

Morgan Lewis

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PREPARING A CLEANTECH COMPANY
FOR A LIQUIDITY EVENT

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The purpose of this outline is to highlight business issues to consider in preparing for a liquidity event, analyzing which type of liquidity event is right for you and considering potential terms you will need to consider and negotiate. Remember, every deal is different, but the issues that need to be resolved in each deal are similar. Thus, you will consistently hear advice to surround yourself with an experienced team to lead you to a successful transaction.

I. Top 10 Issues To Consider One Year Prior To A Proposed Liquidity Event

1. What are your primary business goals (i.e., near term cash, long-term value, ongoing control of business) and relative priorities of those goals.
2. Upgrade management, if needed, particularly focusing on the CFO and internal financial reporting capability generally if planned liquidity event is an IPO.
3. Choose experienced deal counsel and, if necessary, transition counsel to be primary corporate counsel so there are no surprises upon commencement of proposed liquidity event transaction.
4. Choose an experienced accounting firm to conduct an audit for at least the full year preceding the transaction and to analyze revenue recognition and depreciation and amortization policy (note: 3 years audited financial statements required for an IPO).
5. Protect key intellectual property assets – obtain license to use any key IP that is not owned, assign of any rights owned by affiliates that was not previously assigned to the Company, and register trade names as trademarks.
6. Check material commercial and investment agreements to determine required consents or amendments for possible liquidity transaction.
7. Assess sufficiency of minute books, stock books and other corporate records prior to due diligence being convened with respect to the liquidity event transaction. Poor corporate records can turn a “stock” transaction into an “asset” transaction, with potentially adverse tax consequences.

8. Establish rational fair market value exercise price for option grants to avoid “cheap stock” issues resulting in compensation expense.
9. Consider adding independent directors to Board of Directors, particularly if planned liquidity event is an IPO. Consider directors and officers insurance.
10. Engage in personal estate planning prior to commencing liquidity event activity and resulting “step-up” in valuation.

II. **Primary Types of Liquidity Events**

- A. Sale of Company
- B. Public Offering (IPO)
- C. Leveraged Recapitalization
- D. Private Equity (sale of part of business)
- E. Employee Stock Ownership Plan (ESOP – sale of business to employees)

III. Comparison of Liquidity Event Characteristics

Primary Differences Among Types of Liquidity Events:

<u>Sale of Company</u>	<u>IPO</u>	<u>Leveraged Recap</u>	<u>Private Equity</u>	<u>ESOP</u>
Sale of all equity by stockholders (or assets) to a third party	Sale of minority interest by company to the public	Leverage company with debt	Sale of partial equity interest to financial buyer	Sale of interest to employees of the Company
Complete divestiture and cash out of founder	Limited initial liquidity for founder	Some cash out, retain equity interest	Some cash out, some ongoing equity interest	Some cash out, some ongoing equity interest
Founder relinquishes control	Current management maintains control with independent Board	Control retained	Private Equity firm generally controls Board	Current management retains control
Adversarial negotiations	Cooperative effort and registration statement preparation	Some adversarial negotiations	Some adversarial negotiations	Cooperative effort
Private company discount/ terms set by buyer and seller	Public company valuation may provide better pricing/ terms when established in a favorable market	Minimal or no loss of equity	Opportunity for multiple liquidity events	Sale price determined over time as ESOP buys shares
Terms can be confidential	Terms are publicly disclosed	Terms can be confidential	Terms can be confidential	Employees learn key information about business
Seller generally responsible for indemnities in Purchase Agreement	Company generally responsible for indemnities in Underwriting Agreement	Company generally responsible for indemnities in Purchase Agreement	Seller generally responsible for indemnities in Purchase Agreement	Limited indemnification
Investment Diversification/ Retirement	More work and pressure for long-term	Investment Diversification/ job retention	Investment Diversification/ pressure from private equity	Investment Diversification/ job retention
6-20 week process	12-15 week process	8-20 week process	12-20 week process	12-20 week process

IV. Outline of Issues to Consider in Preparing for a Sale of a Company

A. Form Working Group

1. Determine management deal team and who will know of transaction within the company.
2. Company counsel.
3. Accountant (determine whether counsel or accountant will serve as primary tax advisor).
4. Investment banker/business broker.

B. Basic Terms of the Transaction

1. Cash:
 - a. Pay entire amount at closing
 - b. Deferred payment; or
 - c. Installment payments.
2. Equity (particularly if sale is to a public company):
 - a. Class of equity (preferred or common) to be issued (whether or not it will be convertible);
 - b. Fixed exchange ratio vs. fixed value;
 - c. Floor, cap or collar;
 - d. Walk-away right if outside collar;
 - e. Put/call restrictions on transfer;
 - f. Contingent value rights and other post-closing price protection mechanisms;
 - g. Federal and state securities law issues relating to issuance of equity;
 - h. Registration rights for securities received or registering publicly traded securities on Form S-4;
 - i. If equity is equity in a public corporation, consider:
 - (i) Rule 145;
 - (ii) If any person must file Schedule 13D or 13G or Form 3;
 - (iii) Form 8-K disclosure required.
 - j. Consider market risk of Buyer's stock.

3. Purchase of Stock versus Purchase of Assets:

<u>Purchase of Stock</u>	<u>Purchase of Assets</u>
Seller generally prefers	Buyer generally prefers
Relatively simple	Somewhat more complicated because need transfer and assignment documents for all assets purchased
Contracts and business can often be transferred without third party consents	Third party consents to transfer contracts may be required
Seller avoids future liability for occurrences prior to sale, except to the extent Seller indemnifies Buyer	Buyer generally able to limit liability to those expressly assumed; Seller retains future liability for occurrence prior to sale, except to the extent Buyer indemnifies Seller
Seller avoids possible double taxation, and may have even more favorable taxation if the stock is “qualified small business stock”	Seller might be subject to double taxation; favorable capital gains rates are available only if Seller is an LLC or an S corporation
Seller must convince all shareholders to sell their stock (or consider merger)	Unanimous agreement of Seller’s shareholders not required
Buyer assumes Seller’s tax basis for assets, even if paid more for the assets than the tax basis; if step up election if filed, Buyer pays tax on step up amount unless Seller is an S corporation	Significant potential for Buyer to obtain step up in tax basis of assets
Buyer cannot write off amount paid for stock (although may be able to write off reasonable amount paid for individual shareholder non-competes)	Significant potential for Buyer to be able to obtain eventual write-off for all or most of purchase price
Buyer takes all assets	Buyer can exclude undesired assets
Buyer may be able to make use of tax loss carryforwards, but there are strict limitations	Buyer may not use tax loss carryforwards

Purchase of Stock

Purchase of Assets

Buyer and Seller may agree on advantageous allocation of purchase price

4. Mixture of Cash and Equity:
 - a. Fixed mixture vs. cash-election
 - b. Two-step structure;
 - c. Tax impact if pay over 50% in cash.

5. Earn-Out:
 - a. Define measurement standard for earn-out (revenue, profits, etc.);
 - b. The measurement standard can be applied pre-tax or post-tax;
 - c. Provide for what happens if Buyer combines with a different business or wants to sell an acquired business unit;
 - d. Exclusion of any matters from the computation of measurement standard;
 - e. Provide for method of determining calculations and resolving disputes relating to calculation; and
 - f. Be careful not to tie earn-out to employment.

6. Purchase Price Allocation – Tax Considerations.
 - a. Allocations must be reasonable.
 - b. Tax impact will vary significantly based on whether tax basis for stock and assets is high or low compared to fair market value and the purchase price and whether the corporation is a C or S corporation.

7. Treatment of Options (if no mandatory acceleration and cash out in change of control transaction).
 - a. Rolling vs. accelerate and cash out.
 - b. Treatment of Buyer's options – in merger of equals, treatment of Buyer and Seller should be the same.
 - c. Golden parachute payments – potential tax problems, unless approved pre-transaction by Seller's stockholders.

8. Treatment of Preferred Stock.
 - a. Class votes;
 - b. Dissenters' rights;

- c. Liquidation preferences – check for participation rights of preferred and treatment of accrued dividends;
 - d. Right of first refusal/co-sale/tag along/drag along rights.
9. Confidentiality Agreement.
 10. Standstill Agreement (if public).
 11. Bust-Up Fees & Expense Reimbursement.
 12. Pre-closing or post-closing Audit obligation.
 13. Purchase Price Adjustment based upon Closing Balance Sheet or other financial criteria.
 14. No shop or limited shop clause.
 15. Covenants not to Compete.
 16. Employment/Consulting Agreements for Key Executives of Seller.
 17. Escrow of portion of purchase price to cover purchase price adjustment and indemnification claims.
 18. Financing contingency or other issues relating to financing of transaction by Buyer.
 19. Responsibility to pay brokers or finders.
 20. Coordination of public announcement.

C. Corporate Approvals.

1. Board approval of both parties for the execution, delivery and performance of the purchase agreement. Consider whether fairness opinion should be obtained.
2. Shareholder approval by Seller generally necessary for:
 - a. Asset Sale:
 - (i) If the sale is out of the ordinary course of business; or
 - (ii) If the sale amounts to a sale of substantially all assets;
 - b. Merger:

- (i) Seller's shareholders generally must approve merger; (requisite number varies by jurisdiction);
 - (ii) Buyer's shareholders may also need to approve merger;
 - c. Binding share exchange – generally, treated similarly to a merger.
 - 3. Consider in connection with shareholder approval:
 - a. State law regarding approval of fundamental transactions;
 - b. State anti-takeover statutes;
 - c. Stock exchange rules; and
 - d. Whether plan of merger amends Buyer's charter, thus triggering Buyer shareholder approval.
 - 4. Consider appraisal rights.
 - 5. Follow proxy rules relating to solicitation of shareholder approval.
- D. Third Party Consents (Typical consents required in asset sales):
- 1. Banks;
 - 2. Debt holders;
 - 3. Landlords;
 - 4. Computer software agreements;
 - 5. Equipment leases;
 - 6. Customer and supplier agreements; and
 - 7. Permits and licenses.

If all outstanding stock is purchased or if a merger is consummated, the transaction is treated in most jurisdictions as if there were no assignment of Seller's assets. As such, no third party consent is necessary. However, third party consent will be necessary if the contract requires consent for a change of control.

E. Hart-Scott-Rodino Antitrust Act

Consider whether transaction will require pre-closing notification to the Department of Justice and the Federal Trade Commission pursuant to the Hart-Scott-Rodino Antitrust Act (HSR). Also consider timing (can file after letter of intent, but note that if early termination of the initial 30-day waiting period is granted, there is a public notice.). Assess whether foreign antitrust filings will be required.

In general, transactions involving (1) a sale price (including assumed liabilities for asset sales) of more than \$56.7 million and (2) for transactions valued at \$226.8 million or less, the Seller or Buyer on a groupwide basis has sales or assets of at

least \$11.3 million, and the opposite party on a groupwide basis has sales or assets of at least \$113.4 million, may be subject to an HSR filing.

Note: These thresholds are adjusted annually.

F. Regulated Industries

Any industry which is regulated by either a federal or state agency, such as the banking, broadcasting, airline or health care industries, usually faces a filing requirement.

Federal regulatory statutes that require approval of changes of control include: the Federal Power Act (FERC), the Public Utility Holding Company Act, and the Atomic Energy Act. In addition, state law regulates changes of certain industries such as utilities, although in certain situations, federal law preempts state regulation of changes of control.

G. Tax Treatment of Acquisition

1. Consider whether transaction is taxable or a tax-free reorganization.
2. Consider whether a stock sale should be treated as an asset sale for tax purposes under § 338 (often desirable when Seller is an S corporation).
3. Section 197 intangibles (in taxable asset acquisition) have a 15 year amortization period.
4. Consider transfer taxes. Certain jurisdictions exempt transfers of substantially all the assets and bulk sales of inventory from state sales tax. New York has a stamp tax on certain stock sales.
5. If business is located in Pennsylvania, consider implications of Business Privilege tax.

H. Employment Matters

1. WARN Act requirements;
2. Differences in pay scale between Buyer and Seller;
3. Voluntary vs. involuntary workforce reduction;
4. Coordination of employee benefit plans;
5. Buyer's granting of credit for time served with Seller for eligibility, vesting and other purposes;
6. Transferability of existing restrictive covenants with Seller's employees;
7. Employment agreements for officers and other key employees.

I. Bulk Sales Law

For asset acquisitions some states still require compliance with bulk sales laws to insulate Buyer from liability from Seller's creditors, if such creditors will not be paid in full with the proceeds of the acquisition.

J. Purchase Agreement Issues

1. Determining scope of Seller's representations and warranties based upon due diligence, concerns for type of business and customary scope for transactions of similar size and industry and scope of Buyer's representations and warranties based on consideration to be received and relative size of transaction to Buyer.
2. Determine covenants with respect to pre-closing and post-closing obligations of Buyer and Seller to each other and to third parties such as employees.
3. Conditions to each party's obligation to close (and rights to terminate Purchase Agreement if not satisfied).
4. Indemnification:
 - a. Breaches of representations, warranties and agreements;
 - b. Breaches of agreements;
 - c. Specific indemnification for known disclosed issues or areas of concern;
 - d. Procedures for handling third party claims;
 - e. Baskets/Thresholds/Ceilings;
 - f. Duration;
 - g. Exclusivity of remedy;
 - h. Set offs for tax and insurance benefits as well as unpaid purchase price;
 - i. Transferee or successor liability:
 - (i) Fraudulent conveyance and bulk sales statutes;
 - (ii) Successor liability as purchaser of "enterprise" for pension, environmental and products liability obligations.
 - j. Joint and several liability; and
 - k. Escrow arrangements.
5. Governing Law; and
6. Dispute Resolution Mechanisms.

V. **Issues to Consider in the Year in Advance of IPO Kick-Off Meeting**

- A. Form Working Group
 - 1. Management
 - 2. Company counsel (including regulatory and IP counsel for IPO transaction)
 - 3. Managing underwriters
 - 4. Underwriters' counsel
 - 5. Auditors
 - 6. Transfer agent
 - 7. Financial printer

- B. Issues to Ask in Choosing Managing Underwriters
 - 1. Firm's expertise in industry
 - a. Recent transactions
 - b. Aftermarket performance
 - 2. Resource commitment (during and after the transaction)
 - a. Investment banking team
 - b. Research analyst (note: independence requirements)
 - c. Market making activities
 - 3. Research positioning in industry
 - a. Current coverage universe
 - b. Firm's ability to articulate the Company's opportunity
 - 4. Valuation, structure and timing
 - a. Approach to valuation
 - b. Transaction terms (see "Structure of Offering" below)
 - c. Filing strategy/pricing strategy
 - d. Recommendation on timing
 - 5. Proposed spread and other underwriters' compensation matters
 - 6. Recommended selling strategy
 - a. Institutional vs. retail
 - b. Domestic vs. international
 - c. Road show recommendations

7. Specific qualifications as a manager
 - a. Differentiation from other investment banking firms
 - b. Value-added capabilities
 8. Lead-managers
 - a. Number of lead managers
 - b. Fee split arrangement
 9. Any recommended changes in Company's management team or corporate strategy?
 10. Ask to speak with CEOs of other clients
 11. Underwriter's compensation issue if affiliate of underwriter is an investor
- C. Time and Responsibilities for Offering
1. Begin to prepare S-1 prior to kick-off meeting
 2. Internal preparation meetings before kick-off meeting
 3. Kick-off Meeting – Week 1
 4. Drafting meetings – Weeks 1 – 4
 5. Due diligence – Weeks 1 – 4
 6. Filing target date – End of Week 4
 7. SEC review period
 - a. 30-35 days to first comments – End of Week 9
 - b. 15 days to complete response – End of Week 11
 8. Road show schedule/presentation – Weeks 12-15
 9. Possible Shareholders' meeting (see "Corporate Structure Issues" below)
 10. Other lead time issues (art work for prospectus, requests for confidential treatment, etc.)
- D. Structure of Offering
1. Offering entity
 2. Offering size

- a. Primary
 - b. Selling shareholders, if any
 - c. Over-allotment option (size and split between company and any selling shareholders)
- 3. Use of proceeds
 - 4. Syndicate strategy
 - 5. Shares to be reserved for specific investors or syndicate members
 - 6. Underwriter compensation – anticipated discount from price to public
 - 7. Road show
 - 8. Nasdaq National Market/New York Stock Exchange listing
 - 9. Ticker Symbol preference (reserve in advance)
 - 10. Directed Share Program

E. Corporate Structure Issues

- 1. Board of directors; management; employees
 - a. Directors
 - (i) Composition of board after offering – a majority of independent directors
 - (ii) Committees, including an audit and compensation committee with at least 3 independent directors
 - (iii) Director compensation arrangements
 - (a) cash compensation
 - (b) stock option compensation
 - (c) committee compensation
 - (iv) Audit Committee “financial expert” and other financially sophisticated matters
 - b. Officers
 - (i) Titles
 - (ii) “Executive” officers vs. “Senior” officers
 - (iii) Section 16 insiders - reporting and compliance issues
 - (iv) Employment arrangements
 - (v) Incentive arrangements
 - c. Employees
 - (i) Non-compete arrangements, non-solicitation and confidentiality arrangements

- (ii) Incentive arrangements and plans
- d. Option and benefit plans
 - (i) Compliance with ERISA, tax and securities laws - Rule 701
 - (ii) Consider plans or plan amendments
 - (a) new equity compensation/stock option plans
 - (b) 401(k) plan (match feature with or without company stock feature)
 - (c) employee stock purchase plan
 - (iii) SEC registration of shares issuable upon exercise of options (Form S-8)
- e. Directors and officers liability insurance
 - (i) coverage amount
 - (ii) cost
 - (iii) breadth of coverage
 - (iv) deductibles

2. Corporate structure

- a. Charter and bylaws - review and make any necessary changes
 - (i) Review capital structure (make sure that there will be sufficient common stock and blank check preferred)
 - (ii) Antitakeover provisions, including consideration of a classified board
 - (iii) Remove any unnecessary provisions
 - (iv) Review indemnification provisions
- b. Review corporate structure
 - (i) Consider merging subsidiaries into parent prior to offering
 - (ii) Tax issues, including the use of a Delaware or foreign “technology” subsidiary for state tax planning
- c. Corporate records
 - (i) (i) Review minute books for completeness and accuracy

3. Share capital

- a. Review existing shareholder list
 - (i) Registration rights/waivers
 - (ii) Lock-ups
 - (a) existing lock-ups required by financing agreements
 - (b) requests for new lock-ups
 - (c) lock-ups in option agreements
 - (iii) Preemptive rights; antidilution provisions

- (iv) Accuracy and completeness of stock book
 - b. Identify all issuances of shares since formation
 - c. Shares authorized and outstanding - amend charter as necessary
 - d. Transition stock recordkeeping to transfer agent
 - e. Stock options outstanding and to be granted
 - 4. Corporate Governance
 - a. Prepare new Board Committee charters
 - b. Prepare Code of Conduct that includes Code of Ethics (note specific issues for biotech companies)
 - c. Prepare Insider Trading Policy
 - d. Prepare Disclosure Controls and Procedures
- F. Review Legal Issues
- 1. Outstanding claims – resolve if practical to do so
 - 2. Third-party consents
 - 3. Disclosure issues
 - a. Confidentiality agreement restrictions
 - b. Material contracts
 - (i) Identify
 - (ii) Disclosure issues
 - (iii) Exhibits to registration statement
 - (iv) Confidential treatment
 - c. Related party transactions
 - (i) Identify
 - (ii) Consider if advantageous to continue
 - (iii) Review documentation
 - (iv) Ratification by independent directors
 - d. Regulatory progress and issues
 - e. Status of IP and any infringement issues
 - f. Employment agreements
 - g. Management compensation
 - h. Option grants to executive officers
 - i. Pending acquisitions or other material transactions
 - j. Restrictions on future activity contained in development agreements, co-promotion agreements and other business agreements
 - k. Antitakeover provisions
 - l. D&O questionnaires - Identify any issues raised by responses

4. Make sure that there is appropriate trademark protection for the Company's name and that there are no other intellectual property conflicts
5. Review web page for "gun jumping" and substantive issues
6. Blue sky matters – most likely not an issue as a result of NSMIA
7. Review NASD affiliations, if any
8. Consider safe harbors and implications of 2005 securities offering reforms

G. Accounting and Financial Issues

1. Preparation and audit of financial statements – 3 years or from inception
2. Need for unaudited interim financial statements - SAS 71 review
3. Historical option pricing or other cheap stock issues
4. Historical review recognition policy
5. Management's Discussion and Analysis of Financial Condition and Results of Operation
6. Comfort letter from auditors to underwriters (note: underwriters may request comfort on all 5 years included in Selected Financials)
7. Management letters
8. Availability and discussion of forecast information
9. Tax issues - NOLs (Section 382 analysis); 409A related matters
10. Goodwill/intangibles
11. SEC requirements for separate financials in connection with acquisitions
12. Pro forma presentations

H. Interaction with Public During Offering Process; Publicity

1. Prior to filing
2. Registration period
3. Post effectiveness
4. Filing press release - Rules 135, 134
5. Employee communications
6. Web page communications
7. Analyst and investor meetings

8. Public relations firm
9. Communications with existing investors

I. Post-Offering Issues for Underwriters

1. Continuing market making
2. Provision of research reports
3. Follow-on offering
4. M&A Services

VI. **Outline of Issues to Consider in Preparing for a Leveraged Recapitalization**

- A. Determine whether to contemporaneously bring in private equity firm for equity investment (see Section VII).
- B. Identify lender to provide debt financing if no private equity firm (if private equity firm, they will usually select lender).
- C. Structure Debt.
 1. Secured or unsecured;
 2. Interest rate (fixed or variable);
 3. Payment schedule;
 4. Conversion rights;
 5. Prepayment rights and obligations;
 6. Consider whether debt is a security, and if so, the federal and state securities law issues relating to the issuance of the debt;
 7. Consider whether debt is exempt from the Trust Indenture Act of 1939; and
 8. Restrictive Covenants – financial and operational.

VII. **Outline of Issues to Consider in Preparing for a Private Equity Transaction**

- A. Will face issues outlined under Section IV (Sale of Company) and Section VI (Leveraged Recap) since a private equity transaction is the sale of a partial interest in the company (generally over 50-90%) and the private equity firm will generally leverage its equity investment with debt.
- B. Structuring Sale of Shares to Private Equity Firm
 1. Cash can be paid up front or over time (i.e., Seller debt);
 2. Often have earn-out component of purchase price;
 3. Often, at least one existing stockholder is required to retain a sufficient minority interest to achieve recap accounting treatment;

4. May have limit (i.e., 19.9%) on amount that can be retained by existing stockholders in order to achieve asset basis step-up.
5. Must allocate consideration to existing stockholders based upon existing liquidation preference rights, but “roll over equity” can be pari-pasu with private equity firm.

C. Management

1. Post-transaction Board;
2. Post-transaction management;
3. Veto rights to equity holders;
4. Restrictive covenants to debt holder;
5. Employment Agreements, including equity compensation for management going forward in addition to any rollover equity.

VIII. **Outline of Issues to Consider in Preparing for an ESOP**

A. Form Working Group

1. Set up ESOP committee to supervise feasibility study
2. Retain experienced ESOP counsel
3. Retain experienced ESOP business valuation firm
4. Retain trustee if feasibility analysis is positive

B. Basic Terms of the Transaction

1. Tax-Deferred Sale vs. Taxable Sale:
 - a. for sale to qualify for tax-free treatment, the following conditions must be satisfied:
 - (i) corporation must be a C corporation
 - (ii) ESOP must own at least 30 percent of the outstanding shares immediately after the transaction
 - (iii) seller must reinvest sale proceeds in "qualified replacement properties"
 - (iv) seller and seller's relatives may not participate in the ESOP (and any 25-percent shareholder also ineligible)
 - b. taxable sale
 - (i) corporation may be either a C corporation or an S corporation
 - (ii) no minimum ESOP ownership requirement
 - (iii) capital-gains treatment for seller
 - (iv) seller may participate in ESOP

2. Tax-Advantaged Financing
 - a. amounts borrowed through an ESOP are fully tax-deductible, principal as well as interest
 - b. after-tax costs of borrowing reduced by approximately 40 percent (for each \$1 of ESOP indebtedness, the company will be entitled to a \$1 tax deduction, which should result in approximately 40¢ in federal and state income tax savings)

3. Sources of Financing
 - a. senior indebtedness
 - (i) bank
 - (ii) insurance companies and other financial institutions
 - b. subordinated indebtedness
 - (i) mezzanine lenders
 - (ii) seller financing

C. The 100-Percent ESOP Buyout

1. Tax-Free Operations for S Corporations
 - a. no corporate-level tax under general rules of Subchapter S of the Internal Revenue Code
 - b. no shareholder-level tax because the ESOP is a tax-exempt entity

2. Financing.
 - a. senior debt
 - b. mezzanine debt
 - c. seller financing
 - d. equity
 - (i) "rollover" of management stock options
 - (ii) employee funds -- transfers from Section 401(k) plans to ESOP

3. Other Planning Considerations.
 - a. ESOP counts as only one shareholder, so corporations with thousands of employees still may adopt an ESOP and make the S election without violating the 100-shareholder limitation applicable to S corporations
 - b. seller and key executives may retain equity interests through phantom stock and stock appreciation rights arrangements without violating the one-class-of-stock rule applicable to S corporations

D. Corporate Structuring Issues

1. Shareholder Voting

- a. shares held by ESOP voted by trustee
- b. employees entitled to direct vote of shares allocated to their accounts only with respect to extraordinary transactions, such as proposal for a merger, sale of substantially all assets, liquidation, or recapitalization
- c. participants do not have the right to direct the trustee as to voting of shares in Board elections
- d. trustee may be allowed to vote ESOP shares in its discretion or subject to direction from the Board of Directors or from a committee designated by the Board
- e. trustee serves at the will of the Board

2. Composition of Board of Directors

- a. ESOP trustees normally will not request either a seat on the Board or representation on the Board
- b. depending on size of ESOP's ownership interest, ESOP trustee may request that some independent directors be retained

3. ESOP trustee will not become involved in day-to-day management

4. No disclosure of confidential information to employees

- a. only the ESOP trustee has shareholder rights
- b. ESOP participants entitled only to information regarding their interests in the plan (number of shares allocated to their account, value of shares, and vesting)

E. Other Transaction Structuring Issues

1. Purchase Price

- a. cannot exceed fair market value of stock purchased and sold
- b. fair market value must be determined by trustee, based on an appraisal performed by an independent financial advisor
- c. seller can obtain full fair market value, but ESOP cannot pay a strategic or synergistic premium (because no synergies are derived from an ESOP buyout)

2. Need for Independent Trustee
 - a. ERISA requires that some person be designated as trustee of the ESOP, with legal responsibility to protect the interests of the employees
 - b. difficult conflicts-of-interest issues raised where trustee is an executive of the plan sponsor or otherwise related to or beholden to the selling shareholder
 - c.
- F. Corporate and Third-Party Approvals
 1. Board of Directors must approve ESOP plan documents, appoint trustee, and authorize financing
 2. ESOP trustee must approve transaction on behalf of employees
 3. No governmental approvals required
 4. No third-party consents required
- G. Contract Negotiations and Disclosures
 1. ESOP trustee negotiates stock purchase agreement on behalf of employees
 - a. agreement should be negotiated at arm's length
 - b. but negotiations are far "friendlier" than negotiations with a third-party purchaser because ESOP can purchase stock only of the plan sponsor
 2. "Quiet" Transaction
 - a. no disclosure of confidential information to potential competitors
 - b. no disclosure of confidential information to employees (see Section D4)
- H. Ongoing Legal Compliance
 1. Plan administration similar to that involved in administering a profit-sharing plan
 - a. annual statements for plan participants
 - b. annual filings with IRS
 - c. administration generally outsourced to a third-party administrator
 2. Annual appraisals required, so that participants can be informed of the value of the shares allocated to their accounts

3. No significant additional legal fees on a year-to-year basis
 - a. occasional amendments to plan will be required, as company's needs change and as federal tax and employee benefit laws are revised
 - b. occasional issues regarding interpretation of plan may arise

IX. **Personal Estate Planning**

- Early gifts of shares to children
- Sales to children at current fair market value on an installment basis
- Transfer of shares to a Family Limited Partnership
- Use of Trusts
- Gift of shares to charity or charitable trust