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When an ESOP owns the selling company, benefits issues become paramount. This column explores the key issues that arise in such a transaction, including voting rights and conflicts of interest.

One of the interesting aspects of dealing with benefits issues in a business transaction is how they usually take a back seat to almost everything else. This situation is nearly completely reversed when the target of the transaction is owned by an employee stock ownership plan (ESOP). Suddenly, the benefits issues are thrust into the front seat (even the driver's seat on occasion!) and become of paramount concern to everyone. In addition, having the ESOP as the seller raises many considerations that are not present in a normal transaction.

This article discusses some of the issues that arise when a third-party buyer is acquiring stock from an ESOP. For the most part (except where otherwise noted), it assumes that the stock is not and has never been publicly traded, so that none of the securities registration rules applies. In addition, it assumes that the ESOP is the sole shareholder of the company.

AN ESOP MINI-PRIMER

Before special considerations are discussed, it is important to know a little about ESOPs.[1] An ESOP is a defined contribution plan that is designed to invest primarily in employer securities. In non-ESOP plans that are not participant directed, the plan's investments are not specifically allocated to the participan ts' accounts. Each participant's account holds an undivided interest in whatever the trustee chooses for the plan. In an ESOP, however, the actual shares of employer stock in the plan are allocated to participants' accounts. Therefore, the participant statements reflect the allocation of a specific number of shares of employer stock, plus an account that is invested in other assets (if there are any). When a participant terminates employment, he or she must have the opportunity to take distribution of the stock. If the stock is not publicly traded, the participant then has the right to "put" the stock to the company for the then-current market value. That is, the participant can demand that the employer buy back the stock. This put right can be exercised only at two different option periods. The first period begins on the date of distribution and continues for at least 60 days. If the put option is not exercised during that period, another option period must begin during the following plan year (after the participant has been notified of the market value for that year), and must also last for at least 60 days.

ESOPs have another distinguishing characteristic: they are able to borrow funds from the employer (or from a third party, with the employer's guarantee) to acquire employer stock. ESOPs that have these types of loans outstanding are called "leveraged ESOPs." The stock purchased by the proceeds of the loan acts as the sole security for the loan and is held in suspense within the plan. As the ESOP gradually repays the loan (usually with contributions from the employer), a portion of the shares is released from encumbrance and allocated to participants' accounts. Therefore, as long as the loan is outstanding, some of the employer stock will be unallocated in a suspense account.

PARTICIPANT VOTING RIGHTS AND TRUSTEE VOTING OBLIGATIONS

One of the key issues when purchasing stock from an ESOP is the voting right tha t accrues to participants. If the stock is publicly traded, the ESOP participants will vote their shares in the same manner as other shareholders. When the stock is not publicly traded, however, the Internal Revenue Code (Code) requires that voting rights pass through to participants only in certain circumstances, including the approval or disapproval of:

- A corporate merger or consolidation
- Recapitalization
- Reclassification

- Liquidation
- Dissolution
- Sale of substantially all of the assets of a trade or business
- "Such similar transactions as the Secretary [of Treasury] may prescribe in regulations."

[I.R.C. § 409(e)] It is interesting to note that there is one glaring omission from this list: the sale of the stock of the corporation. In addition, the Treasury has not promulgated any regulations to Code Section 409(e).

One interpretation of this language is that if Congress had wanted participants to vote on a stock transaction, it would surely have been listed with the other similar transactions. In addition, since this is an exclusive list, but for additions by the Secretary that are still forthcoming, there is no obligation to pass through those rights to participants in a stock sale. (Nevertheless, be sure to be very careful about this. Many stock acquisitions are structured as mergers. The enumerated list of transactions requiring pass-through voting includes mergers.)

Nonetheless, a cautious ESOP trustee and a cautious buyer may determine that it is best to have the pass-through voting take place. Why? One reason is that neither the ESOP trustee nor the buyer wants to be in a position of fighting litigation in the future arising from participants' assertion of a right to vote on the transaction. The second reason, which is based on employee relations considerations, is the fact that employee-owned companies often have a culture in which the concern for the employees is paramount. The sale of the ESOP's stock is the *pièce de résistance* of being part of an employee-owned company—the chance for the employees to cash in on their investment of sweat equity. Cutting the employees out of the transaction could contradict the entire culture of the company, and may annoy the employees sufficiently to jeopardize the business's success after the acquisition is complete.

If voting pass-through is desired, but not required under the law because the transaction is a stock sale, it is a good idea for the plan to be amended to provide for the voting in a stock transaction—or, at least, in *this* stock transaction. If this is not done, there is arguably no basis for the participants' voting, and the ESOP trustee may be in the unenviable position of having the legal responsibility to vote the shares, but not the legal obligation to do so based on the employees' directions.

Once the decision is made to have pass-through voting take place (or after it is determined that it is required by law), the question becomes: how is that done? The plan must provide participants with sufficient information to vote their shares properly, and must also provide a mechanism for the vote to occur. Again, there is no guidance on point; however, both the buyer and the target want to minimize the chances of a lawsuit by participants because the vote was improperly handled or the information was insufficient.

Probably the safest course of action is to follow the guidance available under federal and/or state securities laws and from the Securities and Exchange Commission (SEC), even though this body of law does not usually apply to participant voting in an ESOP. One can model the employee voting information statement based on the SEC-required disclosures to shareholders for mergers or proxy voting. The trustee and the target must ask themselves: if this were to end up in litigation, what standard would the court apply to evaluate whether the voting process was proper? In all likelihood, the court would look to the most analogous guidance available, and that is in securities law. Therefore, it only makes sense for the buyer and the ESOP trustee to look there for a road map of how to proceed and to retain qualified securities counsel to assist them in that process. Be prepared, however: the level of disclosure mandated by securities laws is very high, and there may need to be some negotiation about what details are included in the employee voter information statement. In particular, SEC disclosure rules usually require that information about executive compensation be made public, something that companies that are not traded on stock exchanges are unaccustomed to sharing, and loathe to share, with their employees.

Only allocated shares are voted by participants. The ESOP trustee votes any unallocated shares, including those in suspense because the plan is leveraged. Although some plans have provisions that direct the trustee to vote the unallocated shares in the same proportion as the results from the voted shares, such provisions may not be binding. In a 1997 case from the U.S. Court of Appeals for the Eleventh Circuit, the court found that the trustee could follow such a provision only if it was prudent to do so. [Herman v. Nationsbank, 126 F.2d 1354 (11th Cir. 1997), *cert. denied*, 525 U.S. 816, 119 S. Ct. 54 (1998) (mem.)]

The ESOP trustee must vote the allocated shares in the manner directed by the participants, while the trustee retains responsibility for voting the unallocated shares. There is some controversy about how the

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trustee should vote shares that are allocated shares for which no direction is received. One court has determined that the trustee may consider nonvoted shares as defaulting to a given choice, as long as the participants are adequately informed about the ramifications of their failure to vote in the employee voter information statement. [*See* Herman v. Nationsbank, *supra*] If no such disclosure is made, the ESOP trustee must vote the shares in its discretion.

CONFLICTS OF INTEREST

In an employee-owned company, it is common for the top executives to wear at least three hats: (1) they are officers of the company with a fiduciary obligation to the shareholders; (2) they are individual participants in the ESOP; and (3) they are employees of the company. In many cases, they have a fourth role: trustee of the ESOP (or if the ESOP is trusteed by an institution, the executives are generally responsible for directing the activities of the trustee or—at the very least—for hiring and firing the trustee).

When an acquisition of the company is pending, all of these roles put the executives in conflict—some personal, and many legal.

> **Example.**
>
> Susan is the company president and one of a committee of ESOP trustees. In her capacity as an officer of the company, Susan needs to make sure for the good of the company that the transaction is a good fit. She will also be negotiating how the company will operate once it is owned by the buyer, and what changes will be made to the company in connection with the transaction. As ESOP trustee, she owes a duty to the plan participants to ensure that she is getting the best price for the ESOP stock. She needs to consider what employee-participants will be terminated in connection with the acquisition, and whether the transaction is in the best interests of the participants and beneficiaries.
>
> As an individual (and possibly a family breadwinner), Susan is interested in retaining her position with the company once the transaction is finalized, and wants to negotiate the best employment package she can—or, if things go sour, the best exit strategy.
>
> Susan's situation is fraught with conflicts. What is good for her personally may not be good for the other participants. Suppose that the buyer wants the company solely for its client list, and is planning to terminate the employment of everyone but the top executives, who will go work for the new parent with better salaries, more responsibilities, and more prestige. This might be a great opportunity for Susan, but the other employees are likely to be unhappy with the results of the transaction (unless the purchase price is extraordinary).

Even if the facts are not as extreme as those in the above example, whenever the executives are in the position of negotiating the price of the transaction and their own post-transaction compensation packages, it is likely that the conflict will be significant. This is particularly true when the buyer has a dollar amount in mind that is to be divided between the acquisition price and the price of incentives, stay bonuses, and executive compensation in connection with the transaction. In that circumstance, every dollar won by the executives for their compensation packages will directly reduce the price being paid to the ESOP for the stock. At that point, the conflict ceases to be potential and becomes actual.

When an executive is a plan fiduciary, a breach of his or her duties under the Employee Retirement Income Security Act of 1974 (ERISA) subjects the executive to personal liability. [ERISA § 409] The executive must—both for his or her own sake and that of his or her family—reduce or eliminate that exposure. Several courts dictate that the executives must resign from their plan-related positions in favor of an independent fiduciary during the pendency of the transaction. This will enable them to pursue their personal considerations without fear of violating their fiduciary obligations to the plan participants. Alternatively, the courts have also recognized that the executives can seek independent counsel and advisors and conduct an "intensive and scrupulous" investigation of the proposed transaction and then carry out the transaction with the greatest degree of care. [Donovan v. Bierwirth, 680 F.2d 263 (2d. Cir. 1982); Danaher Corp. v. Chicago Pneumatic Tool Co., 635 F. Supp. 246 (S.D.N.Y. 1986)] The second alternative, however, is probably not practical for an executive who wants to protect him- or herself from claims of wrongdoing. A court reviewing the transaction is likely to presume that the continued fiduciary relationship with the plan produced an

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immutable conflict of interest, and will scrutinize the transaction and the executive's behavior in connection with the transaction extremely carefully. The executive has to ask him- or herself: why do I want to let myself in for that?

An independent trustee can be retained to oversee the transaction and to make sure that it is fair to the participants. The trustee can also retain the services of other necessary advisors, such as an appraiser to make sure that the purchase price is appropriate, a lawyer to ensure that the contract to sell the stock is properly drafted, and a compensation specialist to make sure that the dealings with the executives are reasonable and that the participants' interests are protected. Usually the fee for the trustee's services will contain some premium in recognition that there is litigation risk involved in overseeing an ESOP transaction. Nonetheless, the independent trustee may also limit its range of discretion to just those areas in which actual or potential conflicts of interest with the executives have been identified (and insist on being a directed trustee with regard to all other issues).

When to get the ESOP trustee involved is another question that must be addressed by the executives and the buyer. On the one hand, the executives want to extricate themselves from the process as soon as possible, because their conflicts of interest arise fairly early on. On the other hand, no one wants to involve the independent party in the transaction until it is clear that the acquisition has a good chance of success. In addition to the fact that the trustee's fees begin to accrue when it is retained, the resignation of the employee-trustees in favor of the independent trustee will generally become public (at least within the company) very quickly. As a result, knowledge of the pending transaction will become widespread, causing concern to the employees involved. Neither the buyer nor the executives want this to occur before they are ready.

As a result, it is important that the buyer and the executives identify the areas of negotiation that cannot take place until the independent trustee is retained, and then scrupulously avoid those issues until that happens. Convincing the buyer and executives to be compulsive about this may be difficult, since they will be anxious to resolve these important elements of the transaction, and they will likely be thrown together in meeting after meeting during the early negotiating process. Nevertheless, the executives must be extremely sensitive to this highest of legal fiduciary duties to the ESOP and its participants, and be aware that their personal financial security is at risk.

THE PRICE

If the ESOP is leveraged, the proceeds of the encumbered stock will go to the lender to repay the loan. If the proceeds exceed the outstanding loan principal and interest, the balance will be an additional gain to the plan participants. Because this is a gain on the sale, its allocation to participants' accounts is not an annual addition subject to the 25 percent or $35,000 limitation of Code Section 415.

Things are different if the value of the stock has decreased, so that the sale of the encumbered stock is insufficient to repay the loan. In that case, the lender will have no further recourse against the plan, but could have a claim against the company or the individuals who originally sold the stock to the ESOP if they acted as guarantors of the loan (this is quite common). If the company is the guarantor, this could further reduce the price that the buyer is willing to pay for the stock.

PROTECTING THE BUYER

It is common in acquisitions for the seller to indemnify the buyer for such issues as a breach of the acquisition agreement, a breach of the warranties made by the buyer, or misrepresentations made in the transaction. Often, a portion of the transaction price is held back by the buyer until the end of the indemnification period. Alternatively, the acquisition is structured as an installment sale, so that the buyer can hold back installments if disputes arise.

Because the buyer becomes a party in interest with regard to the ESOP (as the shareholder of the target, which is the ESOP's sponsor), many of the normal protection devices raise prohibited transaction issues.

Installment transactions are generally not possible when the seller is an ESOP, because of the prohibited transaction rules. An installment sale is essentially a loan between the seller and buyer that is being paid over time. This is prohibited by the Code and ERISA. [I.R.C. § 4975(c)(1)(B); ERISA § 406(a)(1)(B)]

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Similarly, if the buyer simply holds back part of the purchase price, the transaction will be comparable to a loan and could be considered to be prohibited. At the very least, the buyer puts itself in a dangerous conflict of interest if it seeks to retain the held-back amount to the detriment of the ESOP participants.

It is common for the buyer and the ESOP to agree to place the held-back funds in escrow with a third party. In this manner, the funds are not within the reach of the buyer unless the contingencies for which the escrow amounts are retained occur. Although there is not specific guidance on poin t, it appears that an escrow does not, in and of itself, raise prohibited transaction concerns. [*See, e.g.,* PTE 82-197 (regarding Janney Montgomery Scott, Inc. Employee Stock Ownership Plan), in which an escrow is used and is not even commented upon by the Department of Labor] Nevertheless, how the escrow is structured and how the funds are released to either the ESOP or the buyer can produce conflicts of interest that must be avoided. For example, if the president of the buyer becomes the ESOP trustee after the transaction (or if the trustee is subject to direction by the president), an escrow that provides for release of funds on agreement between the buyer and ESOP creates a conflict for the president.

If the holdback in the ESOP is tied to specific concerns, the escrow agreement can be drafted to narrowly define the events that permit a release of funds to the buyer. For example, suppose that the target is involved in litigation with a third party at the time of the acquisition, and the possible judgment against the target is $1 million. The buyer is not willing to pay the full purchase price and to absorb the risk of the litigation. If the litigation is concluded in the target's favor, however, the buyer is willing for the full purchase price (less litigation fees and expenses) to be paid to the ESOP. In that situation, $1 million of the purchase price may be set aside in escrow pending the results of the litigation, with the funds going to pay the litigation judgment or to the ESOP participants. In addition, the escrow agreement may provide specifically for the payment of the legal expenses, and the attorneys involved in the litigation may be directed to bill the escrow directly for their fees and costs. This permits the buyer to extricate itself from the decision making of how the money is used, and, in fact, the buyer never has the opportunity to receive the funds directly—they will go to the ESOP, the plaintiffs in the lawsuit, or the lawyers.

If the hold-back is ultimately allocated to ESOP participants, it will be based on the share allocation to participants' accounts at the time of the purchase. As a result, it is likely that there will be additional funds due to participants who terminated employment before the escrow is finalized and have been fully cashed out of their nonescrow funds. This may produce a logistical challenge, requiring the re-establishment of accounts for these individuals pending a second payout. In addition, new election forms will likely be required for this additional amount.

CONCLUSION

Acquiring a company from an ESOP involves significant complexities that are not present in other types of transactions and are often completely unexpected by the mergers and acquisitions team representing the buyer. In addition, the potential liabilities are far greater than they are under normal business acquisitions, because of all of the ERISA implications that are normally not present in a corporate purchase. The challenges may be surmounted by careful planning in all stages, particularly before negotiations begin in earnest, and by having the client get competent ERISA and securities advice.

Footnotes

1 To know more, see Ferenczy, Employee Benefits in Mergers and Acquisitions, Chapter 8 (New York: Panel Publishers 2000). To know lots more, see Howett, Employee Stock Ownership Answer Book (New York: Panel Publishers 2000).

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