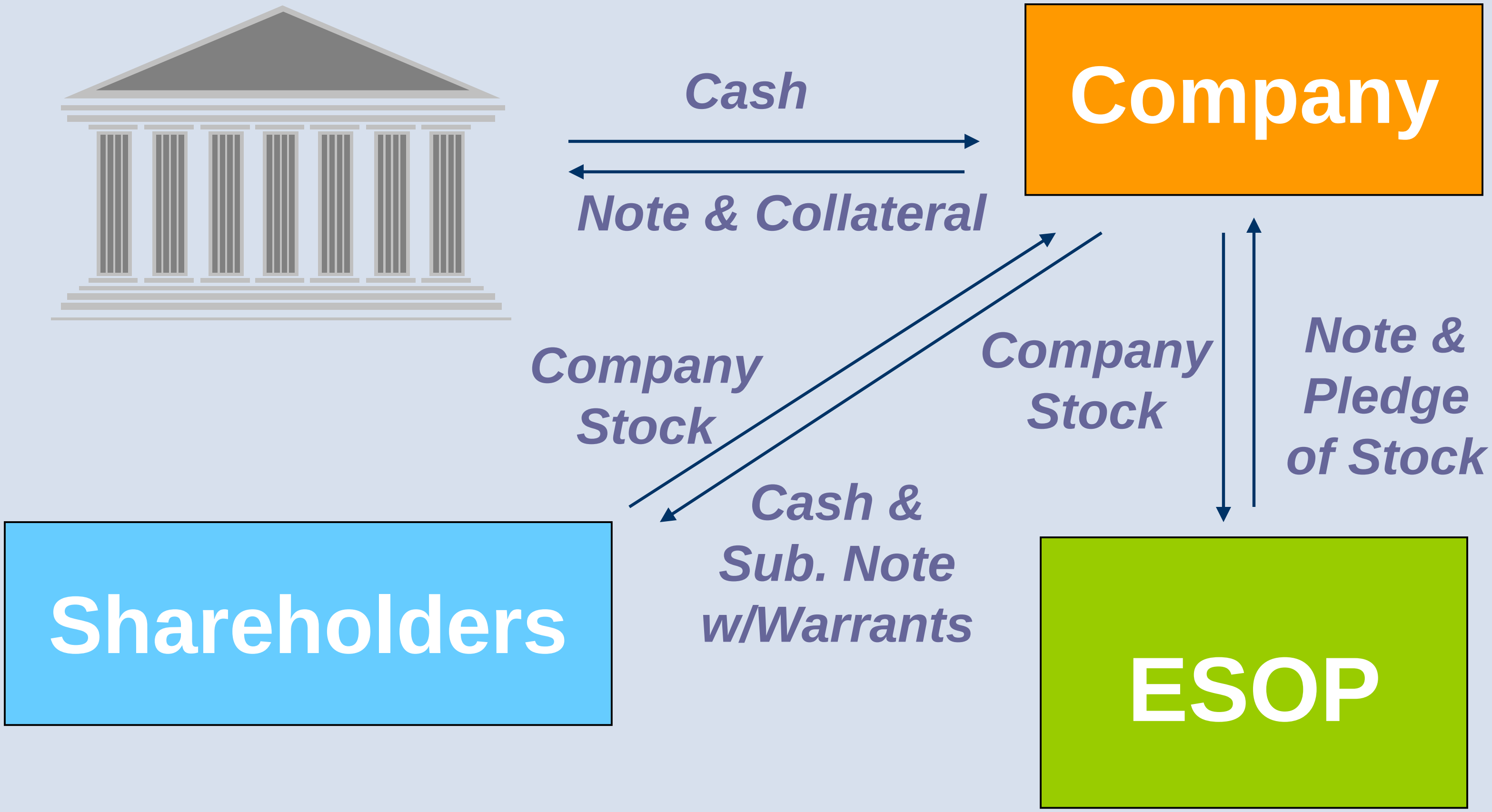
Initial "C" Corporation ESOP Transaction



ESOP Loan Repayment



Initial "S" Corporation ESOP Transaction



ESOP Transaction Concerns

- Valuation
- Financing
- Effect of ESOP on overall benefits structure
- Legal/fiduciary risk
- Cost and complexity

Steps in an ESOP Transaction

- Feasibility study
- Financing
- Appraisal
- Plan Design
- Legal Documents
- Closing
- IRS Determination Letter

Ongoing ESOP Items

- Annual appraisal update
- Annual recordkeeping and administration
- Repurchase obligations
- Communications training and education
- Legal compliance

Key Legal Issues in an ESOP Transaction

- Compliance with ERISA requirements
  - Plan design
  - Prohibited Transaction exemption
  - Independent appraisal
  - Prohibited allocations (Section 409(n))
  - Section 409(p) S corporation rules
- Fiduciary considerations
  - Trustee selection
  - Trustee advisors
  - Fiduciary process

Key Legal Issues in an ESOP Transaction (cont.)

- Tax and Related Considerations
  - Section 1042 election
  - Documenting contributions and loan repayments
  - Documenting plan adoption
- ESOP Transaction Documents
  - ESOP purchase documents
  - ESOP loan documents
- Related documents
  - Financing
  - Executive compensation
  - Related party leases, etc.

Key ESOP Legal Operational Issues

- Contributions/Dividends/Distributions paid to the trust
- Operation of the ESOP in accordance with its terms
- Annual appraisal
- Board monitoring of trustee
- Corporate governance
  - Pass-through voting issues

ESOP Fiduciary Obligation--Definition

- An ERISA fiduciary must act:
  - Solely in the interest of plan participants
  - With the care, skill and prudence that a prudent person familiar with such matters would use under the same circumstances (the prudent expert rule)
  - In accordance with the terms of the plan documents insofar as they are consistent with ERISA

Typical Trustee Decisions

- Deciding whether to buy (or sell) Company Stock
- Decide on how to vote company stock
- Establishing the annual Company Stock valuation

Trustee Role In ESOP Transactions

- Due diligence and transaction negotiation on behalf of the ESOP
- Hire legal and financial advisors
- Review independent appraisal and embedded assumptions and obtain transaction fairness opinion
- Act on behalf of ESOP to enter into transaction

Typical Transaction Terms Negotiated By Trustee

- Price and terms of purchase
- Financing terms, including warrants and inside ESOP loan terms
- Anticipated governance and board composition
- Management compensation, including any deferred compensation or synthetic equity

Typical Ongoing Fiduciary Issues

- Corporate governance
- Offers to purchase the ESOP-owned company and/or the ESOP shares
- Acquisitions
- Valuation
- Benefit levels/repurchase obligations
- Synthetic Equity

ESOP As Shareholder

- Shares owned by an ESOP are held in trust of behalf of ESOP participants and beneficiaries
- The trustee(s) of the ESOP have legal possession of ESOP shares and the ability to exercise all of the rights and privileges of a shareholder
- ESOP participants and beneficiaries have no direct shareholder rights—a participant has no legal right to attend a shareholder meeting or to demand information to which shareholders are entitled

ESOP as Shareholder (Cont.)

- ERISA requires that participants be permitted to instruct the trustee as to voting of individual allocated shares with respect to recapitalization, reclassification, merger, consolidation, dissolution, liquidation, or sale of substantially all corporate assets
- ESOP plan may permit but does not require “pass-through” voting on other corporate matters or instruction as to tender or exchange of shares held by the ESOP

Role And Election Of Board Of Directors

- The Board of Directors is the locus of corporate authority and power
- Directors must be elected by shareholders
- Corporation does not have authority to agree to elect specific directors

ROLE AND ELECTION OF BOARD OF DIRECTORS (Cont.)

- Corporate organization documents may provide:
  - Staggered terms
  - Restrictive nominating provisions

Role And Election Of Directors (Cont.)

- Trustee in 100% ESOP-owned company often has theoretical power to elect and/or remove entire board
- Trustee will (as most institutional shareholders in public companies) defer to management nominees unless there are apparent issues with business or director performance
- Some ESOPs have pass-through vote for or against management slate

Questions ?

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