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Legal Considerations for Buyers and Sellers of ESOP Companies

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Legal Considerations for Buyers and Sellers of ESOP Companies

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Like other tax-qualified retirement plans, ESOPs are required to be established with an intention to be permanent. However, companies owned, in whole or in part, by an ESOP ("ESOP companies"), like non-ESOP companies, are bought and sold on a regular basis and engage in the full scope of corporate transactions. The fiduciary obligations of ESOP trustees require that the trustee be open to the possibility of engaging in corporate transactions, including the sale of the company if the appropriate situation presents itself. In many ways, selling an ESOP company is no different than selling a non-ESOP company. There are, however, unique matters that arise in the course of selling an ESOP company that buyers and sellers need to consider when negotiating the transaction. The other articles in this publication explore several of these situations. This article discusses the legal considerations that arise in the sale of an ESOP company.

Unless otherwise noted, this article explores the stock sale of a middle-market ESOP company, since this represents the typical transaction involving the sale of an ESOP company.

Representations and Warranties When Selling an ESOP Company

In most transactions involving the sale of a company or its assets, a potential buyer will require someone to provide representations and warranties about the company and its operations. The representations and warranties, in conjunction with the buyer's due diligence, present information about the company and its operations. Additionally, the representations and warranties effectively shift risk to the party who receives the proceeds of the sale by imposing liability for breaches of the representations and warranties, as explained in more detail below when discussing indemnification. Finally, true, accurate, and complete representations and warranties also serve as a condition to closing in transactions where there is an executory period between signing the transaction agreement and closing the transaction, thereby giving the buyer an opportunity to walk away from the deal or renegotiate in the event that the buyer discovers a material issue that was not properly disclosed. The representations and warranties are not to be ignored. They are very detailed, which is why they take up a surprisingly large portion of the relevant purchase or merger agreement.

In many closely held middle-market companies, majority shareholders are in a position to know or ascertain whether the representations and warranties are true, accurate, and complete, which is why the representations and warranties are often made by the majority shareholders. ESOP trustees, on the other hand, are generally not involved in the company's operations and consider the ESOP to be a stockholder that has a passive investment in the company. As such, an ESOP trustee will typically refuse to make representations and warranties about the company and its operations even though there is no legal prohibition to doing so. From the buyer's perspective, this can be a challenge and lead to protracted negotiations or anxiety if the buyer does not feel confident of adequately understanding or hedging against the risk of the transaction. In some cases, the buyer may even seek to effectively hold more in reserve for unknown risk by paying less. In this sense, an ESOP-owned company is very similar to a publicly traded company, where the owners are truly passive investors and thus cannot make such representations and warranties.

Representations and warranties do not exist in a vacuum. Most transaction agreements have extensive "disclosure schedules" that permit the seller to list several items that are exceptions to, or provide additional detail about, the representations and warranties. It is common for disclosure schedules for ESOP companies to be fairly sparse. This is a mistake. ESOP trustees should require management to make full use of extensive disclosure schedules to help mitigate against possible liability and the risk of a transaction not closing.

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Indemnification and Related Topics

Because the buyer uses the representation and warranty provisions of the applicable agreement in part to shift risk, it will typically require the seller to indemnify the buyer for any misstatements in the representations and warranties or exceptions thereto that are not disclosed in the disclosure schedules. Indemnification is a legal concept whereby one party makes a legally binding commitment to cover any losses and expense that arise from and are related to the misstatement. In other words, the seller promises to cover any harm due to the seller's incorrect or incomplete disclosure. For example, if a liability arises that should have been disclosed in the agreement but was not, then the buyer overpaid, and it is only fair for the seller to reimburse the buyer for this liability.

Indemnity Limited to Escrow

Most ESOP trustees and their counsel take the position that the ESOP is permitted to indemnify the buyer, but indemnification claims will be capped and limited solely to amounts placed in escrow. An escrow is an amount deducted from the purchase price and held by a third party, who may use the escrow only for purposes of satisfying indemnity claims pursuant to a detailed escrow agreement. Most buyers insist on an escrow for the transaction so that there is a ready source of funds to satisfy any breaches of the representations and warranties, rather than relying solely on an unsecured promise to pay. If there is money left in the escrow account and no unresolved claims following a fixed period of time (typically 12 to 24 months following the closing of the transaction), then such funds will be returned to the sellers, typically in proportion to their ownership interests at the time of the sale or as provided in the applicable agreement. By requiring indemnity claims to be limited solely to amounts in escrow, the ESOP trustee is effectively capping the potential post-closing exposure so that the ESOP's participants and beneficiaries cannot be liable for any exposure beyond such amounts. This is another example of how selling an ESOP company is similar to selling a publicly traded company, since the shareholders in a publicly traded company have no post-closing exposure.

The purported reason why ESOP trustees claim that indemnification must be limited to amounts placed in escrow is due to the prohibited transaction rules of the Internal Revenue Code of 1986, as amended (the "Code") and the Employee Retirement Income Security Act of 1974, as amended (ERISA). The prohibited transaction rules prohibit, among other things, certain direct or indirect transactions between a plan and a "disqualified person" (the term used by the Code) or a "party in interest" (the term used by ERISA).[1] Of relevance for indemnification, the Code and ERISA prohibit a direct or indirect lending of money or other extension of credit between the plan and a party in interest. The concern is that if indemnification permits a buyer to recover from the assets in the ESOP trust, then the buyer, who perhaps could be a party in interest, has extended credit to the ESOP trust or vice versa. Because of this risk, ESOP trustees flatly refuse to permit the buyer to seek indemnification from the ESOP trust.

One underused tool for dealing with indemnification for ESOP companies is representation and warranty insurance, which is insurance individually underwritten to pay claims related to breaches of representations and warranties. Payment of premiums for the insurance is typically a matter of negotiation between buyer and seller. In many cases, using representation and warranty insurance will result in more net consideration being paid to the ESOP than solely using an escrow arrangement.

Escrow Considerations in Valuation

The use of an escrow account to settle indemnity claims raises a very interesting question. What is the purchase price: the stated purchase price, or the stated purchase price minus the amount placed in escrow? This question is very important for the trustee to answer, in consultation with the appraiser, who is engaged by the trustee to complete an interim valuation of the company and issue an opinion that the terms of the transaction, taken as a whole, are fair to the ESOP from a financial point of view. That is because ERISA requires that the consideration received in the transaction is no less than "adequate consideration" as defined

1. Although there are minor differences between the Code's use of the term "disqualified person" and ERISA's use of the term "party in interest," such differences are not material for purposes of this article, so both terms are used interchangeably.

in ERISA Section 3(18). In determining the transaction price, most ESOP appraisers take the position that only consideration that is not at risk for indemnity claims should be considered when determining whether the ESOP received adequate consideration. As such, the assets held in the escrow account are typically not considered for this analysis.

ERISA does not require a trustee or appraiser to exclude the value of the escrow account from its determination of adequate consideration. If the escrow account, or a portion thereof, will not be excluded from determining adequate consideration, then the trustee and the appraiser should be able to provide justification for why the escrow was not completely excluded from their adequate consideration analysis. For example, the appraiser could survey available industry information for indemnity claims to determine what percentage of escrow assets is ultimately paid to sellers to determine what ratio should apply to the analysis. There are, however, no formally approved methods of making this determination. Most appraisers and trustees, therefore, prefer to exclude the entire value of the escrow account from the analysis since this presents little risk that they overvalued the transaction consideration for fiduciary purposes.

The exclusion of the escrow account from the adequate consideration analysis can make negotiating a transaction more difficult for both buyer and seller. Most sophisticated buyers and sellers recognize that if full disclosure has been made and risks properly valued, all or a large percentage of the escrow account will likely be returned to the sellers, and the escrow acts as an "insurance policy" for claims that were not envisioned. Because the treatment of the escrow account by most appraisers and trustees is at odds with conventional transactions, the parties may have a different perspective of the total deal value.

For example, assume a $150 million transaction with $15 million of that amount set aside in an escrow account. Most buyers believe that they are paying $150 million for the company but require that the seller set aside $15 million of that amount to reimburse the buyer if there is a claim that reduces the value of the company by this amount. Most sellers look at it the same way. An ESOP seller, however, views this transaction very differently. The ESOP seller instead looks at this as a transaction for $135 million with a potential for up to $15 million more if there are no claims. This different viewpoint complicates negotiations, especially if all or a portion of the $15 million is the difference between whether the trustee and appraiser can determine that the sales price satisfies the adequate consideration requirement. To the extent that the ESOP has engaged a qualified investment banker to run a competitive process for selling the company, as discussed in the article "Evaluating Offers to ESOP Companies: The Case for Engaging an Investment Banker" in this publication, these issues can be negotiated more easily because the market process really dictates adequate consideration.

Joint and Several Indemnification

Where the ESOP is the sole recipient of the transaction proceeds, the ESOP, through the indemnity escrow, will be solely responsible for indemnity claims. If, however, the ESOP is not the sole owner of the company's stock, or there are other parties, such as warrant holders, who have a financial interest in the transaction, indemnification becomes more complicated.

The buyer's favored approach to indemnification when there is more than one shareholder is to require the sellers to provide joint and several indemnification for breaches of representations and warranties. Joint and several liability is a legal concept that provides that the harmed party (the buyer in this case) can seek total recovery from any party (any seller in this case), who is then required to individually satisfy the complete liability and seek recovery from other parties, if applicable. Joint and several liability does not work when the ESOP trust is a party to a sales transaction.

If the ESOP is one of several owners and is party to an agreement that requires joint and several liability, then the ESOP could be liable for 100% of an indemnification claim even though it was not the 100% recipient of the transaction proceeds. This situation is impermissible under the prohibited transaction rules discussed earlier because the ESOP could be indirectly providing an extension of credit to the other shareholders since it could legally be liable for all indemnity claims.

Rather than joint and several liability, an ESOP trustee will instead require that the representations and warranties and any related indemnification are several rather than joint and several. This means that

each party is separately liable for its share of the indemnification claim in proportion to the proceeds that each party received in the transaction. For example, if there were two owners, a 60% majority owner and a 40% ESOP owner, under several liability, the majority owner would be liable for only 60% of the indemnity claim and the ESOP would be liable for only 40% of the indemnity claim.

Sellers' Representative

When there are several shareholders in a sale, most buyers prefer to work with a single person or entity for matters that arise after closing, such as approval of indemnity claims or releases of the escrow. This person is typically referred to as a sellers' representative since he or she is tasked with representing the interests of all sellers. Most ESOP trustees take the position that the sellers' representative cannot represent the ESOP's interest because the ESOP must make its own decisions. The primary reason for this is because the trustee does not believe that ERISA's fiduciary requirements permit the trustee to delegate its discretion on post-closing matters even though there are no explicit prohibitions on the use of a sellers' representative.

Working Capital

Working capital is the difference between current assets and current liabilities. The buyer and seller agree on what level of working capital is needed for the ongoing operations of the company. This target level of operating liquidity, or working capital, is often heavily negotiated between buyer and seller. Due to the fact that the components of working capital often fluctuate on a monthly, seasonal, or other basis, it is quite common for the company's balance sheet at closing to vary from the agreed-upon level of working capital. As such, there will often be adjustments after closing to ensure that the company has the agreed-upon level of working capital. Where the balance sheet is stronger than the target level of working capital, this results in an adjustment in favor of the seller. Where the balance sheet is weaker than the target level of working capital, this results in an adjustment in favor of the buyer. For the same reasons described above regarding the use of an escrow account to satisfy indemnity claims, ESOP sellers will require that there is a working capital escrow account to satisfy potential working capital adjustments after closing. A working capital escrow account may also be set up by a buyer to satisfy any adjustments in favor of the seller. For the same reasons discussed earlier related to a sellers' representative and joint and several indemnification, the ESOP trustee will typically require that any adjustments in favor of the buyer will be on a several (rather than joint and several) basis and that the trustee retains discretion to approve adjustments rather than rely on a sellers' representative.

Stock vs. Asset Deal: Pass-Through Voting

Transactions that are structured as a sale of the company's stock generally do not require that the ESOP's participants and beneficiaries are given the ability to vote on the transaction.[2] The ESOP trustee is the party that has the sole discretion as to whether it should be a party to the transaction. If, however, the transaction is instead structured as a sale of assets (rather than stock), then the Code requires that the trustee must give the ESOP participants the ability to direct the trustee as to how the shares in their accounts should be voted for the transaction. Because of this complicating factor, as well as factors related to winding down the ESOP after closing, most ESOP companies prefer that the transaction is structured as a sale of stock rather than a sale of assets. There may, however, be certain benefits to the buyer in structuring the deal as an asset deal, particularly with respect to limiting liability and tax matters, which may make it worthwhile to the buyer to buy the assets instead of stock.[3]

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2. Although not required under the Code, some ESOP plan documents give participants the right, in a stock transaction, to direct the trustee as to how the shares in their accounts should be voted. If so, then participants must be given this ability even though it is not required under the Code. In addition, if the transaction involves the sale of stock in a publicly traded company, then the Code requires that all participants be given the right to vote.
3. Although there are tax reasons why a buyer may prefer an asset purchase rather than a stock purchase, most stock purchases can be structured to still take advantage of the tax rules that apply for asset purchases, so this is typically not the primary factor in the structure of the transaction.

Closing Thoughts

Although ESOP companies are bought and sold on a regular basis, such transactions present unique legal and structuring considerations that are not present in transactions that do not involve ownership by an ESOP. For buyers who do not have an ESOP or do not have ESOP experience, this additional complexity may appear to be a barrier to a successful transaction. On the other hand, if the parties have advisors experienced with ESOP transactions and are proactive in addressing the unique issues involved in buying and selling an ESOP company, the issues are addressable and can even provide informed buyers a competitive advantage over less experienced suitors and can enable sellers to maximize net proceeds while minimizing risk.

Ed Renenger, *a lawyer and shareholder of Stevens & Lee, advises business owners on how to sell their companies to its employees through an ESOP and also provides legal advice on other ESOP-related transactions. Ed also advises ESOP trustees on their fiduciary obligations in ESOP transactions and when unique situations arise in already established ESOPs.*