

Planning a Successful ESOP Transaction

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Topics

- Sell-Side Advisor
- Trustee Selection and the Request for Proposal (RFP)
- Trustee Due Diligence
- Negotiations
- Plan Design
- Financing
- Documentation
- Closing
- Post-Closing

Sell-Side Advisor

- Feasibility
- Structure
 - Partial
 - 100%
- Financing
 - Bank
 - Seller
- Plan Design
- Benefit Level/Repurchase Obligation

Trustee Selection and the RFP

Responsibility for selection

- Clarify any delegation of responsibility to a committee or individual(s) who will select the trustee
- Have a well-documented, prudent process
- Issue a written RFP
- Collect written responses and related materials
- Finalize selection in writing

Trustee

- Internal v. External
- Directed v. Discretionary
- An external, discretionary trustee is advisable for an ESOP transaction

Trustee Selection and the RFP

- Background
 - Trustee/trust company history
 - Individual trustee
 - Trust company
 - Specific industry experience
 - Depth of Experience of Professionals
 - Number of ESOP professionals
 - Length of their experience
 - Membership in NCEO and other associations
 - Number of ESOP transactions in the last 3 years
 - Number of ongoing clients
 - Size of ESOP transactions in the last 3 years (smallest/largest based on value)

Trustee Selection and the RFP

- Background
 - Trustee's Committee and Process
 - How many people serve on the trustee's committee that will approve the transaction?
 - What are their backgrounds?
 - How often does the committee meet during transactions?
 - Key issues the committee will focus on?
 - Liability Insurance
 - Amount
 - Any specific coverage requirements for transaction
 - Will the trustee be a named insured?

Trustee Selection and the RFP

- Background
 - Prior and current Department of Labor (DOL) investigations
 - Prior and current lawsuits
 - DOL
 - Participants
 - Party to a process/settlement agreement?
- Indemnification
 - Breach of fiduciary duty standard
 - Negligence versus gross negligence standard
 - Misconduct versus gross misconduct standard

Trustee Selection and the RFP

- Process
 - Lead representative
 - Expectations on projections
 - Application of DOL Process Agreements to transaction
 - Approach to value determinations
 - Availability/timeline
 - References

Trustee Selection and the RFP

- Fees and Agreements
 - Transaction fees / engagement letters
 - Trustee
 - Valuation Advisor (VA)
 - Legal counsel
 - Nondisclosure agreements
 - Post-transaction arrangement
 - Discretionary regarding valuation
 - Discretionary regarding voting
 - Discretionary regarding non-stock investments
 - Post-transaction fees

Trustee Due Diligence

- Trustee Determines Value
 - Adequate Consideration
 - Fair Market Value (FMV)
 - Engage and rely on VA
- Selection of VA
 - Independence
 - Experience
 - Credentials
- Selection of Legal Advisor

Trustee Due Diligence

- Timeline
- Contact list
- Transaction summary
- Closing checklist
- Due Diligence
 - Document Request List
 - Accessible, well-organized data room!

Trustee Due Diligence

- Kick-off Meeting
 - Agenda
 - On-Site Management Interviews
 - Tour of Facilities
- Management Interviews
 - Company History
 - Organizational Structure
 - Customers/Competitors/Suppliers
 - Previous offers to sell (LOI's)

Trustee Due Diligence

- Management Projections
 - Who prepared them?
 - Any potential conflicts of interest?
 - Key Assumptions - Process
- Valuation Review
 - Valuation Approaches
 - Discounted Cash Flow
 - Capitalization of Earnings
 - Guidelines Companies
 - Question Assumptions and Key Inputs
 - Understand Conclusion and Document the Process
 - VA Checklist
 - Trustee Checklist

Trustee Due Diligence

- Valuation Review – Key Areas
 - Earnings Adjustments
 - Projection Support
 - Determination of Risk Factors (Discount Rate)
 - Selection of Market Multiples
- Fairness Analysis
 - Valuation Ranges
 - Financing Terms
 - Management Incentive Plans
 - Employment Agreements/Noncompetition Agreements

Negotiations

- Terms Sheet/Spreadsheet
 - Transaction Overview
 - Key Terms
 - Financial terms
 - Governance
 - Management incentives/employment agreements/noncompetes
 - Pre-Closing Conditions/Post-Closing Covenants
 - Indemnification
- Bank Financing
- Definitive Agreements

Plan Design

- Plan document
 - Individually designed document provides flexibility
 - Proposed pre-approved plan
- Match provisions in other retirement plans
 - Key definitions (Compensation, Disability, Highly Compensated Employee, Normal Retirement Age, Years of Service)
 - Eligibility (Age, Service Requirement, Exclusions)
 - Vesting (Graded v. Cliff)
 - Allocation Conditions (e.g., 1,000 hours, Last-Day Requirement)

Plan Design

- Compliance Testing
 - Section 414(s) – compensation definitions
 - Section 415 – annual additions
 - Section 410(b) – coverage testing
 - Section 409(p) – S corporation nondiscrimination rules

Plan Design

- **Distributions**
 - Types: Normal retirement age, Disability, Death, Severance
 - Installments over 5 years
 - 5-year delay for severance
- **Distribution Policy**
 - Rebalance, Recycle, Redeem
 - Segregation
 - Diversification
- **Consider drafting the Plan as stringently as the law will allow**
 - Can always change the Plan in the future to provide more favorable provisions

Financing

- **Typical Sources**
 - Senior Bank Debt:
 - Multiple of EBITDA (e.g., 2x-3x)
 - 4-5 Years (short duration)
 - LIBOR + 150-300 bps
 - Junior and Subordinate Seller Debt:
 - Multiple of > 3x AEBITDA
 - 5-10 Years or more
 - 6%-8% Cash Interest (Plus Warrants?)
- **Other Possible Sources**
 - Mezzanine Debt
 - 401(k) Lateral Transfer

Financing

- Example:
 - Senior Bank Loan \$8M
 - 5-year term
 - LIBOR plus 200 bps
 - Company Excess Cash \$4M
 - Seller Note \$8M
 - 10-year term
 - Interest only for 5 years
 - 7.5% interest
 - Warrants (5.5%)
- Total \$20M

Financing

- Bank Diligence
 - History of Management
 - Bench Strength
 - Industry
- Collateral coverage requirements
- Cash flow requirements
- Personal Guaranty
- Pledge of Assets
 - Real Estate held by Owner
 - Corporate-Owned Life Insurance

Financing

- Senior Debt Transaction
 - Bank Loan Documents
 - Collateral
 - Subordination of Seller Debt
 - Legal Opinions
 - Company Opinion
 - ESOP Opinion (?)

Documentation

- Pre-Closing Corporate Matters
 - Updated Articles
 - Updated Bylaws
 - Have corporate records/minutes in order
 - Any Corporate Restructuring or Stock Splits
 - Terminate shareholder agreements
 - Leases
 - Title to real property/title insurance
 - Environmental issues (phase 1 study)
 - IP filings (patents, trademarks)
 - Third-Party Consents
 - Governmental authorizations

Documentation

- Pre-Closing ESOP Matters
 - Plan Document
 - Trust
 - Summary Plan Description
 - ESOP Committee Guidelines
 - Benefit level study
 - Section 409(p) test, if applicable

Documentation

- Pre-Closing/Closing ESOP Matters
 - Trust Account
 - Trust EIN
 - ERISA Fidelity Bond
 - ERISA Fiduciary Insurance

Closing

- ESOP Transaction
 - Closing Checklist (Exhibit A)
 - Shareholder Rights Agreement
 - Addressing Contributions, Distributions, and Dividends
 - Corporate Governance and Board of Directors
 - Independent Directors
 - Limits on Compensation
 - Noncompetes
 - Fiduciary Insurance
 - Bond
 - Related-Party Transactions
 - Financial statements (audited)
 - Repurchase studies
 - SAR plan

Closing

- ESOP Transaction
 - Shareholder Rights Agreement (continued)
 - Event Protection
 - Sale of the company
 - Termination of the ESOP
 - At what percentage?
 - Financial statements (audited)
 - Determination letter filing (Form 5300)
 - Cooperation on tax issues
 - Maintaining ESOP status/S corporation status, if applicable

Post-Closing

- Post-Closing
 - Working capital adjustment
 - Distribute SPD/Employee rollout
 - Appoint independent director(s)
 - IRS Determination Letter submission
 - TPA agreement
 - SAR grants
 - Fiduciary insurance and bond, if not already obtained
 - 1042 election
 - S election, if applicable

Don't Forget!

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Exhibit A

Closing Checklist including:

- Board Consents
- Certified Articles/Certificate(s) of Good Standing
- Secretary's Certificate
- Trustee's Certificate
- Agreement
 - Purchase v. Redemption
 - Purchase Price Adjustments
 - Clawback or Earnout
 - Liability for unaudited financial statements
- Disclosure Schedules
- Shareholder Rights Agreement
- Investor Rights Agreement
- Fairness Opinion
- Management representation letter
- ESOP loan documents
- Seller loan documents
- Warrants
- Updated stock certificates and stock powers
- Updated stock ledger