

# The Morning After:

## We've Just Completed our ESOP Transaction... Now What?

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# Introduction

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- New ESOP companies often receive volumes of professional advice up to the day the ESOP is created and the ESOP transaction is closed.
- This session will address the issues that ESOP companies need to address during the first year after the closing including:
  - What to do with the closing documents, stock certificates, and promissory notes;
  - How and when to roll out the ESOP to employees; how to set up recordkeeping ("TPA") services;
  - What to communicate to your attorney, TPA, and trustee, and to the trustee's independent financial advisor -- and what communications should you expect from them;
  - How and when to determine annual contributions, distributions, and/or dividends; how and when to pay the outside financing and the ESOP loan; what to file, and when; and more.

# Outline

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- Know the Parties.
- Know the Governing Documents.
- Communicate the ESOP to Employees.
- Appendix
  - Trustee Checklist

# Know the Parties

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- **Trustee(s)**: The Trustee is the legal owner of the stock in the ESOP. The Trustee acts as an ERISA fiduciary, for the benefit of the plan participants.
  - Responsible for determining value of stock. May engage professional advisors (including independent financial advisor).
  - Is the ongoing Trustee the same as the transactional Trustee?
    - ✓ Resignation? Resolutions appointing? Amend Trust Agreement? Transfer of records?
  - Where is the ESOP trust account (stock certificates, cash, other investments).
  - If no Trustee appointed, Board of Directors may be default trustee (and therefore an ERISA fiduciary).
- **Trustee's Independent Financial Advisor ("FA")**. Performs annual valuation of Company. Advises the trustee on valuation.
  - Coordinate timing of annual ESOP valuation with annual financial statements (each requires the other to be done first).

# Know the Parties

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- **Shareholder(s)**: The ESOP may be the sole (100%) shareholder, or one of many. Shareholders elect the Board of Directors and vote on major corporate events.
  - Notice of meetings? Resolutions?
  - Some ESOP Companies treat participants as quasi-shareholders (generally, not required but many believe that it helps employees learn to “think like owners.”)
- **Board of Directors**: The Board of Directors oversees management of the Company. The Board acts as a fiduciary, for the benefit of all shareholders. Generally a non-ERISA fiduciary except for (1) appointing, monitoring and (if necessary) removing the Trustee; (2) directing a “directed Trustee”.
  - Committees: Compensation, Audit, ESOP, others?
  - Notice of meetings? Resolutions?
  - Policy regarding unsolicited offers?

# Know the Parties

- **Accountants**: ESOP causes changes to financial statements, including shareholders equity (FASB's Statement of Position 93-6: "Employers' Accounting for Employee Stock Ownership Plans").
  - If making an S-election, know who is filing it.
  - If seller(s) is making a 1042 election, know who is responsible for QRP, forms, and filings.
  - Coordinate timing of annual financial statements with annual ESOP valuation (each requires the other to be done first).
- **ESOP Administrator / "TPA"**: Keeps track of individual account balances, allocations, vesting, distributions, diversification, compliance testing; prepares (and may file) Form 5500; prepares (and may distribute) individual account statements.
  - S-corps: Notify TPA of any changes in "synthetic equity" and changes in family relationships among employees.
  - Coordinate between ESOP and other qualified plans TPA.

# Know the Parties

- **ESOP Attorney:** Provides ESOP transaction closing documents; obtains determination letter from IRS. Consulting on corporate governance, changes in Plan Documents, subsequent transactions. New SPD every 5 years.
- **\*ESOP Communication Professionals:** For employees to appreciate an ESOP, they must understand what it is and what it is not.
- **\*ESOP Culture Committee:** (Not to be confused with Board of Directors ESOP Committee).
- **\*Become Involved in ESOP Community:** National Center for Employee Ownership, The ESOP Association, Employee Ownership Foundation, ESCA. Tell your Senator/Representative!
- **\*Repurchase Obligation Analysis:** Usually done 3 -5 years after closing, sometimes sooner. May be done by TPA, Company financial advisor or accountant, stand-alone service provider.

\*Important, but not *immediately* mandatory.

# Know the Governing Documents

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## Articles of Incorporation and Bylaws

- Meetings of shareholder(s) and Board of Directors.
- Election of directors.
- Board of Directors Committees (Conflicts of interest and the business judgment rule or entire fairness doctrine).

## Plan Documents (Plan, Trust, Summary Plan Description):

- Is trustee discretionary or directed?
- Documentation of appointment/change of Trustee.

## Transaction Documents

- Stock Purchase / Redemption Agreement(s) may include:
  - Post-closing covenants
    - Working capital adjustments
    - Nomination of outside Board members



# Know the Governing Documents

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## Transaction Documents (cont.)

- Stock Purchase / Redemption Agreement
  - Post-closing covenants (cont.)
    - Financial Statements
    - Repurchase Obligation Analysis
    - Compliance Testing
- Representations/Warranties/Indemnification (seller obligations to Company and/or Trust).
  - Time Limits
  - Notice
- “Outside” loan documents-
  - Original Promissory Note(s) to lender(s), or Company hold for safekeeping;
  - Payment Schedule
    - If floating rate, know when and how it adjusts

# Know the Governing Documents

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## Transaction Documents (cont.)

- “Outside” loan documents – (cont.)
  - Collateral
  - May include affirmative and/or negative covenants; Some may require periodic (monthly, quarterly, or annual) reporting
  - Warrants
    - Post Transaction Value?
- “Inside” (aka “ESOP”) loan documents-
  - Payment Schedule-
    - Exact payment dates matter! Notify TPA of any variation from amortization schedule.
    - Original Promissory Note to Company.
    - Original ESOP stock certificate to Trustee, but . . .
      - May be pledged to Company to secure ESOP Loan
      - Company may assign ledged stock to Bank to secure Outside loan
      - Need to release allocated shares from pledge annually

# Know the Governing Documents

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## Transaction Documents (cont.)

- Transaction Valuation Report issued by Trustee's FA.
- Employment Agreements
  - Former owners' new relationship with their job, compensation and Board of Directors.
- SARs or other MIP
  - Post-transaction value?
  - Documentation of Awards
  - Performance Criteria for Awards & Vesting
  - TPA?
- Financial Projections given to Trustees FA in connection with transaction valuation.
  - Relationship to future expenses

# Communicate the ESOP to Employees

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- Communicate *before* first ESOP account statement is distributed.
- Properly communicated, an ESOP can be a powerful tool to Attract, Retain and Motivate employees. Poorly (or not) communicated, an ESOP can be a source of misinformed expectations, disappointment, resentment and distrust.
- In the short term, vested account balances are impacted by:
  - Small % of shares allocated
  - Lack of vesting
  - Impact of transaction debt on Company valuation.
- As time passes, these negative impacts are quickly reduced by ongoing allocations, gradual vesting, and amortization of debt.

# Appendix – Trustees Annual Checklist

## Trustees Annual Checklist

Note 1: the "Period" represents the time either Before (-) or After (+) First Day of Plan Year to complete the task

Note 2: specific due dates are for calendar year end. Dates marked with an "\*" are date certain

|    | Period       | Duty            | Description  |
|----|--------------|-----------------|--|
| 1  | - 2 mos      | Distribution    | Ensure Diversification & RMD Distributions for current & next plan year                            |
| 2  | - 2 mos      | Investment      | Engage Valuation Firm  |
| 3  | - 1 mos      | Distribution    | Engage Third Party Administrator   |
| 4  | 31-Jan *     | Compliance      | Last day to Prepare and Mail IRS Form 1099-R AND IRS Form 945                                      |
| 5  | + 1 mos      | Distribution    | Determine Participant Eligibility  |
| 6  | 28-Feb *     | Compliance      | Last day to Prepare and Mail IRS Form 1096   |
| 7  | + 2 mos      | Distribution    | Review Share Release Calculation & Allocation  |
| 8  | + 2 mos      | Investment      | Review Financial Statements of underlying Company  |
| 9  | 15-Mar       | Compliance      | Last day to Receive Company Contribution for prior plan year (unless corporate return is extended) |
| 10 | + 3 mos      | Investment      | Read Valuation Report & Establish Price  |
| 11 | + 3 mos      | Distribution    | Review Allocation Report & Distribute Participant Statements                                       |
| 12 | + 3 mos      | Compliance      | Distribute Diversification Notices   |
| 12 | 1-Apr *      | Compliance      | Last day for RMD payments to any participant who turned 70&1/2 in prior year                       |
| 13 | + 4 mos      | Distribution    | Review & Prepare Participant Distributions   |
| 14 | + 5 mos      | Corp Governance | Review Proposals & Nominated Directors   |
| 15 | + 5 mos      | Corp Governance | Distribute Proxy Information to Participants   |
| 16 | + 6 mos      | Compliance      | Last day to Execute Diversification Elections  |
| 17 | + 6 mos      | Corp Governance | Attend Annual Meeting  |
| 18 | + 6 mos      | Corp Governance | Vote Proxy   |
| 19 | +7 mos       | Compliance      | Last day to file 5500 (can be extended 2&1/2 mos)  |
| 20 | 30-Sep       | Compliance      | Last day to Distribute Summary Annual Report (within 2 mos after filing tax return)                |
| 21 | +10 mos      | Distribution    | Review Repurchase Obligation Study   |
| 22 |              |                 |  |
| 23 | 31-Dec *     | Compliance      | Last day for RMD distributions   |
| 24 | Occasionally | Compliance      | Distribute Summary Plan Description to new participants  |
| 25 | Occasionally | Corp Governance | Review Corporate Actions, Budgets & Plans  |
| 26 | Occasionally | Corp Governance | Engage Plan & Trust Legal Advisor  |
| 27 | Occasionally | Custody         | Collect, Receive and Invest Asset revenues (divs or S-Corp earnings)                               |
| 28 | Occasionally | Custody         | Accept Employer Contribution(s)  |
| 29 | Occasionally | Investment      | Engage in Assets Purchases or Sales  |
| 30 | Occasionally | Investment      | Prepare and Process Loan Payments  |
| 31 | Recurring    | Compliance      | Monitor Plan & Trust compliance with applicable laws & regulations                                 |
| 32 | Recurring    | Custody         | Hold, Control and Maintain assets  |
| 33 | Recurring    | Investment      | Determine Plan Investment Prudence   |

# Questions?

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# Don't Forget!

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