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What Private Equity and Family Office Groups Should Know About Purchasing a Company Owned by an Employee Stock Ownership Plan

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Over my years of representing private equity groups and family offices that have purchased companies owned by an employee stock ownership plan (ESOP), there are several unique liability issues associated with the purchase of an ESOP company which are often overlooked by the purchaser. This article discusses some of the unique liability issues in order to avoid any surprises post-transaction, as well as possible solutions to address these issues.

Directors and ESOP Trustee Interests Are Not Aligned

A major misconception is that the interests of the board of directors of the ESOP Company and of the ESOP trustee are aligned and that the work performed by the ESOP trustee protects the directors. The directors have two types of fiduciary duties: the traditional state law corporate duties (such as the duties of care and loyalty) and the Employee Retirement Income Security Act of 1974 (ERISA) duty of oversight relating to the actions and activities of the ESOP trustee and ESOP company ERISA fiduciaries (i.e., duty to monitor).

Compared to the traditional state law corporate duties, the duty to monitor is a higher fiduciary standard (i.e., a "prudent person" standard without any business judgment protection). On the other hand, the ESOP trustee, unlike a traditional owner, is a service provider that is being paid to be the ESOP trustee and has a duty to monitor the directors (and their process). Because the ESOP trustee is a service provider, the ESOP trustee's decisions are based on its liability exposure. As a result, 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.

In many transactions, the purchaser assumes the contractual indemnification of the directors. Since the purchaser is assuming the indemnification of the directors and the purchaser is aware of the ESOP trustee-directors situation, the purchaser should consider the following:

1. The purchaser should require that the directors engage a financial advisor to assist them with respect to the financial aspects of the transaction (including receipt of a fairness opinion) because (a) the ESOP trustee valuation firm works solely for the ESOP trustee (which is not shared with the directors), and (b) the work product of many ESOP trustees (including the work product of many valuation firms that represent ESOP trustees) are subject to litigation and Department of Labor investigations on other transactions. If the purchaser is assuming the indemnification obligation, it is important that the purchaser guide the directors down a path that allows the directors to demonstrate that they are overseeing the work of the ESOP trustee and the ESOP trustee's valuation firm, in the event that the ESOP trustee's decision is challenged; and

2. The purchaser should require the directors to purchase a directors and omissions insurance policy with ERISA ESOP fiduciary coverage (D&O insurance) that covers both the directors and the ESOP company ERISA fiduciaries (the ESOP committee members) for six years after the transaction (six-year D&O tail). Normally, the directors and ESOP committee members are indemnified by the ESOP company for their actions, which includes the duty of monitor. From a purchaser standpoint, it is important to understand that the Department of Labor or the plaintiffs' counsel representing an employee of the ESOP company will normally allege in a lawsuit that the directors breached the duty of monitor and that the ESOP trustee breached its fiduciary duties to the ESOP. 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 six-year D&O tail with appropriate coverage limits.

In these types of transactions, the directors are actively engaged in the negotiations with the

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purchaser and the ESOP trustees tend to be somewhat inactive. The ESOP trustee, however, will (1) monitor the progress of the transaction, (2) work with its valuation firm to obtain an opinion that the ESOP is receiving at least fair market value of equity value, and (3) focus on the ESOP trustee's liability exposure and its ability to preserve its contractual indemnification from the ESOP, which creates significant deal tension.

Unique ESOP Indemnification Items

There are four areas of ESOP liability exposure concerns:

1. S-corporation status, ESOP S corporation Section 409(p) compliance and the built-in gains taxation period;
2. The pre-transaction and post-transaction ESOP operational liabilities (satisfying specific nondiscrimination S corporation ESOP compliance tests, proper allocations, timely and proper tax filings, timely distributions and valuations);
3. 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; and
4. The contractual indemnification obligations of the ESOP trustee, the ESOP trustee's valuation firm, the third-party administrator (ESOP parties) and the directors.
5. This article focuses on the transactional definitive agreement indemnifications and the unique contractual indemnification obligations of the ESOP parties that are a trap for the unwary purchaser.

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, unless some of the proceeds are placed in an escrow (holdback or earn-out) (escrow). Because the ESOP will be terminated (in most cases), this will affect the length of time of the escrow period.
- The ESOP is required to receive an opinion from the ESOP 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.

Many ESOP trustees (and their valuation firms) are unwilling to count the amounts held in escrow as the consideration (i.e., sale proceeds) received by the ESOP, which can create some challenges for the purchaser and the directors. This issue can be resolved by the purchaser procuring a representations and warranties insurance policy (RWI) to cover the representations and warranties set forth in the definitive agreement (which should include some of the operational aspects of the ESOP and reduce or eliminate the need for an escrow except for known liability items). The parties will need to negotiate who is responsible for paying the cost of the RWI.

Unique ESOP contractual indemnification obligations with the ESOP trustee, ESOP trustee valuation firm and ESOP third-party administrator.

The ESOP trust agreement and the engagement letters for ESOP trustee, the valuation firm engaged by the ESOP trustee, and the ESOP third-party administrator normally contain overly broad contractual indemnification provisions that are potentially worth millions of dollars to the ESOP parties. These contractual indemnification provisions require the ESOP company (or the purchaser) to fund the litigation defense and pay for any damages to the claimants. Normally, these provisions have no caps on the indemnification amounts and have an indefinite indemnification period.

The ESOP parties expect these contractual indemnifications to be assumed by the purchaser. By assuming these contractual obligations of the ESOP parties, the purchaser is potentially taking on substantial liability exposure in the event that there is litigation related to the ESOP.

The ESOP parties will take the position that these contractual indemnifications are structurally part of the ESOP company. The truth is that their position is insular, self-fulling and incompatible with the reality of the transactional world. The purchaser should conclude that these contractual indemnifications (i) do not benefit the ESOP company or the ESOP participants, and (ii) are not part of the structure of the ESOP company. This is the reason that the Department of Labor always argues the ESOP trustee indemnification is invalid under ERISA and void against public policy.

ESOP litigation is normally brought by the Department of Labor and employees of the ESOP company (which is not a good spot for the purchaser). Because these contractual indemnifications provisions are not structural

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to the ESOP company and do not benefit the ESOP participants, the purchaser should be unwilling to assume the ESOP trustee's contractual indemnification and require modifications to the ESOP trustee valuation firm and the ESOP third-party administrator's contractual indemnification. At the end of the day, the ESOP trustee and the ESOP parties are looking to protect themselves from liability. It will become very apparent to the purchaser that these parties are focused on their self-interest. The assumption of these contractual indemnification provisions can be a trap for the unwary purchaser.

Since this situation can create significant deal frustration, the purchaser should address this item with the directors and the ESOP trustee early in the process. The purchaser should condition the transaction upon directors and the ESOP trustee purchasing a specific six-year D&O tail policy for the directors (and this policy should cover individual ESOP trustees) and a specific six-year tail ESOP trustee insurance policy for the ESOP trustee (if the trustee is an institution) for the transaction, which will replace the ESOP trustee's contractual indemnification. The amount of the coverage becomes part of the definitive agreement negotiations. In addition, 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 ESOP third-party administrator, the purchaser should negotiate (or cause the directors to negotiate) reasonable indemnification with caps and a reasonable duration period.

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