You Don’t Know What You Don’t Know: ESOP Compliance Issues

Issues and Case Studies:

Misunderstood or Overlooked Administration, Fiduciary & Financial Requirements for Mature ESOPs

2014 ESOP Invitational
March 23-25, 2014
Williamsburg, Virginia

Michael A. Coffey *Lisa J. Tilley, CPA* *S.G, Brooke Tucker, ASA*

This Conversation is About…

How to Keep the ESOP Hamster Running

Why ESOPs Don't Always Stay on Track

Agenda for Our Conversation

A. Companies operating maturing ESOPs already know the basics. Beyond that, there is a real need to understand both the array of operating rules and, most of all, how to coordinate their application. You hire an expert TPA, but a misstep on data collection or communication can have negative results.

B. Reliance on intermediaries such as insurance agents or attorneys who assisted with implementation of a strategy to communicate to all parties is not prudent.

C. A clear delineation of duties is necessary to assure defensible appraisals are issued.

D. We will briefly review some case studies with problems that could have been avoided with some cause and effect evaluation, quick cross referencing or clear communication.

Despite Best Efforts, Mistakes Are Made

ESOP stock flows change for various reasons in a plan year.

1. Share release
2. Redemptions as a part of the distribution process
3. Transactions
4. Stock contributions

The Equity universe of a corporation may change as well

1. Restricted stock plan
2. Deferred compensation plan
3. Stock options
4. Other creation of synthetic equity
5. Redemptions
6. Stock contributions

What Does a Change in the Equity Universe Affect?

1. Financial statements
2. Appraisal: enterprise value and per share price
3. Calculations for Dividend or S-distribution purposes
4. 409(p) testing for S-Corporations
   a) Allocation of Contributions upon failure
   b) Nuclear meltdown

Foolproof Compliance?

1. Communicate any equity changes to CPA, TPA, appraiser at the time it is "officially created or issued".
2. HR and CFO need to review completed TPA data request each year. HR does not always know about Key Executive Plans immediately.
3. Stock ledger = financials = appraisal = recordkeeping
4. Provide corporate financial statements with footnotes and entire appraisal report with commentary on executive compensation to TPA for cross referencing.
5. When reviewing before issuance of financials, appraisal and recordkeeping cross reference for accuracy.

Not Prudent: What One Company Did

1. S-Corporation established an ESOP in 2006, over time acquired 100% of the shares, paid off the ESOP loans and continued with 60 employees.
2. Had a share price appreciation each year until the "economic bubble" of 2008 when the stock depreciated over 10% a year for 2008 and 2009.
3. Implemented "rich" deferred compensation agreements in 2010 for the two shareholders still working.
4. Accrued long term liabilities on the financial statements which the appraiser took into account beginning in 2010.
5. Provided the appraisal report which included the financial statements and a section on key executive compensation to the record keeper.
6. Experienced depreciation in share value of over 20% in 2010 and 2011.
7. Upon hiring CCR to perform a repurchase liability study, the questions began. 409(p) was an issue and corrections were made.

What Happened to Another Company-Incorrect Share Release

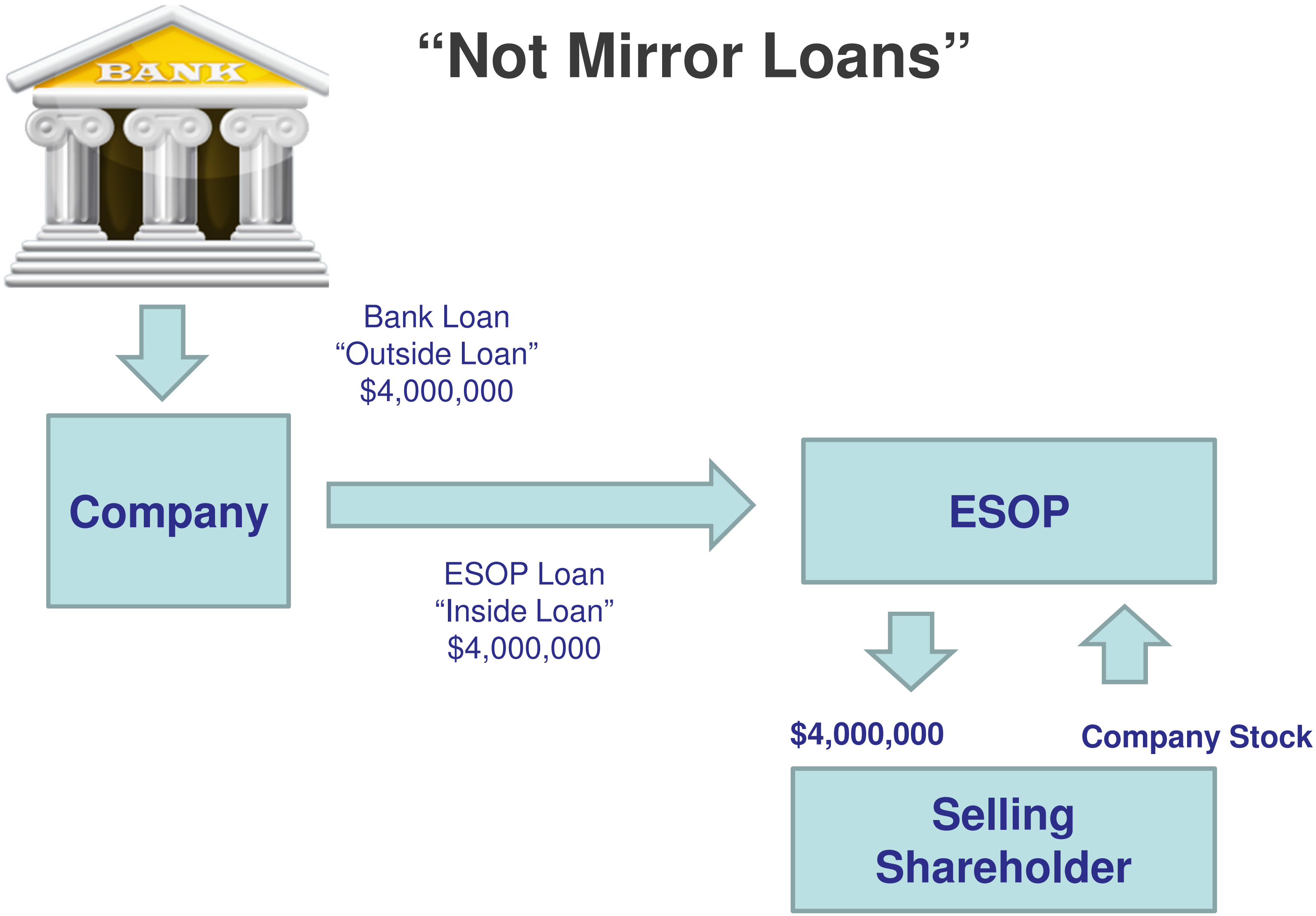
1. S-Corporation established an ESOP in 2001, over time acquired 100% of the shares, paid off the ESOP loans and grew to have 150 employees.
2. Had multiple shareholder loans in place from a transaction in 2004.
3. Paid seller notes with S-distributions and contributions.
4. In 2004, the record keeper double counted a share release causing the shares allocated in the ESOP to be overstated in physical count and about $450,000 of value.
5. Hired CCR to perform a repurchase liability study where the problem was discovered and corrections were made going back 8 years.

Another Case Study-Use of S-Distributions to pay ESOP Debt

1. S-Corporation established an ESOP in 2000, 27% of the stock was purchased in tranche 1.
2. A second ESOP stock transaction occurred in 2008 after the initial loans were paid off to allow the ESOP to own 51% of all shares.
3. Large S-distributions were paid to the ESOP each quarter to pay the loan payments. There was no excess cash in the ESOP to serve as a source of funds for payment. The CFO assumed all funds were available to pay down debt on the second tranche of stock, which is not the case. Only distributions on those "specific" shares are useable to pay ESOP debt on those shares.
4. Hired CCR to perform a repurchase liability study where the problem was discovered and corrections were made.

Case Study-Internal ESOP Loan vs. External

“Not Mirror Loans”



Case Study-Internal ESOP Loan vs. External

1. S-Corporation established an ESOP in 2002, 100% out of the box.
2. Borrowed money from bank and made a loan to the ESOP which were mirror loans.
3. In 2007, Bank loan and internal loan was renegotiated with new loan agreements executed. The more rapid pay down, higher interest rate bank loan amortization schedule was provided to the record keeper and CPA as the basis for releasing shares and tracking ESOP debt service payments.
4. Hired CCR to perform a repurchase liability study where the problem was discovered and corrections were made going back several years.

Appraisers-Special Considerations

1. Recognizance of DOL scrutiny of appraisal report and determination of value.
   a. DOL ESOP Project
   b. Increased budget
2. Reliance on management financial projections.
   a. Look back, how close were they?
3. Consideration of the ESOP repurchase liability in determining value.
4. Review of appraisal by Auditing CPA firm.
5. What is the appraisers duty to ongoing Trustees?
   1. Are the Trustees performing duties correctly to evaluate appraisal report and participate in the process?

Case Study Involving Governance

- Government Contractor
- $18 million revenue S Corp ESOP in 2007
- $8.8 million ESOP Note
- Former Owner
  - Chairman of the Board
  - Note Holder
  - Trustee

Governance *(continued)*

- Accelerated ESOP Note by $1.3 million in 2008
- Reduced FMV by $800,000
- 2009 Performance was down
- Total FMV decrease was $1.7 million.

Governance *(continued)*

- 2010 Performance was flat.
- Late 2010 shifted to another inside Trustee.
- 2011 appointed Institutional Trustee.
  – Modified ESOP Note to restore net working capital.
  – Most of value has been restored.
- 2012 DOL Audit – passed.
- 2013 FMV Appraisal in Process

Turnaround Case Study

- HVAC and Electrical Contractor - $22 million in revenues.
- ESOP Since 1996 – no debt.
- Contracted to $15 million in revenues with heavy losses in 2008-2010.
- Board hired outside CEO to effect turnaround.
- Inside Trustee

Turnaround *(continued)*

- Compensation Package - $330,000 salary and 30% of net operating profit for four years.
- 2011 Compensation = $ 540,000
- 2012 Compensation = $1,325,000
- 2013 Compensation = $1,400,000 Estimate
- 2013 Revenue = $30 million and net profit is $3 million.

Turnaround *(continued)*

- FMV Flat due to working capital deficiency – on going.
- Contractual Compensation Obligation
- Good profitability – no cash flow.
- FMV will return in 2014

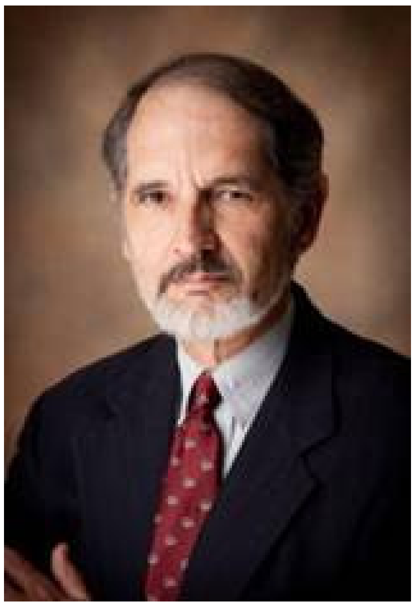
Fiduciary Obligations

- ERISA's fiduciary duties require:
  - operate plan *solely* in the interest of participants and beneficiaries
  - for the exclusive purpose of providing benefits and defraying reasonable expenses
  - with the care, skill, prudence and diligence of a prudent person *familiar with such matters*
    - "reasonable expert standard"
  - reduce risk by diversifying
    - "Employer stock" exception
  - in accordance with the plan documents
  - trustees <u>and</u> board members are fiduciaries

Questions?

CORPORATE CAPITAL RESOURCES LLC

TUCKER & MELTZER
VALUATION ADVISORS



Michael_Coffey@ccrva.com
Office – (540) 345-4190

Lisa_Tilley@ccrva.com
Office – (540) 345-4190

brooke@tuckerandmeltzer.com
Office – (410) 779-9402