Evolving Issues on ESOPs

2019 Fall Tax Meeting – American Bar Association

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CURRENT ENVIRONMENT

• High degree of regulatory oversight relating to ESOPs
  • Internal Revenue Service (IRS)
    • Form 5500 audits are becoming more prevalent
    • Audit findings following litigation
  • Department of Labor (DOL) – Substantial audit activity, increasingly focused on recent transactions/newly implemented ESOPs

• Litigation Exposure
  • DOL audits resulting in filed complaints
  • Plaintiff counsel focused on overvalued stock purchased by ESOP
DOL AUDIT/LITIGATION FOCUS

• DOL’s Projections and Valuation Methods/Issues
  • Criticism of projections as compared to historical operations
  • Criticism of projections as compared to projected growth of an industry
  • Focus on shifting technologies, customer concentration risk, industry competition
  • [Valuation Method – Discounted Cash Flows] Elements of discount rate, including company specific risk premium, are incorrect
  • Assertions of **added** control premiums, **lack of** discounts for minority interest, or too-low discounts for lack of marketability
  • Transaction debt analysis did not consider ability to pay seller debt balloon payment (e.g., junior debt is commonly structured not to require amortized principal payments in deference to outstanding senior debt requirements so, absent prepayments, would require a significant outlay of cash at the end of the term)
  • Second stage transaction – the incumbent valuator is no longer independent as the company may understand the valuation methodology to be undertaken in a second stage transaction as a result of historical review of the annual valuation process
**DOL AUDIT/LITIGATION FOCUS**

- **DOL’s Control Concerns**
  - Assertions of control covenants in documents
  - Statements that continuation of board participation (pre and post transaction) indicates a lack of control
  - Nomination of board members by the company for a directed trustee indicates a lack of control
  - Suggests a discount for lack of control should be applied to the underlying valuation (not just a lack of a control premium)

- **DOL’s View of Synthetic Equity**
  - Management Incentive Plans reserving grants based on equity value/stock value are dilutive (regardless of feature, performance requirements) and should be discounted from transaction value
  - Warrants should be treated as fully dilutive equity, despite the fact that these instruments are a cost of financings (like interest expense)
DOL AUDIT/LITIGATION FOCUS

• DOL Concern with Diligence and Negotiation Process
  • SWOT analysis
  • Documentation of the diligence review
  • Lack of sufficient time between transaction kick-off and closing
  • Lack of transaction scrutiny during committee meetings (assertions that meetings were minimal as to number held and duration)
  • Deficient record as to concerns raised/addressed during the trustee process
  • Negotiation process included discussions over a few terms and over the course of only “several” turns of a term sheet indicating a low level of negotiation participation by the trustee
CHALLENGING PROCEDURAL ISSUES ON DOL REVIEW

• Providers involved in the DOL process
• Concerning procedural matters relating to certain audit steps
• Repeated requests for tolling agreements
• Hindsight review
PRIVATE PLAINTIFF ACTIONS - CLASS ACTION CLAIMS

• Predicated on allegations of ESOP overpayment
  • Complaints filed primarily based on customary post-transaction drop in value, citing other allegations that “will likely have evidentiary support”
  • Complaints echo DOL allegations
    • Decrease in value following transaction leverage
    • Unrealistic projections
    • Conflicts of interest
    • Lack of control post transaction

• *Lee v. Argent Trust Company*, as trustee of the Choate Construction Company ESOP – “Plaintiff, however fundamentally misunderstands the nature of the December 2016 transaction that created the Choate ESOP and Choate’s subsequent valuation”
  • Court holding that a post-transaction value, alone and representing the debt incurred in the transaction, is insufficient to establish damages
CONTINUED APPLICATION OF DUDENHOEFFER

• *Dudenhoeffer* – “more harm than good” standard – plaintiff must “plausibly allege an alternative action that the defendant could have taken that would have been consistent with securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than to help it”

• *Jander v. Retirement Plans Committee of IBM et al.*, 2nd Circuit – plead specific alternative actions that could have been taken to avoid further loss in value
  • Supreme Court to review
SELL-SIDE LITIGATION

• *Rush v. GreatBanc Trust Company*, as trustee of the Segerdahl Corporation Employee Stock Ownership Plan – allegations that a sale without an auction process could not ensure fair market value

• *Godfrey v. GreatBanc Trust Company*, as trustee of the McBride & Son Employee Stock Ownership Plan – allegations that the employer’s redemption of stock held by the ESOP was less than fair market value that would have been paid by an unrelated third party
WHAT MAY BE COMING....

• Burden shifting analysis
  • Pleading/review showing burden is being placed on the fiduciary to “prove up” the defense versus plaintiff proving the complaint

• Application of “Farnum” analysis to warrants?

• IRS prohibited transaction findings following litigation
TRANSACTION CONSIDERATIONS

• Transaction structure considerations
  • Redemption and sale to the ESOP
  • Second stage transactions

• Provider engagement

• Diligence process
  • SWOT analysis
  • Document process
  • Quality of earnings / other market studies

• Active negotiation of transaction terms and documents
TRANSACTION CONSIDERATIONS

• Direct trustee vs. discretionary trustee status
• Documentation of appropriate corporate governance acknowledging who/what group “controls” voting
• Use of warrants
  • Event protection
  • Limits on contractual restrictions
• Management Incentive Plans
• Transaction insurance alternatives
  • Disconnect between the transaction and ongoing ESOP requirements on an implementation transaction
• Sale of an ESOP owned company – auction?