ESOPs in Corporate Acquisitions:
What Every Buyer Should Know
About the Target Company’s ESOP

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The acquisition of a corporation owned in whole or in part by an employee stock ownership plan presents the acquiring corporation with a number of issues that do not arise in most corporate acquisitions. This article addresses some of those issues with a view toward demystifying the process of acquiring an ESOP company. Although these issues do not create insurmountable barriers to the closing of the acquisition, the efficient closing of the acquisition of an ESOP company requires their early attention.

Few corporate acquisitions are routine. After all, just about every corporate acquisition involves at least a few unique issues that must be resolved before the deal can be closed. When the target company is owned in whole or in part by an employee stock ownership plan (an “ESOP”), the acquisition may be not only unique, but it also may be the buyer’s first exposure to an ESOP. Because ESOPs are often perceived as peculiar and complex, this can be a source of anxiety for the uninitiated buyer. In the race to close the acquisition, the buyer often blames the ESOP for adding unwanted complexity and cost.

However, by devoting a small amount of attention to the special issues raised by the acquisition of an ESOP company in the early stages of the acquisition process, the existence of the ESOP need not complicate the acquisition and the additional cost of completing the acquisition of an ESOP company, if any, can be minimized. Early planning is critical to the minimization of ESOP-related complications in the acquisition. Indeed, the very nature of the transaction—merger, stock purchase, or sale of assets—may be driven, at least in part, by the need to address issues raised by the existence of the ESOP. If the nature of the transaction is fixed in the early stages of transaction planning, before the ESOP issues are addressed, the nature of the transaction may need to be changed—at significant
potential cost and aggravation to the parties—when the ESOP considerations are later taken into account.

This article briefly describes what an ESOP is and addresses a number of issues that a buyer will likely need to address when acquiring an ESOP company. These issues include decisions the buyer will need to make when and if it terminates the ESOP after the acquisition is closed.

WHAT IS AN ESOP?

An ESOP is a tax-qualified retirement plan that invests primarily (and usually exclusively) in the stock of the sponsoring employer. Most ESOPs leverage their acquisitions of employer stock by borrowing funds from the sponsoring employer or from a third-party lender coupled with a guarantee from the sponsoring employer. The stock acquired with the borrowed funds is placed in a “suspense account” and, generally, pledged as collateral for the loan. The employer makes annual cash contributions to the ESOP, which the ESOP uses to repay the loan. As the loan is repaid, a pro-rated number of shares of employer stock are released from the suspense account each year and allocated to employee accounts established under the ESOP. Typically, the shares released from the suspense account for a year are allocated to the accounts of ESOP participants pro-rata based upon annual compensation. When an ESOP participant’s employment terminates, the participant’s ESOP account is usually cashed out and the participant receives a cash distribution equal to the fair market value of the stock allocated to his or her ESOP account.

The assets of an ESOP are held in a trust. The ESOP trustee is generally a company insider or an independent, third-party institutional trustee. The Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA) impose on ESOP trustees, like all trustees of tax-qualified retirement plans, a number of fiduciary obligations, including the obligation to act prudently and the obligation to act solely in the interest of ESOP participants and beneficiaries. The Department of Labor, which has jurisdiction over ESOPs in this regard, has historically given high priority to the examination of ESOP transactions and the activities of ESOP trustees to ensure compliance with those fiduciary obligations.

The Internal Revenue Code contains a number of ESOP-specific tax-qualification provisions, relating to, among other things, the voting of company stock held by the ESOP and the form and timing of distributions to ESOP participants. Since an ESOP is a tax-qualified
ESOPs in Corporate Acquisitions

retirement plan, an ESOP must satisfy the Internal Revenue Code's rules prohibiting discrimination in favor of highly compensated employees. As a result, ESOPs tend to benefit a relatively broad group of the sponsoring company's employees. Indeed, most of the target company's employees—from senior management to the rank-and-file—will likely have an ESOP account (and, therefore, an interest in ensuring that the sale of the company is a good deal).

A number of the fiduciary and tax-qualification provisions of the Internal Revenue Code and ERISA are triggered by the sale of an ESOP company. If the acquisition is structured as a stock sale or a merger, the buyer has a substantial interest in ensuring that the seller complies with all of the ESOP-related provisions of the Internal Revenue Code and ERISA since the buyer will inherit the target company's liabilities. A target's failure to ensure compliance with the fiduciary provisions of the Internal Revenue Code and ERISA risks incurring claims for damages by ESOP participants and Department of Labor fines and penalties. A target's failure to ensure compliance with the tax-qualification provisions of the Internal Revenue Code risks disqualification of the ESOP, which can result in significant liability to the Internal Revenue Service.

Even in an acquisition structured as a sale of assets, in which the buyer generally does not assume any liabilities of the target company, the buyer has an interest in ensuring that the seller complies with the ESOP-related provisions of the Internal Revenue Code and ERISA since the seller's employees will presumably become employees of the buyer after the deal closes. In this regard, the buyer will want some assurance that the seller's employees feel that they were dealt with fairly in the transaction—both in terms of price as well as procedure. Even if the buyer bears little risk of liability for the target's failure to abide by the rules of the Internal Revenue Code and ERISA, a buyer who is knowledgeable about the ESOP-specific issues raised in connection with a sale of assets will have a better understanding of the seller's concerns, which is likely to promote a smoother closing.

The remainder of this article addresses a number of discrete fiduciary and tax-qualification issues triggered by the acquisition of an ESOP company that the buyer and the seller may need to address in order to close the acquisition successfully.

THE ROLE OF ESOP PARTICIPANTS

Perhaps the most visible issue in the acquisition of an ESOP company is the issue of whether ESOP participants will have a role in
ESOPs in Corporate Acquisitions

approving or disapproving the transaction. From a practical standpoint, buyers and sellers alike generally prefer to minimize the involvement of the target company's employees in the approval or disapproval of the acquisition because the approval process is cumbersome and the involvement of employees in the decision-making process adds an element of uncertainty to the successful closing of the transaction. Nevertheless, in certain circumstances, the target company must give ESOP participants a voice in the approval or disapproval of the transaction. Moreover, the involvement of ESOP participants in the approval process may provide the ESOP trustee with significant protection from ERISA's fiduciary duty provisions. For that reason, many ESOP companies voluntarily extend to ESOP participants the right to participate in the approval or disapproval of the transaction.

Allocated Shares

The most direct way in which ESOP participants can become involved in the transaction's approval process is through control over the decision-making with respect to the shares allocated to their ESOP accounts. The extent of ESOP participants' involvement with respect to allocated shares may depend upon the nature of the transaction.

Mergers and Sales of Assets

Section 409(e) of the Internal Revenue Code provides that, in certain circumstances, each participant in an ESOP has a right to direct the ESOP trustee as to the manner in which the ESOP trustee should vote the shares of the sponsoring employer's stock allocated to his or her ESOP account. This is known as "pass-through voting." If the target is a public company, Section 409(e) provides that this pass-through voting right extends to any shareholder vote. If the target is a private company, this pass-through voting right extends only to a shareholder vote with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, or dissolution, or a sale of substantially all of the assets of a trade or business.

As a result, regardless of whether the target company is public or private, if the acquisition is structured as a merger or a sale of assets, ESOP participants have a right to direct the ESOP trustee with respect to the voting of the shares of the target company's stock allocated to their ESOP accounts.
Note that Section 409(e) is much narrower than it might appear at first glance. Section 409(e) does not stand for the proposition that ESOP participants are shareholders with respect to the shares allocated to their accounts. ESOP participants are not shareholders—under Section 409(e) or otherwise—and, therefore, do not have the right or the power to vote the shares allocated to their accounts, nor do they have any of the other rights extended to shareholders under state corporate law, such as the right to attend shareholder meetings. Section 409(e) merely gives ESOP participants the limited right to instruct the ESOP trustee with respect to any vote under state corporate law that may be required on a merger or sale of assets. The ESOP trustee votes the shares in accordance with those instructions and attends any shareholder meetings applicable to the merger or sale of assets.3

Stock Sales

Nothing in the Internal Revenue Code or ERISA requires a pass-through in a stock sale. Section 409(e) only requires a pass-through of voting rights. If the acquisition does not involve a shareholder vote, Section 409(e) does not require a pass-through. Accordingly, Section 409(e) does not require the participation of ESOP participants in the approval or disapproval of a sale of the target company's stock because a stock sale does not require a shareholder vote under state law (rather, a stock sale involves a mere decision to sell or not to sell by each shareholder) and, even if it did, a stock sale is not among the events listed in Section 409(e) for which a pass-through is required.

Although a pass-through vote is not required in a stock sale, many ESOP companies have provided in their ESOP plan and trust documents that ESOP participants have a right to direct the ESOP trustee as to whether to sell the shares allocated to their ESOP accounts in the event of a "tender offer," which is generally understood to mean an offer by the buyer to buy all of the target company's outstanding stock. A tender offer is usually conditioned upon a minimum number of shares being tendered to the buyer. The minimum number is usually established as the percentage of the outstanding shares of the target company that would be necessary for the buyer to accomplish a "squeeze-out" merger of the target into the buyer after the acquisition is completed.

In the ordinary private company context, where the number of shareholders is small, this is generally not an issue since a deal that is
acceptable to all of the shareholders can usually be negotiated and a tender offer is not necessary. This is generally no less true where the target company is owned in whole or in part by an ESOP because the ESOP trustee is generally the decision maker with respect to all of the shares held by the ESOP. However, where the ESOP plan document extends a tender offer pass-through right to ESOP participants, it can be more difficult for the buyer to obtain a controlling interest in the target or to negotiate a universally acceptable deal because decision-making authority with respect to the allocated shares held by the ESOP is no longer centralized in the ESOP trustee but, rather, diffused among a broad group of ESOP participants.

Fortunately, neither the buyer nor the seller is required to extend tender offer pass-through rights to ESOP participants. If the ESOP plan document includes a tender offer pass-through feature, the target company can amend the plan document to eliminate the feature before the acquisition is closed. Although neither the Internal Revenue Code nor ERISA prohibits such an amendment, the elimination of this feature can have an adverse effect on the good will of employees who may feel that they are entitled to a voice in a decision that could have a substantial impact on their lives—the decision to sell the company for which they work. Employees of ESOP companies often feel that they are shareholders of the company (ESOPs are often marketed to employees that way) and that they should, therefore, have all of the rights normally enjoyed by shareholders, including the right to decide whether to sell the shares allocated to their ESOP accounts. In fact, as indicated above, they are not shareholders—the ESOP trust, acting through the ESOP trustee, is the shareholder—but the buyer and the seller may need to address the expectations of ESOP participants so that the failure to meet these expectations does not breed resentment or worse, misguided allegations of wrongdoing.

**Fiduciary Aspects of Pass-Throughs**

The most significant practical drawback to a pass-through with respect to allocated shares is the decentralization of the ESOP’s voting and tender rights. Where there is no pass-through, the ESOP trustee makes all voting and tender decisions on behalf of the ESOP. Where there is a pass-through, that decision-making authority is divided among ESOP participants. This decentralization of decision-making authority can complicate the buyer’s efforts to close the acquisition efficiently.
Why, then, would any target company provide ESOP participants with pass-through voting or tender rights? As indicated above, in the case of allocated shares to be voted in connection with a merger or sale of assets, Section 409(e) of the Internal Revenue Code requires a pass-through. However, in the case of a sale of the target company's stock, a pass-through tender is never required and is always within the control of the target company.

In that instance, the primary reason for providing ESOP participants with pass-through tender rights is that the pass-through tender—like a pass-through vote—may provide the ESOP trustee with significant protection from ERISA's fiduciary duty provisions. In this regard, voting and investment decisions with respect to target company stock held by an ESOP are generally considered to be fiduciary decisions. Where there is no pass-through of the voting or tender decision in connection with the buyer's acquisition of the target company, the ESOP trustee has discretion with respect to the voting or tender of the target company stock held by the ESOP and, therefore, risks fiduciary liability with respect to its voting or tender decision. If the ESOP trustee's voting or tender decision is not prudent, ESOP participants can sue the ESOP trustee for breach of fiduciary duty and recover any losses suffered as a result of the breach.

However, where the voting or tender decision is passed through to ESOP participants, ESOP participants become "named fiduciaries" under ERISA with respect to that decision. Generally, this means that the ESOP trustee is not subject to fiduciary liability with respect to the voting or tender of the shares of target company stock held by the ESOP to the extent that the ESOP trustee is merely following the voting or tender instructions of ESOP participants. This is, of course, a significant potential benefit to the ESOP. In light of the ESOP trustee's right to indemnification from the target company, this is also a significant benefit to the target company and the buyer.

In order to receive the fiduciary protection afforded by a pass-through voting or tender provision, the ESOP trustee may not completely dissociate itself from the voting or tender process. In this regard, the ESOP trustee has an obligation to disregard the voting or tender instructions of ESOP participants if the ESOP trustee determines that those instructions are not "proper"—that is, if the ESOP trustee determines that the instructions are the product of the employer's coercion or undue influence, inconsistent with the terms of the ESOP plan and trust documents, or otherwise inconsistent with ERISA.

This means that the ESOP trustee generally must provide ESOP participants with information necessary to make a proper decision as
well as a confidential voting or tender procedure. The confidential nature of the procedure is intended to ensure that the employer does not unduly influence or coerce an ESOP participant's voting or tender decision. In a confidential environment, employees would presumably have less fear of reprise should they direct the ESOP trustee to vote or tender in a manner contrary to the wishes of management. Generally, the ESOP trustee can meet these obligations by distributing an information statement to ESOP participants that explains the nature of the proposed transaction and by arranging for the confidential collection and tabulation of voting or tender instructions from ESOP participants. Depending upon the volume of information to be disclosed and the number of ESOP participants, this process can be somewhat cumbersome. As a result, pass-through planning should begin as soon as possible after the principals have determined the structure of the transaction and determined that a pass-through vote or tender will occur.

Except where a pass-through vote is mandated by Section 409(e) of the Internal Revenue Code, the consideration of whether to provide pass-through voting or tender rights to ESOP participants in a corporate acquisition involves a balancing of the short-term impracticalities of a pass-through—diffused decision-making authority and a cumbersome pass-through procedure—against the fiduciary benefits of the pass-through. In many cases, the exigencies of closing or the buyer's need to acquire 100 percent of the target company will mandate against a pass-through. However, in many cases, a pass-through may prove to be well worth the inconvenience.

**Unallocated Shares**

Even if ESOP participants have a right to direct the voting or tender of shares allocated to their accounts in connection with a merger, sale of assets, or tender offer, the ESOP trustee will need to independently determine how to vote or tender unallocated shares held in the ESOP suspense account (if the ESOP is leveraged).

In making this determination, the trustee should be guided by the ESOP plan and trust documents. If there has been no pass-through with respect to allocated shares, the ESOP plan and trust documents will usually direct the ESOP trustee to make an independent fiduciary decision on the voting or tender of unallocated shares. If there has been a pass-through with respect to allocated shares, the ESOP plan and trust documents may instead direct the ESOP trustee to vote or tender unallocated shares in the same proportion as shares
for which the ESOP trustee has received voting or tender instructions from ESOP participants with respect to allocated shares. This is known as a “mirror voting” or “mirror tender” provision. Like a pass-through tender provision, an ESOP’s provisions for voting or tendering unallocated shares can be amended at any time before the acquisition is closed.

If there is to be a pass-through of voting or tender rights with respect to allocated shares, from a practical standpoint, it may make sense to include a mirror voting or tender provision with respect to unallocated shares—provided that the same fiduciary protection that is extended to allocated shares is available with respect to unallocated shares voted or tendered in mirror fashion.

Historically, there has been some debate over whether this fiduciary protection extends to unallocated shares. The Department of Labor generally takes the position that ESOP participants cannot be named fiduciaries with respect to unallocated shares and that, therefore, mirror voting or tender provisions do not protect an ESOP trustee from fiduciary liability under ERISA for imprudent decisions. In Herman v. NationsBank Trust Co., 126 F.3d 1354 (11th Cir. 1997), rehearing denied, 135 F.3d 1409 (11th Cir. 1998), certiorari denied, 199 S. Ct. 54 (1998), the Department of Labor sued NationsBank Trust Co. (“NationsBank”), the trustee of the Polaroid Corporation (“Polaroid”) ESOP, for failing to tender all of the unallocated shares of Polaroid stock held by the Polaroid ESOP to Polaroid in connection with competing tender offers for Polaroid stock extended by Polaroid and another offeror. NationsBank, following the instructions of ESOP participants pursuant to the pass-through and mirror tender provisions of the Polaroid ESOP, had tendered unallocated shares to both Polaroid and the other offeror.

It was the position of the Department of Labor that NationsBank was duty-bound to follow the mirror tender provision of the Polaroid ESOP plan document but, because ESOP participants cannot be named fiduciaries with respect to allocated shares, to disregard that provision if it would otherwise produce an imprudent result. NationsBank, on the other hand, argued that ESOP participants were named fiduciaries with respect to the unallocated shares and that it should not be liable for a breach of fiduciary duty for tendering unallocated shares to both Polaroid and the other offeror in accordance with the mirror tender provision. The Eleventh Circuit held that ESOP participants cannot be named fiduciaries with respect to unallocated shares if they are not adequately informed of the effect their directions with respect to allocated shares will have on
unallocated shares. Since NationsBank had not met this disclosure burden, the Eleventh Circuit sided with the Department of Labor.

In so holding, the Eleventh Circuit did not reach the broader question—that is, whether ESOP participants can, with adequate disclosure, be named fiduciaries with respect to unallocated shares. By not addressing this broader issue, the Eleventh Circuit seemed to be suggesting that they can. However, a significant amount of uncertainty continues to surround mirror voting and tender provisions. Accordingly, they should be adopted and followed only with an awareness of these uncertainties and the risks attendant to them.

**Nonresponse Shares**

If the acquisition involves a pass-through of voting or tender rights, some ESOP participants will inevitably fail to provide any voting or tender instructions to the ESOP trustee. As with unallocated shares, the ESOP trustee's treatment of these "nonresponse shares" should be guided by the ESOP plan and trust documents. Those documents typically direct that nonresponse shares be treated in one of three ways: (1) as not voted or tendered, (2) as voted or tendered in the manner determined by the ESOP trustee in its discretion, or (3) as voted or tendered in the same proportion as allocated shares for which the ESOP trustee does receive voting or tender instructions (a mirror voting or tender provision).

The Department of Labor takes the position that ESOP trustees have an affirmative fiduciary obligation to make a voting or tender decision with respect to nonresponse shares. However, in NationsBank, the Eleventh Circuit held that an ESOP trustee has no affirmative duty to make a voting or tender decision with respect to nonresponse shares provided that ESOP participants are adequately informed that a failure to provide the ESOP trustee with voting or tender instructions will result in their shares not being voted or tendered. An ESOP trustee can meet this disclosure obligation in the disclosure materials distributed in connection with the pass-through.

The Department of Labor also objects to the mirror voting and tender of nonresponse shares. The Eleventh Circuit's rationale in NationsBank with respect to the mirror tender of unallocated shares would appear to have equal application to the mirror voting or tender of nonresponse shares. However, in the absence of clear guidance approving such a practice, the mirror voting or tender of nonresponse shares should be avoided.
ENGAGING AN INDEPENDENT TRUSTEE

If the ESOP trustee is an insider of the target company, the buyer should consider requiring the seller to engage an independent third-party trustee to replace the inside trustee in connection with the acquisition. A number of financial institutions provide independent, third-party ESOP trustee services in connection with corporate transactions. Although these services tend to be expensive, most buyers of ESOP companies feel that the services are worth the price, particularly in light of the Department of Labor's historically high level of interest in the fiduciary aspects of ESOP transactions and the risk of ERISA claims for breach of fiduciary duty by ESOP participants.

Although ERISA does not prohibit an insider from serving as trustee of an ESOP in connection with a corporate transaction, most insiders have a conflict of interest that can make compliance with ERISA's fiduciary duties more complicated, if not impossible. In many cases, the inside trustee is an owner—indeed, the founder—of the target company and, like the ESOP, a selling shareholder in the transaction. Among the fiduciary duties imposed on ESOP trustees are the duty to act prudently and the duty to act solely in the interest of ESOP participants and beneficiaries. The latter duty is compromised where the ESOP trustee is selling in his personal capacity as well as in his capacity as trustee.

It is very difficult for an inside trustee in that situation to demonstrate that he acted solely in the interest of ESOP participants and beneficiaries rather than in his own self-interest in deciding whether to sell and in negotiating the terms on which the sale is completed. If the terms of the deal are different for the inside trustee, in his individual capacity, and the ESOP, the deal struck on behalf of the ESOP will be inherently suspect. On the other hand, where an independent trustee strikes a deal that is different from the deal struck by non-ESOP shareholders of the target company, the independence of the trustee tends to create an informal presumption of fairness—a presumption that, to the extent it even exists, is lost where decisions are made on behalf of the ESOP by a conflicted inside trustee. Even where the terms of the deal are identical for the insider and the ESOP, the insider may be motivated for any number of reasons to strike an imprudent deal on behalf of himself as well as the ESOP. If the trustee is independent, the Department of Labor or the federal courts might be more willing to give the trustee the benefit of the doubt on the issue of prudence as well as on the issue of proper motivation.
The fiduciary risk associated with decision-making by an inside trustee is usually a risk ultimately borne by the buyer, at least in the context of a merger or stock sale. Most companies that sponsor ESOPs generally indemnify the fiduciaries of the ESOP, including the trustee, against liability incurred by the fiduciary as a result of the fiduciary's breach of fiduciary duty, subject to certain exceptions (for example, fiduciary liability resulting from gross negligence). Accordingly, in the usual case, the target company will have indemnified the ESOP trustee for any loss it suffers as a result of a breach of fiduciary duty. If the trustee's decision to sell is imprudent or not in the sole interest of ESOP participants and the trustee is held liable to an ESOP participant, the trustee will have an indemnification claim against the target company. As a result of the stock sale or merger, that indemnification claim becomes a claim against the buyer or a subsidiary of the buyer. Of course, the buyer (or the buyer's new subsidiary) may, in turn, have an indemnification claim against the target company sellers (including, ironically, the ESOP) for breach of a representation or warranty in the acquisition agreement, but indemnification rights are generally a poor second choice to avoiding liability in the first instance. After all, collection on indemnification rights is never guaranteed. Moreover, acquisition-related indemnities usually expire one to three years after the acquisition is closed.

ENGAGING AN INDEPENDENT APPRAISER:
VALUATION AND FAIRNESS OPINIONS

If the transaction is structured as a sale of stock or a merger of a private company, the ESOP trustee will generally engage an independent financial advisor to render an opinion that (1) the ESOP received at least fair market value for the stock (a "Valuation Opinion") and (2) the transaction is fair to the ESOP from a financial point of view (a "Fairness Opinion"). Because the process of rendering independent Valuation and Fairness Opinions is time-consuming, the ESOP trustee should engage an independent financial advisor as early as possible in the planning of the transaction. Like independent trustees, independent financial advisors tend to be expensive. However, the engagement of an independent financial advisor is so routine in corporate ESOP transactions that the failure to do so in the context of the sale of an ESOP company could unnecessarily heighten the scrutiny of the transaction. If the independent financial advisor engaged to provide advice with respect to the transaction has historically valued the target company's stock for purposes of the
annual valuation of the ESOP's assets required by the Internal Revenue Code, the cost of retaining the independent financial advisor for purposes of the transaction may be less than would otherwise be the case since the independent financial advisor will already have a great deal of familiarity with the target company.

**Valuation Opinion**

The customary engagement of an independent financial advisor to render a Valuation Opinion in this context has its origins in ERISA's prohibited transaction rules. Section 407(e) of ERISA generally prohibits certain transactions between retirement plans and "parties-in-interest"—generally, persons or entities who are affiliated with the plan in some way. These are known as prohibited transactions. Examples of parties in interest include the company that sponsors the plan, controlling shareholders and employees of the plan sponsor, and certain persons or entities providing services to the plan.

However, ERISA also includes a number of statutory and regulatory exemptions from the prohibited transaction rules. One exemption, located in Section 408(e) of ERISA, is the purchase or sale by a plan of stock of the employer that sponsors the plan if the purchase or sale is for "adequate consideration." Proposed Department of Labor Regulations state that where the sponsoring employer is a private company, adequate consideration generally means fair market value, as determined by an independent appraiser.11

When an ESOP buys stock of the sponsoring employer, the ESOP generally obtains a Valuation Opinion from an independent financial advisor stating that the price paid for the stock is no greater than fair market value because the seller is usually a party-in-interest with respect to the ESOP (for example, the sponsoring employer, or a controlling shareholder or employee of the sponsoring employer). In the case of the ESOP’s purchase of stock, the Valuation Opinion is intended to ensure that the purchase is treated as an exempt prohibited transaction.

When the ESOP sells stock, on the other hand, the buyer is usually not affiliated with the ESOP or the sponsor of the ESOP. To that extent, the sale of the target company's stock from the ESOP to the unaffiliated third-party buyer is not a prohibited transaction and a Valuation Opinion is not, therefore, necessary to ensure that the transaction is exempt from ERISA's prohibited transaction rules. Nevertheless, it is customary for the ESOP trustee to engage an independent financial advisor to provide a Valuation Opinion under these
circumstances stating that the purchase price for the ESOP's shares is at least equal to the fair market value of the shares. Although a Valuation Opinion is not necessary to ensure that the sale is an exempt prohibited transaction, an independent financial advisor's Valuation Opinion does add value to the transaction because it bolsters the ESOP trustee's position that the sale is prudent from a fiduciary perspective. This can be quite valuable to the ESOP trustee if the Department of Labor should scrutinize the sale or an ESOP participant should claim that the sale was not prudent and, therefore, a breach of fiduciary duty.

**Fairness Opinion**

The customary engagement of an independent financial advisor to render a Fairness Opinion derives from the Department of Labor's position that an ESOP trustee has a fiduciary obligation to ensure that the ESOP, as a shareholder, is treated fairly relative to the other shareholders of the target company. Although this does not mean that the ESOP must participate in the transaction on precisely the same terms as the other shareholders, it does mean that the ESOP must derive reasonably equivalent value from the transaction taking into account all relevant factors.12

For example, even if the ESOP and the non-ESOP employee shareholders of the target company receive the same dollar amount per share in the transaction, it is not uncommon for the non-ESOP employee shareholders of the target company to negotiate for additional consideration by means of lucrative, above-market, post-closing contracts of employment with the buyer. The Department of Labor or the federal courts could view the excess value of the contracts as disguised consideration and conclude that the ESOP trustee breached its fiduciary duties to ESOP participants by engaging in the transaction on less favorable terms than other shareholders.

Like the Valuation Opinion, the Fairness Opinion is not necessary to obtain an exemption from ERISA's prohibited transaction rules, but it does bolster the ESOP trustee's position that the transaction is prudent from a fiduciary perspective.

**SPECIAL DUE DILIGENCE ISSUES**

In light of the detailed regulatory scheme applicable to ESOPs, the acquisition of an ESOP company presents a number of specialized due diligence issues.
**Fiduciary History**

If the ESOP is or was leveraged, the buyer should carefully examine the fiduciary history of the ESOP. Just as the sale of ESOP shares raises fiduciary issues such as the prudence and relative fairness of the transaction, the transaction by which the ESOP originally acquired its shares raised similar issues. In addition, unlike the sale of ESOP shares, which, as discussed above, does not raise prohibited transaction issues because the buyer is usually not affiliated with the ESOP or the company that sponsors the ESOP, the transaction by which the ESOP originally acquired its shares likely did raise prohibited transaction issues since the seller of those shares was probably either the target company that sponsors the ESOP or a controlling shareholder of the target company. In either case, the seller would have been a party-in-interest with respect to the ESOP and the sale would, therefore, have been a prohibited transaction unless the parties complied with the exemption requirements of Section 408(e) of ERISA.

If the ESOP is or was leveraged, the loan from the target company to the ESOP (or the target company's guarantee of a loan from a bank to the ESOP) also raises prohibited transaction issues since it, too, was a transaction between the ESOP and the target company (a party-in-interest with respect to the ESOP). There is, of course, an exemption for loans between ESOPs and their sponsoring companies (or sponsoring company guaranties); however, the requirements of this exemption are fairly complex (and beyond the scope of this article).

The buyer in a stock sale or a merger has a direct interest in ensuring that the original transaction by which the ESOP acquired the shares that it is now selling was completed in accordance with all of the fiduciary and prohibited transaction exemption requirements of ERISA. As discussed above, most companies that sponsor ESOPs indemnify the fiduciaries of the ESOP for any liability they may suffer as a result of the performance of their duties as fiduciaries. These would generally include most losses suffered by the ESOP trustee as a result of a claim for breach of fiduciary duty. In a stock sale or a merger, the buyer will inherit these indemnification obligations. In addition, if the shares that the ESOP is selling were acquired in a non-exempt prohibited transaction or with funds received in a non-exempt loan, the target company may be liable—either directly or indirectly through indemnification—for payment of a 15-percent excise tax. This excise tax is assessed and cumulates each year until
the prohibited transaction is corrected (by reversing the original prohibited transaction). The cumulative nature of the prohibited transaction excise tax can result in very significant potential liabilities for the target company.

Accordingly, the buyer should inquire into the nature of the fiduciary compliance efforts made in the original transaction. Did the target company engage an independent trustee? Did the trustee engage the services of an independent financial advisor and obtain a Valuation Opinion and a Fairness Opinion? Are there any other facts and circumstances suggesting that the transaction might have been imprudent from the ESOP's perspective? If the ESOP is leveraged, was the loan to the ESOP an exempt loan? By inquiring into these issues, the buyer may be able to expose hidden ESOP liabilities before closing.

**Prior Valuations**

In some cases, the purchase price in the acquisition significantly exceeds the recent annual valuations of the target company's stock by the ESOP's independent appraiser. Although this will probably be good news for current ESOP participants, former ESOP participants—who were cashed out at much lower values—may be upset. These participants could claim that the purchase price in the transaction proves that the pre-transaction valuations of target company stock were too low and that they should have been entitled to larger distributions. In that event, the target company (either directly, or indirectly by means of its obligation to indemnify the ESOP trustee) could be faced with sizeable claims for additional benefits by former ESOP participants. Although neither the buyer nor the seller is presumably in any position to minimize this risk, the buyer should investigate prior valuations and, if appropriate, consider negotiating for special indemnification rights from the seller with respect to this potential liability.

**Section 1042 Excise Tax**

One of the primary motivations for a target company's establishment of a leveraged ESOP is Section 1042 of the Internal Revenue Code, which enables existing shareholders of a company to defer federal income taxation of the gain on the sale of their shares of the company's stock if the sale is made to an ESOP. A number of requirements must be met before a selling shareholder can elect to defer gain under Section 1042. Most of these requirements are beyond the...
ESOPs in Corporate Acquisitions

scope of this article as they do not bear on the buyer’s acquisition of the target company.

However, one requirement of Section 1042 is significant to the buyer. In order for the selling shareholders to take advantage of the Section 1042 tax deferral, the company sponsoring the ESOP must formally consent to the imposition of an excise tax if the ESOP disposes of any shares that it acquires from the selling shareholders during the three-year period beginning on the date the shares were acquired. The amount of the excise tax is equal to 10 percent of the amount realized by the ESOP on the disposition of the shares.15

The excise tax does not apply to a sale of assets (since a sale of assets does not involve a disposition of shares) or a corporate merger structured as a tax-free reorganization under Section 368(a)(1) of the Internal Revenue Code.

Accordingly, the buyer should carefully examine the original transaction by which the ESOP acquired its shares. If the buyer’s acquisition of the target company occurs within three years after the ESOP was established and the shareholders that sold their shares to the ESOP elected to defer gain under Section 1042, then the buyer may need to take the 10-percent excise tax into account in structuring, pricing, and closing the transaction.

ESOP Qualification Requirements

As part of the buyer’s normal due diligence with respect to the target company’s employee benefit plans, the buyer should note the special qualification provisions that apply to ESOPs under the Internal Revenue Code. For example, the buyer should determine whether there have been any shareholder votes for which Section 409(e) of the Internal Revenue Code requires a pass-through and confirm that the target company complied with those pass-through requirements. Similarly, the buyer should confirm that the target company complied with the rules regarding the form and timing of distributions that apply to ESOPs under Sections 409(h) and 409(o) of the Internal Revenue Code.

POST-CLOSING: TERMINATING THE ESOP

Following a stock sale or a merger,16 the buyer must decide what to do with the ESOP, which is, at that point, either sponsored by the buyer directly or indirectly through the buyer’s new subsidiary, the target company. The buyer could continue the ESOP, either for the
benefit of the former employees of the seller, or for a broader group of the buyer's employees. However, as a practical matter, most buyers choose to terminate an ESOP acquired as part of a stock sale or merger. The termination of a leveraged ESOP following an acquisition presents several practical problems.

**Repayment of the Remaining Debt**

If the ESOP is to be terminated, the ESOP must use the proceeds of the transaction that are allocated to the shares held in the suspense account to repay the debt. Any excess cash in the suspense account following repayment of the debt must be allocated to ESOP participants' accounts. It appears that the excess cash allocated to an ESOP participant's account is not considered to be an annual addition for purposes of Section 415 of the Code, which limits the amount of annual additions that may be allocated for the benefit of any individual under any combination of defined contribution plans sponsored by an employer for any year.

The price at which the shares in the suspense account are sold may greatly exceed the outstanding principal amount of the debt. In that event, the decision to terminate the ESOP and repay the debt will result in an immediate allocation of the excess value to ESOP participants' accounts. Although the buyer may perceive this to be a windfall to ESOP participants, ESOP participants would otherwise have been entitled to that excess value had the ESOP not been terminated because the excess value would have been allocated ratably over the life of the loan as contributions were made by the target company.

If the cash in the suspense account is insufficient to repay the remaining debt in its entirety, the buyer may forgive repayment of the excess debt. The Internal Revenue Service has concluded that the amount forgiven under these circumstances is not an annual addition for purposes of Section 415 of the Code.

**Repurchase Liability**

When the ESOP is terminated, the assets of the ESOP must be distributed to ESOP participants. Generally, distributions are in the form of cash (although buyers with publicly traded stock will occasionally distribute the assets of the ESOP in the form of stock).

If the consideration used to acquire the target company was cash, the ESOP will have a ready source of cash to fund distributions.
However, except in limited circumstances, ESOP participants have a right to demand distribution in the form of "employer securities." Generally, "employer securities" are (1) shares of the class of the common stock having the best combination of voting and dividend rights of any class of the capital stock within any group of affiliated companies or (2) preferred stock that is convertible into such common stock. Generally, following an acquisition, the target company's stock (if the target company still exists) will no longer meet the definition of employer securities because the buyer's stock, as the target's parent, will have a higher ranking. If the buyer is not itself the ultimate parent corporation in a chain of affiliated companies, then the buyer's ultimate parent corporation may have the only securities that may be viewed as employer securities. Regardless, a buyer that intends to make cash distributions in connection with the termination of the ESOP must be prepared to distribute an ESOP participant's benefits in the form of employer securities upon demand. In the private company context, the right to demand distribution in the form of employer securities does not typically create a significant obstacle to the termination of the ESOP because presumably few, if any, employees would want illiquid stock when they can have cash.

On the other hand, if the consideration for the acquisition was paid in the form of shares of the buyer's capital stock, the buyer will need to repurchase the shares for cash so that the ESOP may fund cash distributions. A cash-poor buyer may be unable to fund that repurchase liability, thereby necessitating a delay in the termination of the ESOP. If the buyer is a private company, the buyer cannot avoid this repurchase liability by choosing instead to distribute the stock. In this regard, cash distribution rights are generally considered to be protected benefits under Internal Revenue Code Section 411(d)(6) that cannot be eliminated by plan amendment. Moreover, participants in ESOPs sponsored by private companies have a right to require the sponsor of the ESOP to repurchase any shares distributed to them. The buyer may satisfy this repayment obligation with a note; however, the note would have to be repaid within five years.

_Escrows and Earn-Outs_

Many, if not most, corporate acquisitions are structured so that the seller is required to place a portion of the seller's sale proceeds in escrow. The escrow fund serves as a source of ready cash to fund any acquisition-related liabilities the sellers may owe to the buyer. In
addition, some corporate acquisitions involve “earn-outs”—essentially, deferred consideration, the amount of which is based upon the post-closing performance of the target.

Escrows and earn-outs complicate the termination of the ESOP. In each case, the precise amount of the consideration the ESOP is entitled to receive will not be known until some future date. In the case of an escrow, the ESOP’s interest in the escrow fund will not be known until the escrow is settled and all acquisition-related liabilities have been paid—usually one to three years after the date of closing. In the case of an earn-out, the ESOP may continue to receive additional consideration during the post-closing performance period. As a result, a short-term liquidation of the assets of the ESOP is problematic.

Conceivably, the ESOP could be terminated and the ESOP trustee could assign to each ESOP participant a pro-rated interest in the ESOP’s share of the escrow account or the earn-out proceeds. However, a commercial escrow agent may balk at the added complication of dividing a single payment obligation to the ESOP trustee among perhaps hundreds—or even thousands—of ESOP participants. Moreover, the value of the assigned interest would presumably be taxable to ESOP participants. A participant could defer the tax obligation by rolling over his or her distribution to another qualified plan sponsored by the buyer (if available) or to an individual retirement account. It may be difficult, however, to locate an individual retirement account custodian or trustee willing to accept a rollover of an interest in an escrow fund or an interest in future earn-out proceeds.

Alternatively, the buyer could simply freeze the ESOP and defer termination until after the escrow is settled or the earn-out period has terminated. The drawbacks to this solution include the need to placate an anxious group of ESOP participants, many of whom may be eager to receive their distributions, and the administrative aggravations attendant to the administration of a qualified plan, such as the obligation to file annual reports on Form 5500. The distribution expectations of ESOP participants can be addressed, at least partially, by amending the ESOP to provide for in-service distributions. However, those distributions would be limited to amounts attributable to contributions that were made more than two years prior to the date of distribution or to participants who have completed at least five years of service under the ESOP.25

To avoid these difficulties, many buyers and sellers simply agree to leave the ESOP out of the escrow or earn-out arrangement and negotiate a different deal for the ESOP. The ESOP should expect to receive less consideration than the other selling shareholders would
receive if there were no indemnification claims against the escrow or all of the earn-out performance targets were met since the ESOP is eliminating the risk on those fronts.

The buyer's human resources executives generally approve of this approach, at least with respect to escrows, because ESOP participants tend to view the buyer's post-closing indemnification claims against the escrow fund as their new employer unfairly taking retirement funds away from them. This clearly counteracts any effort the buyer may be making to win over the trust of its new group of employees.

CONCLUSION

It is probably true that the existence of an ESOP adds cost and complexity to the otherwise "routine" corporate acquisition. The acquisition of an ESOP company will likely include the engagement of an independent trustee and an independent financial advisor, and the closing of the transaction may depend upon the approval of ESOP participants. As a selling shareholder, the ESOP's negotiating position may be handicapped (or, from the perspective of an ESOP participant, perhaps, improved) by the fiduciary burdens of ERISA. Nevertheless, the added cost is usually manageable, particularly in light of the fiduciary risks attendant to ESOP transactions, and the added complexity can be minimized with early planning and an informed approach by the buyer to the ESOP-related issues presented in the transaction.

NOTES

1. This article assumes that the documents by which the ESOP trust is established assign to the ESOP trustee the power to exercise all shareholder rights that attach to shares held by the ESOP.

2. In some states, it appears that approval in the form of the written consent of a corporation's shareholders is not a "vote." Consequently, it would appear that in some states, the pass-through directive of Section 409(e) can be circumvented by obtaining shareholder approval of a merger or sale of assets in the form of a written consent rather than a vote.

3. There is some uncertainty as to whether the obligation to pass-through voting rights under Section 409(e) with respect to a merger requires the ESOP trustee to pass-through to ESOP participants who directed the ESOP trustee to vote against the merger the right to an appraisal normally accorded to shareholders who vote against a merger.

4. In some cases, the documents by which the ESOP trust is established provides that the ESOP has the power to dispose of the shares held by the ESOP, but that the ESOP
is directed by another entity—perhaps an inside committee of the sponsor of the ESOP—with respect to the decision to sell, in which case, the other entity would be the decision maker. This article assumes that, in the absence of a pass-through, the ESOP trustee is not directed by any other entity.

5. Some might speculate that an ESOP sponsor cannot amend an ESOP plan document to eliminate a tender offer pass-through feature. However, there appears to be no basis for this concern. Although Section 411(d)(6) of the Internal Revenue Code prohibits the elimination of certain “protected benefits,” a tender offer pass-through feature is not a protected benefit.

6. The Sixth Circuit Court of Appeals has introduced some doubt on this issue with respect to the voting of ESOP shares, in *Grindstaff v. Green*, 133 F.2d 416 (6th Cir. 1998). *Grindstaff* could be read broadly to stand for the proposition that the voting of ESOP shares is not a fiduciary act. However, the better reading of *Grindstaff* is a narrower one—that in connection with the voting of ESOP shares for elections to the board of directors, an ESOP fiduciary’s routine vote for himself as a director is not, alone, a fiduciary act. Presumably, the Sixth Circuit would agree that the voting of ESOP shares in the context of a corporate acquisition is a fiduciary act. The Department of Labor and other federal courts have taken the position that the voting of ESOP shares is a fiduciary act. See, e.g., *Delta Star, Inc. v. Patton*, 76 F. Supp. 2d 617 (W.D. Pa. 1999); Department of Labor Advisory Opinion (Jan. 29, 1999) (Not Numbered).

7. See Letter from the Department of Labor to Ian D. Lanoff (Sept. 28, 1995), reprinted in 22 Pens. & Ben. Rep. (BNA) 2249 (Oct. 9, 1995) (the “Lanoff Letter”). It appears that in determining whether the instructions are consistent with ERISA, the trustee need not inquire into the prudence of the instructions. See *Herman v. NationsBank Trust Co.*, 126 F.3d 1354 (11th Cir. 1997), reh’g denied, 135 F.3d 1409 (11th Cir. 1998), cert. denied, 199 S. Ct. 54 (1998). Such an inquiry would, of course, defeat the purpose of the pass-through, which is to relieve the trustee of liability for an imprudent decision in the transaction. There appears to be no authority suggesting that by complying with its fiduciary obligation under ERISA to disregard improper voting instructions, the ESOP trustee would thereby violate the pass-through requirement of Section 409(e) of the Internal Revenue Code. Presumably, Section 409(e) contemplates that its pass-through directive must give way to an ESOP trustee’s fiduciary duties under ERISA.


11. For prohibited transaction purposes, independent trustees are not generally required to rely on the report of an independent appraiser in assessing fair market value. However, the ESOP qualification rules compel the engagement of an independent appraiser in all ESOP valuation activities involving non-publicly traded stock. Internal Revenue Code Section 401(a)(28)(C).


13. ERISA Section 408(b)(3); Department of Labor Regulation Section 2550.408b-3.

14. For prohibited transactions occurring prior to Aug. 5, 1997, the excise tax is 10 percent. For prohibited transactions occurring prior to Aug. 20, 1996, the excise tax is 5 percent.
15. Internal Revenue Code Section 4978.

16. Following a sale of assets, the ESOP remains the seller's plan and, therefore, the seller is responsible for terminating the ESOP, unless the buyer has agreed to assume sponsorship of the ESOP in connection with the sale of assets.

17. The Department of Labor takes the position that the proceeds of the sale of unallocated shares may not be used to repay the debt if the shares were not pledged as collateral for repayment of the debt. See Department of Labor Advisory Opinion 93-35A (Dec. 23, 1993). The Internal Revenue Service has taken the opposite position. See Private Letter Ruling 9416043. In practice, this issue rarely arises because the vast majority of leveraged ESOPs pledge their unallocated shares as collateral for the loan. Nonetheless, the buyer should confirm the pledge of unallocated shares before the loan is repaid and the ESOP is terminated.

18. For years, the Internal Revenue Service maintained that the excess cash was considered an annual addition and, therefore, subject to the limitations of Section 415. See Private Letter Rulings 9507031, 9426048, 9416043, 9417033, and 9417032. This conclusion made immediate termination of many ESOPs following an acquisition difficult if not impossible because the excess cash often exceeded the amount that could be allocated to participants' accounts under Section 415 in the year of termination. However, it appears that the Internal Revenue Service changed its position on this issue in 1998. In this regard, the Internal Revenue Service issued an unpublished Technical Advice Memorandum to a taxpayer in 1998 that concluded that the excess cash in the ESOP suspense account following a sale of assets was not an annual addition for Section 415 purposes. See also Private Letter Ruling 9837032, in which the Internal Revenue Service assumed in ruling on other matters, that excess cash in the ESOP suspense account following a merger was not an annual addition for Section 415 purposes.


20. If the buyer is a Subchapter S corporation or if the buyer's charter documents restrict ownership of substantially all of the outstanding stock of the sponsoring company to employees or qualified retirement plan trusts, such as an ESOP, an ESOP participant has no right to demand distribution in the form of employer securities. Internal Revenue Code Section 409(h)(2)(B)(ii).


22. Internal Revenue Code Section 409(i).


24. Internal Revenue Code Section 409(h)(5).