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SPECIAL FEATURE

ESOPs from the Corporate Counsel Perspective

By Samuel Nagler

In 2010, two long-standing clients completed their first employee stock ownership plan transactions.

These also happened to be my first ESOP transactions, so I thought I would share some of the lessons I learned on these transactions with corporate counsel who may be experienced in most types of transactions affecting corporate clients, but inexperienced with ESOPs.

The benefits of ESOPs are well documented.

Among other things, they cause employees of the company to become "owners" and, in many cases, with proper communication, to become more loyal, motivated and productive employees.

For the selling shareholders, they create a market for their shares which would otherwise generally not exist.

There are also potentially significant tax benefits, including deferral of gains for the selling shareholder in a C corporation and, in the case of an S corporation, effectively a reduction in income tax attributable to the percentage of the company's shares owned by the ESOP.

Galvanized by these prospects, my clients assembled a team consisting of an ESOP advisor and counsel, a lending bank (and, ultimately, lender's counsel) and myself, as corporate counsel, and proceeded to closing mode.

In each case, I was pleased the closings occurred substantially on time and as contemplated. However, there were some surprises along the way that counsel should be aware of:

You and your client will need to get comfortable with the roles of the attorneys.

In each instance, the ESOP plan and trust were drafted by ESOP counsel, who was extremely experienced and knowledgeable on all aspects of ESOPs.

Counsel patiently answered the many questions I had about the transaction, and the relationship was cordial, constructive and collaborative. Nonetheless, ESOP counsel's client was a separate entity, the ESOP Plan and Trust itself, so counsel's loyalty was by necessity to his or her client.

Apparently in some transactions, the company hires its own ESOP counsel to look over ESOP counsel's shoulder in reviewing the plan and trust documents and, to the more limited extent ESOP expertise is helpful, the transactional documents.

However, in each case my client was already paying my fees, bank counsel fees, ESOP counsel fees and its consultant's fees, and understandably had no appetite to pay yet additional fees. My client and I had to get comfortable with the fact that ESOP counsel's careful review of all ESOP-related issues would also inure to the benefit of the proponent of the ESOP, my client.

You may be in a technically adverse relationship with the key employee of your client.

In each transaction, I had represented the company for over 20 years and had a very close working relationship and friendship with the company's leader.

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In one transaction, ESOP counsel required that the company enter into an employment agreement with its founder; in another, the key employee took back financing from the ESOP.

For reasons of economy, in each case the key employee elected not to retain separate counsel. Accordingly, I tried to be the "honest broker," communicating the requirements from ESOP counsel and comments back from the key employee.

In both cases, it seemed quite odd not to be on the "same side" technically as the individual with whom I had developed such a close relationship over the years.

Be prepared for a "real" stock purchase agreement.

In the first of the two transactions, I assumed there would be a document evidencing the purchase of the shares by the ESOP from the selling shareholders.

I naively thought that this would be a simple, straightforward document similar to what one sees when one insider sells to another. What I learned, however, is that the ESOP has a fiduciary duty to the Plan participants (i.e., the employees) to perform the type of due diligence an arm's length stock purchaser would conduct.

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In each transaction, we were presented with a lengthy stock purchase agreement, replete with the typical representations, covenants and schedules. My clients were less than enthusiastic about compiling the various schedules, retrieving documents, providing feedback to me as I negotiated the agreement.

Moreover, the agreement was subject to negotiation only within the contours of what a sophisticated, completely arm's length purchaser with a fair degree of leverage would agree to. So where a "I would not give this level of indemnification to any shareholder buying only X percent of the shares" approach might work, a "Why can't we all be friends?" will not.

Be prepared to explain to your client that they do not have the typical rights of a creditor.

In each transaction, ESOP counsel drafted the documents evidencing and securing the loan from the company (and in one, from the selling shareholders as well) to the ESOP.

In each case, the loans were secured by a pledge of stock from the ESOP to the company.

I was surprised to see that the note did not provide for and, in fact, prohibited acceleration, and that the pledge agreement for the stock only allowed secured party remedies with respect to that portion of the pledged stock equivalent to the particular payment that was not made.

This was not a matter of ESOP counsel simply using a "pro-borrower form," but required by the applicable regulations, which took some explaining to the client.

Prepare to engage in multiple closings at once.

Corporate counsel needs to simultaneously represent the company on the closing for (a) the stock purchase; (b) the bank financing; (c) the closing on the financing provided by the company to the ESOP; and (d) if applicable, the closing on the seller financing.

Among other things, ESOPs cause employees of the company to become "owners" and, in many cases, with proper communication, to become more loyal, motivated and productive employees.

There was yet another mini-closing in one transaction because one of the selling shareholders — an S-corporation eligible estate planning trust established by the founder of the company — had an institutional trustee which balked at signing the ESOP Stock Purchase Agreement due to the numerous warranties and representations.

We arranged for a separate purchase of these shares by one of the selling shareholders.

The bank financing in each case was made easier by the fact that the bank already had an existing lending relationship with my client, avoiding any inter-creditor issues. Even so, in each transaction the loans represented a higher degree of loan exposure for the bank, and there were specific issues relating to the ESOP that had to be addressed.

In one case, the bank initially required an assignment by my client of all of its rights as lender against the ESOP. This created some tension until the bank relented, since my client saw the ESOP as an entity it had created for the benefit and protection of its employees and did not want the bank to have even the theoretical right to exercise enforcement remedies against the ESOP.

It was also a somewhat eye-opening experience for the founders of the company in one of the transactions to realize that due to bank underwriting standards, one of their goals for the ESOP, diversification of their own portfolios, could not be fully achieved. The bank required that a substantial portion of the funds received by the founders as payment for the stock be pledged to the bank as collateral for its ESOP loan to the company, and there was extensive negotiation as to the amount pledged and the terms and conditions governing the gradual release of these funds from the pledge.

The transactions followed a remarkably similar trajectory on the part of the companies' principals: great enthusiasm initially and a profound feeling of accomplishment after we closed for the employees, the company and the selling shareholders.

In both instances, after the company catches its breath and pays down some of the initial bank debt, the plan is for a second round. Somewhere in the middle of both cases, each client openly questioned whether it was worth it. Most of that thankfully temporary discouragement arose from the fact that many of the issues described above came as surprises.

I look forward to my third transaction when, as a grizzled veteran, I can provide sage advice as to what to expect at the outset. NEIH