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What Directors Should Know About Selling a Company Owned by an Employee Stock Ownership Plan

The interests of directors are not always aligned with those of the ESOP trustee.

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Over my years of representing boards of companies owned by an employee stock ownership plan (ESOP) and dealing with trustees of ESOPs, I realized that there are several unique issues associated with the sale of an ESOP. This article discusses some of the unique issues, as well as possible solutions, associated with selling an ESOP.

Director Duties and Responsibilities

Directors have two types of fiduciary duties:

- Traditional state law corporate duties (such as the duties of care and loyalty)
- The ERISA duty of oversight relating to the actions and activities of ESOP fiduciaries (i.e., duty of monitor).

Compared with the traditional state law corporate duties, the duty of monitor is a higher fiduciary standard (i.e., a prudent-man standard without a business judgment protection). In addition, the ESOP trustee has a duty to monitor the directors (and their process). This means that the directors need to act in a manner that demonstrates that they are satisfying their fiduciary obligations as directors, and they must document their decision-making process.

As part of the process, the directors should engage a financial advisor to assist them with respect to the financial aspects of the transaction, because the ESOP trustee valuation firm works solely for the ESOP trustee, and it is public knowledge that most of the ESOP trustees (and the work product of the valuation firm) are subject to litigation and DOL investigations on other transactions. As part of the engagement, the individual directors should receive a fairness opinion from their financial advisor. (It is important to demonstrate that directors are overseeing the work of the ESOP trustee and the ESOP trustee's valuation firm.)

A major misconception is that the interests of the directors and of the ESOP trustee are aligned, and the work performed by the ESOP trustee protects the directors. The ESOP trustee has a duty to monitor the directors, and the directors have a duty to monitor the ESOP trustee. Normally, the directors are actively engaged in the negotiations with the purchaser. The ESOP trustee will:

- Monitor the progress of the transaction.
- Work with its valuation firm to obtain an opinion that the ESOP is receiving at least fair market value of equity value.
- Focus on its liability exposure and its ability to preserve its contractual indemnification from the ESOP, which creates significant deal tension.

Unique ESOP Indemnification Items

Private equity/family office purchasers focus on a minimum of three areas of ESOP liability exposure concerns:

- The operation of the ESOPs (proper allocations, timely and proper tax filings, timely distributions and valuations).
- The prior transactions involving the ESOP purchasing the capital stock. (There is always a valuation concern, since an ESOP cannot pay more than fair market value at the time of the purchases.)
- The contractual indemnification obligations normally set forth in the ESOP trustee's engagement letter, the ESOP trustee's valuation firm's engagement letter and the third-party administrator's engagement letter.

There are three areas of indemnification that a purchaser will consider as part of the overall transaction terms.

Customary transactional definitive agreement indemnification provisions and the use of a representations and warranty insurance policy (RWI). In the definitive agreement, the purchaser will expect customary seller transactional representations, covenants and warranties. In contrast to a non-ESOP company seller:

- The ESOP is a qualified retirement plan, so any consideration that is paid on closing to the ESOP will be distributed to the participating employees and is not available to the purchaser for resolving indemnification claims. This will affect the length of time of the escrow, the holdback and the earn-out period.
- The ESOP is required to receive an opinion from the trustee's valuation firm that the ESOP received "at least fair market value" as consideration for the transaction. This will affect the size of the escrow and holdback.

Many ESOP trustees (and their valuation firms) are unwilling to count the amounts held in escrows, holdbacks and earn-outs as the consideration (i.e., sale proceeds) received by the ESOP, which can create some challenges for the directors. The issue is resolved by the purchaser procuring a RWI to cover the representations and warranties set forth in the definitive agreement (which should include the operational aspects of the ESOP and reduce or eliminate the escrow/holdback amounts except for known liability items).

Unique ESOP contractual indemnification obligations with the ESOP trustee, ESOP trustee valuation firm and ESOP third-party administrator. The engagement letters for ESOP trustee, the valuation firm engaged by the ESOP trustee, and the third-party administrator normally contain overly broad contractual indemnifications provisions. These provisions have no caps on the indemnification amounts and have an indefinite indemnification period.

The ESOP trustee, the ESOP trustee's valuation firm and the third-party administrator expect these contractual indemnifications to be assumed by the purchaser. Normally, the purchaser will be unwilling to assume the ESOP trustee's contractual indemnification and will expect modifications to be made to the indemnification rights of the ESOP trustee's valuation firm and the third-party administrator. At the end of the day, the ESOP trustee and its valuation firm are looking to protect themselves from liability — and the directors will be able to identify these parties' self-interest.

Since this situation can create significant deal frustration, the directors should address this item with the ESOP trustee early in the process. The directors and the ESOP trustee should consider the purchase of a specific six-year ESOP trustee insurance policy for the transaction, which will replace the ESOP trustee contractual indemnification. The cost of the insurance is normally a reduction from the purchase price, but this is a negotiated point of the transaction. With respect to the ESOP valuation firm and third-party administrator, the directors should negotiate an indemnification with caps and duration periods.

Contractual indemnification obligations with the directors and ESOP committee members. Normally, the directors and ESOP committee members are indemnified for their actions, including the duty of monitor. The Department of Labor or the plaintiffs' counsel normally will allege in a lawsuit that the directors breached the duty of monitor. This is normally how directors are brought into the litigation. Many purchasers are willing to work with the directors to assume some part of the indemnification of the directors, provided that the directors purchase a directors and omissions and ERISA fiduciary coverage that covers both the directors and the ESOP committee members for six years after the transaction, also known as the six-year tail. ■

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