Employee Ownership Conference

Overhauling an ESOP: What To Do When Your Business Conditions Change Drastically Post-Transaction

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Discussion Overview

1. Most ESOP stories are positive with desired outcomes for all parties. There are, however, some cases where post transaction circumstances require adjustments to assure a successful outcome.

2. Recent studies indicate very few leveraged ESOP deals fail, only about 1.3% defaulted on their loans between 2009 and 2013. A higher percentage, 3.1% had to restructure their loans but successfully paid off lower debt during the same time period.

3. Recent activity of the Department of Labor focused on “valuation” and the “process” fiduciaries follow in determining the value of employer securities being purchased by or already held in an ESOP should be considered.

Protecting Value in an Economic Downturn

1. Unexpected circumstances may cause:
   a) Insufficient cash flow to support leveraged ESOP debt service.
   b) A decline in employer stock value.
      - Re-evaluate valuation methodology?
      - Avoid sharp drops over a short period.
   c) Change in plan administration.
      - Modify distribution rules?
      - Change account segregation (cash vs. stock) provisions?
   d) Reduction in balance sheet strength.
      - Bonding problems.
      - Bank debt covenant violations.

Protection of Value – Non-Economic Factors

2. Unexpected circumstances:
   a) Death of shareholder or key employee
      - Personal bank guarantees
      - No corporate owned life insurance
   b) Fraud/embezzlement
      - Absence of Directors & Officers insurance
      - Absence of internal controls permits the problem
   c) “Brain drain” with no cross training
      - Absence of employment/non-compete agreements
      - Institutional knowledge of key employees lost
   d) Selling shareholder(s) “white knuckle grip” on control is resistant to needed change
      - Successor management is discouraged

Case Study-Economic Downturn

1. S-Corporation established an ESOP in 2010, acquired 100% of the shares in 2011. Seller note used for most of the sales proceeds.
2. Share price depreciated due to impact of ESOP debt plus a reduction in revenues.
3. Cash flow is severely limited.
   - ESOP debt service cannot be made in a timely manner.

Case Study-Downturn *(continued)*

Renegotiate loan terms of ESOP/seller note?

1. Negotiate the original purchase price down?
2. Extend term of original note?
   - Will the shares released still provide a substantial recurring benefit to plan participants as required under ERISA?
3. Reduce interest rate?
4. Move to temporary interest-only payments?
   (a) Will any of these change the share release method or rate of release, i.e. principal-only vs P+I share release methodology?

   (b) Who negotiates on behalf of the ESOP?

Case Study-Downturn *(continued)*

- Coordinate any actions with the appraiser to ascertain the impact on value first.

Case Study 2: Economic Downturn

1. S-Corporation established ESOP in 2004, acquiring 51% of shares using an outside bank loan with a five-year amortization and a longer internal loan between the company and the ESOP.
2. Outside bank loan is paid off. In 2011, cutback in workforce reduces the payroll requiring partial plan termination.
3. Share price drops 30%.
4. Internal loan requires larger amortization than IRC 404 deductible limits and available S-earnings permit.
   a) Special Independent Trustee engaged to evaluate impact on participants.
   b) Special Trustee and Board of Directors, after a series of negotiations, agreed to write down the internal ESOP loan to the FMV of the unreleased shares.
   c) Balance sheet strengthened and share price is enhanced due to reduction of contra-equity account.
   d) Revised loan payments now within 404 deductible limits.

Treatment of Debt

What are the financial statement or tax treatment effects of any changes?

Outside Debt of Company

- Senior Lender
- Mezzanine Lender
- Outside Sub-debt Lender
- Seller Debt

Inside Debt between ESOP and Company

1. Any required or necessary changes?
2. Impact on stock value?

   (a) Depends upon appraisers original approach concerning post transaction impact of ESOP debt on share price.

   (b) Balance sheet strength improves.

What if Nothing is Done?

What happens to participant accounts?

- Value self corrects down?
- Protection for those in payee status?
- Employee perception-possible mass exodus?
- Effects of default on ESOP loan.

Fiduciary breach?

Litigation?

- Insurance coverage?
- Personal liability?

The Importance of “Process When “Things” Change

Board of Directors

1. Formal Meetings
   a) Written minutes
2. Unanimous consents in lieu of meetings for specific actions
   a) Written consents adequately describing actions
3. Composition
   a) Shareholders only
   b) Combination of shareholders/key employees
   c) More diversified, reflecting broad business/financial experience
   d) Minimum number of total directors
      - Odd for tie breaker
      - Sufficient outside directors to chair compensation and audit/finance committee
      - Depends on size of company

The Importance of “Process When “Things” Change

Board of Directors

4. Indemnification of Board members
   a) Insurance (D&O vs. fiduciary liability)
   b) Bylaw provisions (general assets of corporation)
5. Fiduciaries
   a) Board of Directors appoints ESOP Trustee
   b) Not protected under D&O coverage

The Importance of "Process"

Trustee

1. Selection
   a) Board of Directors appoints Trustee(s)
   b) Outside Trustee uses:
      - Special Independent Trustee for transaction purposes and any post-transaction adjustment purposes
      - Consulting fiduciary to serve with a Board of Trustees
2. Trustee Is a Fiduciary
   a) Charged with responsibility to operate the plan for the exclusive benefit of ESOP plan participants.

The Importance of "Process" *(continued)*

Trustee

3. Responsibilities

   a) As legal owners of employer securities and cash investments

      - Must follow a written Investment Policy Statement.
      - Vote ESOP shares annually to select the Board of Directors.
      - Special vote pass –through (proxy) to individual plan participants for seven major reasons: merger, liquidation, recapitalization, sale of substantially all of the assets of the corporation, dissolution, reclassification and consolidation.
      - Voluntary vote pass-through to confirm stock sale benefits.

The Importance of “Process” *(continued)*

Trustee

3. Responsibilities *(continued)*

   b) Interact with the Board of Directors relative to:

      - Financial projections
      - Anticipated capital expenditures
      - Developing strategy for funding of ESOP repurchase liability obligations
      - Executive compensation

The Importance of “Process” *(continued)*

Trustee

3. **Responsibilities** *(continued)*

   c) **Preparation of adopting resolution summarizing any transaction**

   d) **Adopt process for review of annual appraisal update**
      - **Schedule meeting with the appraiser**
      - **Review document request from appraiser**
      - **Review draft valuation report**
      - **Prepare minutes reflecting discussion of appraisal report**
      - **Inquire & understand the content and methodology**

The Importance of “Process” *(continued)*

Insurance Coverage

1. Board Members and Trustees are Fiduciaries under ERISA and may become personally liable for a breach of fiduciary duty.
2. Fiduciary liability insurance
   a) Directors & Officers (D&O) and Employment Practices Liability (EPL) coverage is not sufficient.
   b) Fiduciary Liability Coverage may be a part of existing Commercial & General Liability Coverage.

The Importance of “Process” *(continued)*

Insurance Coverage

Fiduciary liability insurance (Continued)

c) If not a part of your existing CGL coverage, a separate policy is required.

d) How much coverage is enough?

- Many policies limit coverage to $1 Million, on a “claims made” (not “claims incurred”) basis.
- Is 30% – 40% of asset value sufficient?
- How much can you afford?
- Is fiduciary coverage separate or is shared with other coverage for limit purposes?

Key Take-Away's

1. Despite best efforts and good management, "Things Happen."
2. Be prepared to adapt to a changing economic and business environment.
3. Establish and adhere to a "Process" that will aid in adapting to changing circumstances and DOL scrutiny.

Bonus Case Study 3: Economic Downturn

1. S-Corporation established cash warehouse ESOP in 2010.
2. 2012 transaction ESOP acquires 100% of shares using seller financing.
3. ESOP debt causes post transaction share price to decrease 40% in 2012.
4. Unexpected regulation severely impacts business model in late 2013. Workforce reduction reduces the payroll requiring partial plan termination.
5. Share price drops another 20%.
6. Board decides to cease operations and the following occur:
   a) Special Independent Trustee engaged to evaluate impact on participants.
   b) Appraiser renders opinion stock value is zero.
   c) Special Trustee and Board of Directors, after a series of negotiations agreed to an S-dividend of cash in an amount close to 2013 value of allocated shares.
   d) Seller buys back shares for a nominal purchase price.
   e) ESOP was terminated and all participants paid 100% of value of S-distribution plus proceeds of sale in 2015.

Bonus Case Study 4: Economic Boom-Trustee Aware of Unsolicited Offer

1. S-Corporation ESOP owns 100% of outstanding shares.
2. A turnaround of a company that 10 years ago did not have a solid balance sheet.
3. Chairman of the Board=President=ESOP Trustee.
4. Company holds attractive franchise agreement and has been successful for a number of years.
5. Unexpected call from the representative of a strategic buyer is disregarded by the President. There is no desire or intent to sell.
6. Repeated contacts from the strategic buyer become more serious and the "Trustee" hat must be put on.
7. A non-binding letter of intent is received for 10 times EBITDA.
8. The Trustee feels he must hire a Special Independent Trustee and enter into negotiations to sell regardless of his personal and employee/participant interests.

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Questions?

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