



Selling an ESOP Owned Company

March 2014

Introduction to the Brereton, Hanley & Co., Inc. Middle Market Corporate Finance Review

The Brereton, Hanley Corporate Finance Review is a periodic journal designed to assist management and investors in the middle market. The journal attempts to address and explain current and anticipated market influences, investor sentiment and the valuation implications of the economic environment; including private company acquisition activity. By introducing periodic data and highlighting critical market issues, we hope that the Brereton, Hanley Corporate Finance Review can help management and investors gain effective insight into the valuation and organization of their business.

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I. Introduction

Due to the fiduciary aspects of ESOPs, the sale of an ESOP-owned company is a complex transaction. This transaction requires special procedures and expertise in order to navigate the requirements to effect a successful sale.

In order for an ESOP-owned company (“target”) to be sold, it must receive no less than “adequate consideration.” This means that any sale transaction must be considered financially fair and prudent on the behalf of (1) the plan, (2) its participants, and (3) its beneficiaries. The sale of an ESOP-owned corporation requires certain experts, including the ESOP trustee as well as the trustee’s independent financial adviser, the Board of Director’s financial advisor (Investment Banker), valuation analysts, and legal counsel. The trustee is tasked with acting as a fiduciary for the ESOP. And, the trustee employs financial and legal advisers to determine the fairness of any proposed transaction and ensure that all regulations and statutes are met.

In order to determine if a proposed sale transaction is fair, the trustee and its financial advisers should perform a thorough due diligence of the target ESOP-owned

Company. The purpose of this due diligence is to determine the fair market value: (1) of the target, (2) of its equity, and (3) of the equity owned or controlled by the ESOP. These advisers should then present their findings to the trustee. The ESOP trustee will make a final determination whether to accept a proposed offer, or, to require the negotiation of different terms and conditions.

II. The Sale Process

The sale process typically begins when the CEO or a Director of the target receives a term sheet or letter of intent from a potential acquirer. Even when an ESOP owns 100 percent of the outstanding stock of the sponsor company, it is usually the board of directors that first receives and considers a proposed transaction.

In other cases, the board may hire an investment banking firm (“Board’s financial advisor”) to actively solicit bids from potential acquirers. The reasons for selling an ESOP-owned company can be many. However, whether it is an unsolicited outside offer or solicited offers vis-à-vis a formally managed process, the Board’s initial review of an offer is usually the first procedure in the sale process.

As fiduciaries it is very important that the board of directors notify the ESOP trustee of the potential sale transaction at the earliest time possible. The board should look at the ESOP trustee as its partner. And, the board should make sure that the trustee has the information it needs to do its part to consummate a successful transaction.

The Board of Directors of an ESOP-owned company has nearly all of the enhanced responsibilities that Directors of publicly-traded companies have. Because of this it is quite common for ESOP-owned company Boards to protect themselves by hiring it’s own financial advisor/investment banker in the event of a sale process. The board has a responsibility to (1) protect the assets of the company and to (2) ensure that the shareholders receive the highest return on their investment. In this capacity, the board should evaluate any and all stock purchase offers.

Typically, the Board’s investment banker will render an opinion to the Board as to the value of the target company. In circumstances where the board relies solely on information from the trustee’s financial adviser, there is the potential for additional layers of complication. This complication may arise due to the fact that the ESOP trustee’s financial adviser is, first and foremost, the



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adviser of the ESOP trustee. If the two parties' motivations become misaligned, then this reliance could present a conflict of interest. In situations where the financial adviser serves two masters by working for both the ESOP trustee and the sponsor company board, there becomes the potential to create: information sharing conflicts or inefficiencies in the negotiation process at best and a failure of fiduciary responsibilities at worst.

All parties should be aware of their responsibilities to maintain their respective fiduciary duties throughout the process. In most ESOP-owned companies, should the Board pursue or respond to an offer to sell, the Board is tasked with negotiating the terms of the offer. However, the Board (and its advisers) and the ESOP trustee (and its advisers) should communicate early and often in the formally managed sale and negotiation process. Even though the Board, through its investment banker, may take the lead in the negotiations, the ESOP trustee ultimately has the final say in approving or disapproving of a deal on behalf of the ESOP. Once the best bona fide offer is received by the investment bankers managing the bidding process and it is shared with the Board, it should also be submitted to the ESOP trustee for review. When the decision is made to proceed with the transaction the ESOP trustee will then require a legal adviser, competent in ESOP regulations, to approve the terms of the deal.

The ESOP trustee may also require its financial adviser to issue a fairness opinion, stating (1) that no less than "adequate consideration" is being paid for the shares and (2) that the deal is financially fair to the ESOP. Pass-through voting is also typically required to sell the shares held in an ESOP.

III. Transaction Fairness and Considerations

The fairness opinion will typically be issued by the existing valuation adviser as of the date of the company sale transaction. It should include a statement that the transaction is fair to the ESOP from a financial point of view. In this capacity, fairness is defined as not receiving less than "adequate consideration" under Section 3(18)(B) of the Employee Retirement Income Security Act of 1974 (ERISA), as amended. This financial fairness is the absolute fairness of the transaction. However, it is also appropriate to give consideration to the relative fairness of the deal. While it is not required that the ESOP receive exactly the same economic return as other parties in the deal, it is prudent to know what that return is relative to all stakeholders and that returns be fair relative to the risks taken. The issue of relative fairness is particularly important in ESOP employer stock sale transactions where the sponsor company management team is offered incentives to remain in place during the sale transition and beyond. The ESOP trustee should be assured that the terms of such programs are reasonable and do not unduly impact the proceeds that would be received by the ESOP.

In the evaluation of an ESOP-owned company sale transaction, there are several factors in both the terms and the nature of the transaction that should be given consideration. For example, is it a strategic acquisition, financial acquisition, or management buy-out (which has its own special considerations)? What are the overall terms and structure of the transaction? Is it an asset sale or a stock sale (tax impact)? Are there any earn-outs or synthetic equity plans? What happens to the Board or to key employees, that is, are there any non-compete, non-solicitation agreements, employment agreements, or termination agreements? Is there any outstanding debt in the ESOP and how is that handled? Are there any unallocated shares and how are they handled (cancel debt in exchange for cancelling shares or allocate shares based on debt payoff source)? What are the voting and disclosure requirements?

IV. Roles & Responsibilities the Parties

The best ESOP-owned sale transactions occur when all of the relevant parties work together cooperatively following best practices, thus avoiding potential scrutiny on the part of regulatory bodies and class action lawyers.

Board of Directors

The Board of Directors must act to maximize shareholder value, including shares owned by the ESOP. As is the case in the publicly-traded company arena, if the Board has decided to solicit or respond to buyer interest in the target company, it is inadvisable to enter into such discussions with only one potential buyer. Given the aforementioned fiduciary responsibilities of the Board, a formally managed sale process providing for multiple potential acquirers to submit offers in a competitive, structured process is considered by the courts to be best practice. The board should evaluate every offer and decide on which offers to recommend to the shareholders via the trustee.

Sponsor Company Management

The management of the sponsor company has a duty to the company and its Board of Directors. In a sale situation, management will be interviewed extensively and will be called upon to provide due diligence support and information. Management may also be in a potential conflict of interest position where their own self-interests are perhaps not aligned with the best interest of the ESOP. In these situations, significant care should be taken to ensure that management fulfills its responsibility to the ESOP-owned company before any personal interests. Where managers also serve on the Board of Directors, this is particularly the case.



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The ESOP Trustee

The ESOP trustee has a fiduciary responsibility to the plan participants and their beneficiaries. Once the Board recommends an offer to the shareholders, the ESOP trustee should evaluate the offer to determine (1) that adequate consideration will be received by the trust and (2) that the offer is fair to the ESOP from a financial point of view. The ESOP trustee should also determine whether it is prudent for the ESOP to enter into the transaction. The structure of the transaction may be such that the ESOP trustee is required to accept voting direction from the plan participants with respect to their allocated shares. In this case, the ESOP trustee will want to assure that the target company makes full disclosure to the participants of all the appropriate information concerning the offer. The ESOP trustee may also want to arrange for the confidential tallying of the participant directions.

Finally, the ESOP trustee will have to determine that the proposed transaction is prudent. In doing so, the ESOP trustee should determine that a prudent man would sell the sponsor company under the proposed terms. Prudence is a matter of judgment, but the ESOP trustee has a responsibility to ensure that the transaction is fair to (1) the trust, (2) its participants, and (3) its beneficiaries.

Special care should be taken to ensure this prudence, as the Department of Labor may require that the trust demonstrate the prudence of the transaction after the fact. Government-imposed penalties for inadequate prudence can be severe. Therefore, it is especially important for the ESOP trustee to use qualified advisers based on experience, knowledge, and qualifications rather than simply on price.

The ESOP Trustee's Legal Adviser

The ESOP trustee's legal adviser, or the ESOP lawyer, has a fiduciary responsibility to the trustee. The role of the legal adviser is to determine that the sponsor company sale transaction doesn't violate company charter documents or any of the terms of ERISA and is structured in an appropriate and legal way.

The ESOP lawyer is also very involved in the negotiation of the "legal-level" issues of the stock purchase agreement and other documents, while the company's investment banker is involved in the "business-level" issues. While the target company through its investment banker and the lender attorneys often negotiate such documents, this adviser also has a major role in the outcome of the negotiations and the transaction. The ESOP trustee legal adviser almost always has deep and specific knowledge of the Employee Retirement Income Security Act (ERISA) and will be very involved in negotiating things such as representations, warranties, and other transaction details.

The ESOP Trustee's Financial Adviser

The ESOP trustee's independent financial adviser may issue an opinion to the ESOP trustee as to whether or not the ESOP trust is receiving no less than adequate consideration and that the transaction is fair to the ESOP from a financial point of view. This fair market value determination should be done in a good faith process whereby the ESOP trustees and the other fiduciaries may make a good faith conclusion of what constitutes adequate consideration for the ESOP-held employer corporation stock. This determination should be in compliance with both Internal Revenue Service and Department of Labor regulations. This financial adviser in an ESOP-owned company sale transaction will typically not have access to the acquiring firm so as to understand things like the synergies that will accrue to the buyer. The acquirer usually works directly with the target company and their investment banker. However, the ESOP financial adviser will try to get as much information as possible by talking with the target company and its investment banker and through independent research.

The Board of Director's Financial Adviser (Investment Banker)

Generally, two distinct sets of financial advisors are necessary to facilitate an ESOP-owned company sale: the Trustee's financial adviser and the target company's Board of Director's financial adviser, or, "investment banker". The investment banker is typically retained on behalf of the company and its Board of Directors to facilitate the following:

- Consult the company regarding the potential price and structure of the proposed transaction(s).
- Structure a transaction to:
 - Achieve the company's and/or selling shareholder's objectives
 - Maximize the probability of obtaining financing
 - Facilitate a favorable opinion from an independent financial adviser regarding the financial fairness of the transaction to the ESOP.
- Prepare a Descriptive Memorandum, a comprehensive document to facilitate a buyer's and capital provider's view and assessment of the target company and the proposed transaction.
- Manage a structured, competitive bidding sale process providing comfort to all constituents that the competitive market process determined the maximum value per share to shareholders, while also facilitating adequate management presentation meetings between target's management and the potential buyer's management to ensure post-transaction culture fit.



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V. Valuation & Termination Issues

Valuation and Fairness

The valuation adviser should provide the ESOP trustee with enough information to make an informed decision. Best practices dictate that the valuation adviser, acting as Financial Advisor solely to the Trustee in this case, provide a Fairness Opinion of the proposed transaction rather than, or in addition to, the annual appraisal.

Plan Termination

When an ESOP is terminated due to a sale or otherwise, there are several tax advantaged options for how to handle the distributions. Each of these options has different benefits and considerations based on the desired post-transaction environment. In the event of plan termination, the ESOP will be wound up and its assets will be distributed (whereby all plan participants become immediately vested). As opposed to simply releasing all of the proceeds in cash, distributions can be rolled over directly into another qualified plan, such as a 401(k) or profit sharing plan. Plan distributions may also be exchanged for the acquiring company's stock, as long as the acquirer's stock is considered to be a "qualified replacement security." Finally, if the acquiring company has an ESOP, then the subject sponsor company ESOP can be merged with the acquiring company ESOP. Or, the acquirer company can simply acquire and maintain the subject sponsor company ESOP after the transaction.

Convert the Plan to a 401(k) or Profit Sharing Plan

In ESOP-owned company sale transactions, the acquiring company can amend the plan to become a 401(k) or profit sharing plan. Similarly, if the target company simply terminates the ESOP, it may rollover the plan assets into one of these qualified plans. This rollover has the benefits of maintaining the plan's vesting schedule and encouraging continued employment. If the amended plan meets the conditions of Internal Revenue Code Section 404(c), then it reduces the fiduciary risk by shifting the investment decision to the plan participant. The amended plan should abide by Code Section 411(d)(6), which protects certain benefits within the plan. The amended plan should be submitted to the Internal Revenue Service with a Form 5300 for a favorable determination letter.

Merge the ESOP Plan with Another ESOP

This transaction structure is slightly more complex. However, it is still a manageable option. This transaction structure has synergistic benefits by combining two ESOP-oriented corporate cultures. However, in this scenario, due diligence should be performed by the advisers on the acquiring company's stock to ensure that the stock offer represents adequate consideration. In addition, shares at the acquiring company should be "qualified employer securities."

V. Summary and Conclusion

Due to the special nature of fiduciary responsibilities within ESOP-owned company structure, the sale of an ESOP-owned target company is a complex transaction fraught with issues that must be navigated properly to avoid legal exposure on the part of company management and the Board of Directors. Such a sale transaction requires special procedures and expertise in order to complete a successful sale. The definition of "success" extends beyond a successful closing to include not receiving future scrutiny on the part of regulatory bodies or class action lawyers.

This transaction structuring requires certain advisers to ensure:

- that the ESOP participants and beneficiaries receive no less than adequate consideration and
- that the transaction is financially fair to the ESOP, and
- that the Board of Directors acted in good faith to maximize the value of the stock of the corporation.

BRERETON, HANLEY AND CO., INC.
Private Investment Banking & ESOP Advisory
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Brereton, Hanley & Co., Inc. is a San Francisco Bay Area investment bank founded in 1995 specializing in:

ESOP Corporate Finance
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