Red Flags in ESOP Transactions

ESOPs are an extraordinarily effective tool for business ownership transitions as well as creating productive ownership cultures. According to the NCEO's 2015 ESOP transaction survey, 92% of ESOP companies are happy with their ESOP transactions.

Like any complex transaction involving the sales of a business, we sometimes hear that the company advisor gave misleading, incorrect, or inadequate advice; or not all of the parties involved were adequately advised, resulting in increasing costs as well as increasing the financial and fiduciary risks after the transaction is completed.

Red Flags

We encourage you to read the following list of key issues to watch out for and ways to avoid them:

Inexperienced Advisors

While many people claim they have ESOP expertise, relatively actually few have meaningful or relevant ESOP transaction experience. For example, just because an attorney has ERISA experience does not automatically mean they have substantial ESOP transaction experience. Valuation firms that may have a lot of experience in your industry may know little about ESOP-specific issues. ESOP valuation firms may not have done more complex ESOP transactions. Third-party administrators (TPAs) for 401k plans are not automatically qualified to be ESOP TPAs. Very few TPAs have specific expertise in ESOP administration.

You should not select your ESOP advisors because they are local, inexpensive, or just claim to have done this before. Inexperienced advisors are more prone to errors, not giving you the full array of possible transaction structure options, and may even cost more in the end. Experienced advisors may cost more but are likely to provide the most thorough and balanced ESOP guidance. Our service provider directory is a great place to start, and you should always ask for references.

Advisor Bias and Blind Spots

Some ESOP advisors may have a bias toward certain transaction structures or approaches. It may be what they believe is the "best" or most tax-efficient ESOP structure, but it may reflect either a cookie-cutter approach, the inexperience issue, or a bias connected to the fee structure in the transaction—if they do more, they charge more. Biases toward certain transaction designs often are accompanied by bias toward certain parties to the transaction and conflicts of interest. For example, is the fully leveraged approach the transaction structure that all parties, the company, the sellers, and the trustee would select? Or is it being presented as the only alternative because of the ancillary services, products, or investments the professional offers?

Unusually High Transaction Costs

The NCEO 2015 ESOP transaction survey found that roughly one third of transactions in 2013 or later cost between $75,000 and $200,000; roughly a third cost less than that range, and roughly a third cost more. It also found that transaction costs in general have been increasing.

Complex and larger transactions cost more than simple and small transactions. Seller financing with warrants, management incentive plans, large number of shareholders, converting to a C corporation to allow sellers to defer their gain under Internal Revenue Code Section 1042, and tender offers are some of the factors that increase the complexity of a transaction.
Company financial advisors provide a variety of valuable services, including creating realistic expectations of value, structuring the transaction to maximize tax benefits, sourcing the most effective bank financing, selecting the trustee team, managing costs, leading the negotiations, and coordinating the entire process to ensure the transaction gets completed on time. Most of the fee for the company's financial advisors is contingent on the transaction being completed. To make sure you are not overpaying, shop around. Talk to more than one provider in each key category (company attorney, ESOP attorney, TPA, and trustee team) to make sure you find the advisors who are experienced with ESOP transactions as well as the best fit for your transaction in terms of fee, style, and other factors.

Inappropriate Use of Floating Rate Notes
Floating rate notes (also called ESOP Notes) are long-term non-callable bonds often used as qualified replacement property for sellers selling to an ESOP. They allow the seller to meet the rules for tax deferrals under an ESOP. The issues with these notes are beyond the scope of this article, but they do not make sense for all sellers. Make sure you get advice from someone not selling the notes before proceeding. If you haven't done a complete personal financial plan before starting the ESOP process, you should.

Excessive Warrants with Seller Notes
Warrants are the right to buy shares in your company for some defined number of years into the future at the ESOP value at the time exercise the warrants. They are structured so the warrant holders receive the difference between the strike price when the warrants are issued and the appraised ESOP stock value when exercised. There is no intent for the warrant holder to own shares in the company.

Warrants are used in about 27% of transactions that include seller financing, according to our transaction survey. Sellers receive warrants in exchange for accepting a lower rate of interest than would be justified by the risk of the loan. The seller and trustee will negotiate the total internal rate of return, which is the sum of the cash interest, PIK (Payment In Kind) interest, and warrant return.

All parties to the transaction can benefit from warrants so long as they do not provide the seller(s) with too many warrants that would substantially dilute the ESOP's ownership interest. There are no regulations or guidelines published on the use of warrants in ESOP transactions, but there are tax and fairness issues in their design and use. Though the U.S. Department of Labor (DOL) has said privately that it is not opposed to warrant structures, it may be difficult to justify to the DOL that the ESOP's fully-diluted ownership is, say, 60% or less of the company the ESOP nominally bought. The DOL looks at transactions after the fact, and is certain to "know it when they see it" in this area as well. Most advisors will be cautious about how warrants are used, but some are too eager to sell the deal by making it more financially appealing to sellers. Ask your advisor where their position on warrants lies in the current spectrum of transactions that they are aware of advisors conducting in the marketplace.

Being Told You Will Get a Certain Price in Advance
Some advisors promise owners a certain price or value as part of the process of getting hired. While they can provide owners with their estimate of value, the trustee is the only one who can determine how much the ESOP will pay based on the determination of fair market value from the independent financial advisor they hire. The trustee can never pay more than this fair market value. That value is only determined as of the closing date of the transaction, not when feasibility studies are commenced.

Some advisors may try to work around the fair market value by using creative transaction structures. But using aggressive amounts of preferred stock, warrants with seller financing, rich board or consulting fees for owners, etc., may raise issues of the prudence of the transaction. The transaction must be at no more than fair market value, prudent, and fair to the ESOP. These are equal legal concerns.

Deal Terms and Structures You Don't Understand
Some advisors try to increase the complexity of the transaction to justify their fee as well as engaging them. Make sure you know exactly what you are signing on to. Some advisors provide thick deal books laden with terms owners don't fully understand. ESOPs can be complicated, but never so complicated that an advisor cannot take you step-by-step through each issue. "Just trust us" is never a good answer. Do a reality check: can the company
prudently afford all of the costs and complexity, and still pursue its strategic plan and not suffer from financial conflicts in the future.

**Offers That Seem Too Good to Be True**

The tax incentives for ESOPs are powerful, but some advisors may oversell them. If someone approaches you with an idea that sounds like a way to avoid the intent of Congress, it is probably not a good idea. Tax avoidance is legal; tax evasion is not. If in doubt, ask for a written tax opinion on the issues of concern.

**Inflexible Plan Design**

Good advisors work with you to find out what your goals are. Bad advisors have a one-size-fits-all approach that adopts standard deal terms and plan rules for every company. There are many ways to approach an ESOP. Knowing the various approaches will make your plan much more likely to succeed.

**Independent Valuation Firms and Aggressive Valuation**

The Process Agreement between the GreatBanc Trust Company and the DOL offers insights into many of factors the Department of Labor uses to determine ESOP valuations are independent and how they are not independent. The DOL made this process agreement public and stated that they "expect" all ESOP trustees to follow this agreement. Many of these provisions are not new and have been followed by prudent trustees for many years. Your trustee and appraiser should already be familiar with them. For example, valuation firms should be selected by the trustee and should not have provided any services to the company or the seller. This means that preliminary appraisals may be not usable by the ESOP in the transaction. The Process Agreement also reflects the DOL's focus on the reasonableness of projections used to support valuation conclusions.

**What to Do**

You need to become educated about ESOP transactions and the seeming myriad of advisors available to support the multiple parties to the transaction. You're spending a lot of money on this transaction, and your life's work and legacy is on the line.

The following considerations will increase the likelihood of a well-run, well structured, cost-effective, less frustrating, and lower-risk transaction:

- Hire advisors with substantial ESOP transaction experience with strong references;
- Don't negotiate for the most aggressive price, terms for the seller note, and other deal elements;
- Don't design a transaction solely or overwhelmingly based on tax incentives;
- If a deal is too good to be true, it probably is.

Our publications are also a great start, especially Selling Your Business to an ESOP. Members can call us with questions or for feedback, and we can have a low-cost conversation to give advice to make sure you are on the right track. We also have webinars and live meetings.

Establishing an ESOP can preserve and protect your company, and many companies find that it makes them stronger than they were before, but all of those good effects only come when the transaction is done right in the first place.

*The NCEO thanks Neil Brozen of Ventura ESOP Fiduciary Services and Kevin Long of Employee Benefits Law Group for their review and wise advice on this article. The errors remain the NCEO's.*

Return to regular version