ESOP Companies Advantage in Making Acquisitions

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Preface

- Please fill out a session evaluation form and drop it off at the table outside of this room
- Your feedback on topics and presenters is important and will be used to develop subsequent TEA programs
- Take a moment to silence your cell phone
- Remember to get your CPE sheet stamped before and after each session for CPE credit

Overview of Acquisition Process

- Development of Acquisition Strategy
- Identification of Potential Acquisition Targets
- Contact and Discussions with Target Companies
- Execution of a Letter of Intent (LOI)
- Development of Transaction Document (Stock Purchase, Asset Purchase or Merger)
- Completion of Due Diligence and Negotiation
- Successful Closing of the Transaction
- Post-Closing Integration Initiatives

Acquisition Considerations

- Goals and Policies (set by the Board)
  - Increase market share and growth
  - Supplement strengths
  - Offset weaknesses
- Company and ESOP Culture
- Acquisition Structure
- Acquisition Financing
- Costs of Evaluation and Transaction
- Integration (Operations & Culture)

Acquisition Team

- Company Acquisition Team
  - Board of Directors
  - Company Officers
  - Investment Banker
  - Legal Counsel
  - Accountant
- Trustee Acquisition Team
  - Trustee
  - Financial Advisor
  - Legal Counsel
  - Oversight Role If Corporate Transaction (to assure no material impairment of ESOP assets)

Typical Buy-Side Acquisition Process

- Buy-side acquisition assignments can be customized by the investment banker to each client's goals and generally follow the four-phase approach outlined below. A client should expect a well-run buy-side process to yield results in a 5 to 9 month time-frame, depending on acquisition criteria, availability of targets and overall market conditions

Phase I: Strategy Assessment

- The Company, working with its investment banker, develops the corporate goals and strategies of an acquisition program
  - Management Objectives
  - Deal Size
  - Industry
- The Company needs to assess resources that it can deploy as part of the program
  - Human Capital / Employees
  - Financial Capacity
- The Company typically leads this phase with the investment banker challenging assumptions and focusing the approach

Phase II: Defining the Universe

- Utilizing the acquisition criteria developed in Phase I, potential acquisition targets are identified
- The investment banker will source transaction opportunities through their network, but will also leverage the Company's deal flow
- The investment banker will prioritize the candidate list for client approval before contacting the targets
  - In certain instances, targets may not ultimately be interested in a transaction

Phase III: Qualifying Targets

- The targets identified in Phase II are analyzed/approached to determine if they are qualified targets
- The investment banker would telephonically assess a target's interest level and viability
- Interested targets provide preliminary information for the team's review typically pursuant to execution of an NDA
- The investment banker and the client would schedule face-to-face meetings with the most attractive targets
- The investment banker and the Company's executive management would work to convince the most desirable targets that an acquisition would be appropriate and would foster their continued success and development

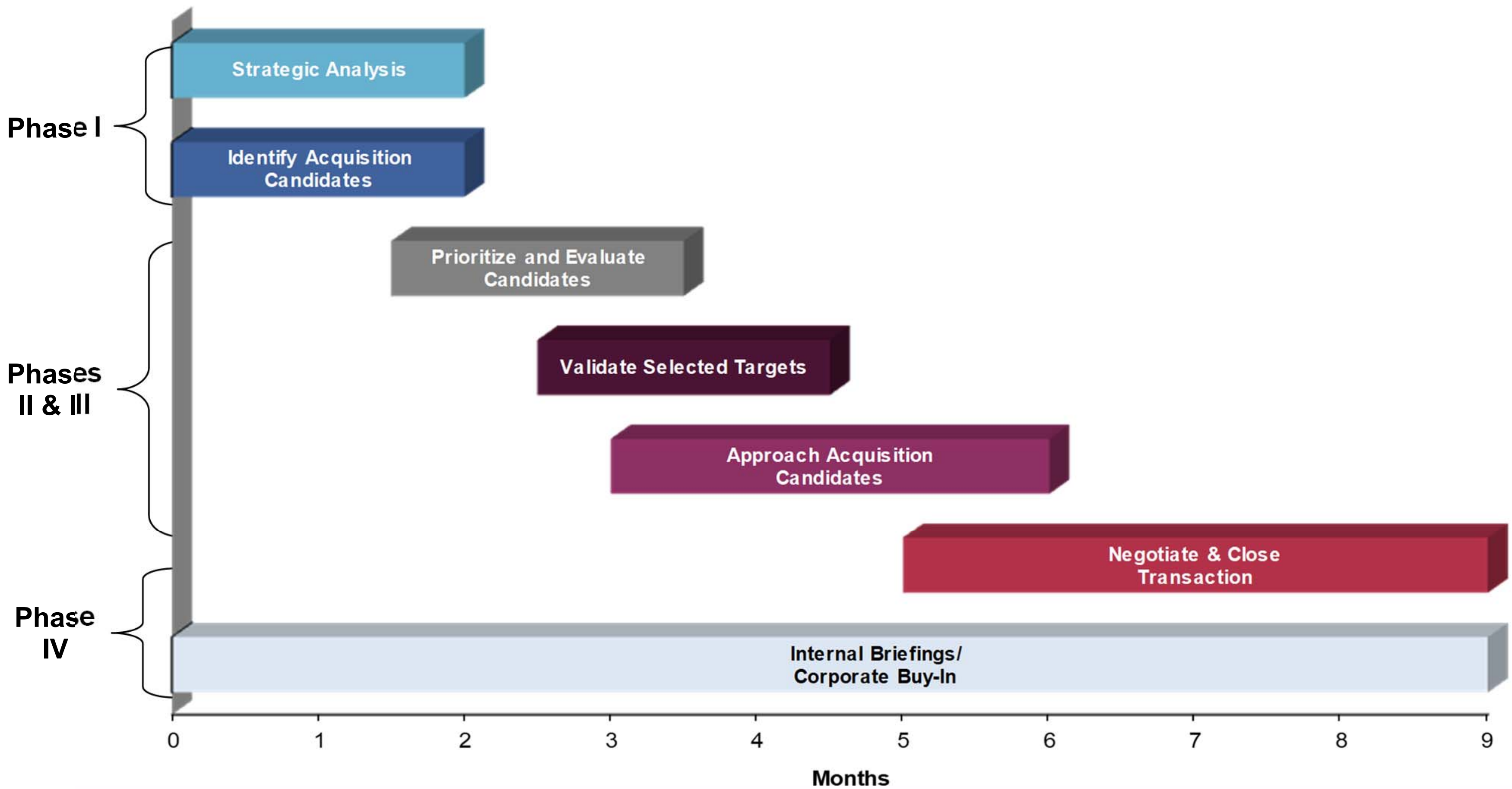
Phase IV: Transaction Mode

- The investment banker takes lead during this stage to best leverage the Company’s resources in this potentially time-consuming process
- The investment banker helps develop deal pricing and financial analysis for the Company to ensure there is internal buy-in at the Company which will facilitate the development of a deal structure and LOI
- The investment banker also oversees/coordinates the process leading up to a successful transaction closing
  - Business, legal and financial due diligence
  - Negotiations
  - Development and signing of definitive agreement at closing

Goal: Value-enhancing successful acquisition

Typical Process Sequencing And Timing

- Depending upon situation-specific variables, the Company and the investment banker could complete an acquisition within five to nine months of developing a prioritized list of acquisition candidates



Factors that Can Lead to a Successful Acquisition

- Pre-transaction planning
  - Structuring alternatives
  - Due diligence initiatives
  - Determining financing capacity
- During the transaction process
  - Deal pricing/valuation
  - Consider employee retention/participation in the acquiring company's benefit plans
    - Retirement plans/ESOP
    - Equity compensation
    - Other benefits
- Post-closing
  - Integration
  - Impact of leveraged financing

Factors in the Pre-Transaction Process

- Fully develop and articulate a corporate strategy
- Determine that an acquisition strategy is a better alternative than other options
  - Organic growth
  - Joint venture
  - Hiring programs/acquiring people as opposed to an entire company/division
- Identify acquisition targets that align with the corporate strategy
  - Enhances capabilities or product/service offerings
  - Fills an existing shortcoming in offerings or geographic presence
  - Synergistic opportunity (revenue or costs)
- Learning from prior acquisition processes to develop a successful and repeatable approach

Company as Acquirer: ESOP Specific Issues

- Understanding how the acquisition and debt will affect the value of stock held by the ESOP
- Structure: Acquisition by ESOP vs Company?
  - Ability to pay different prices?
  - What synergy premiums can be paid?
  - Can ESOP use cash in the deal?
  - Opinions needed? Who provides?
  - Effects on participants?
- Is the acquisition covered by ERISA rules or is it strictly a “business judgment” question?

Company as Acquirer: ESOP Specific Issues (cont.)

- Will/When will target company's employees become ESOP participants?
- How will acquisitions affect repurchase obligation cash flows?
- Issues arising if acquirer is an older ESOP, whose shares are fully allocated?
- Should Company acquire target if accretive on a Company-wide basis, but dilutive on a participant basis?

Company as Acquirer: Negotiation and Letter of Intent

- Goal is non-binding letter of intent summarizing key financial terms and transaction overview
- Involve advisors (legal, financial, tax) early regarding key structure issues
- Creates obligation to proceed in good faith
- Get the target to “stand still” – provide exclusivity – for a short time (a binding provision of the LOI)
- Confidentiality Agreement prior to LOI
- Letter of intent may “cap” purchase price with downward adjustments based on due diligence and normalized working capital levels
- Refundable or non refundable deposits? Break-up fee?

Company as Acquirer: Due Diligence

- Define Scope and Depth:
  - Financial statements
  - Customer issues
    - Review of material agreements
    - Interaction with customers
  - Industry issues
    - Market conditions
    - Technological initiatives
    - Legislative initiatives
  - Environmental issues
  - Employee issues
    - Interaction with employees
  - Health care and benefit plans
  - Role of internal team vs advisors

Company as Acquirer: Due Diligence (cont.)

- Analyze Potential Liabilities/Pitfalls
- Examine Target Agreements with Advisors
- Confirm Acquisition Fit to Company Goals
- Confirm Target Valuation – Resolve Conflicts
- Revise Letter of Intent and/or Confirm Purchase Agreement to Diligence Issues

Company as Acquirer: Financing

- Sources Include:
  - Company cash/investments
  - Senior debt based on acquirer balance sheet
  - Senior debt based on Target balance sheet
  - Mezzanine/private equity funds
  - Stock of acquiring Company (or Sub)
  - Seller financing
  - Benefit plan assets
    - Securities laws

Factors that are Important During the Process

- Maintaining a disciplined and well-conceived approach
  - Remove any potential “emotional” reactions
  - Limited and identified point(s) of contact
- Completing proper diligence on the target (some of which may be completed pre-transaction)
  - Financial and Tax
  - Operational
  - Legal
  - HR
  - Environmental
  - Customers/vendors
- Assessing whether there will be a successful cultural fit between the organizations

Factors that are Important During the Process (cont.)

- Developing and maintaining an appropriate view on the valuation of the target
  - Diligence in supporting potential synergies and normalizing adjustments
  - Proper negotiation surrounding who should receive credit for the synergies
  - Determining an appropriate price (and related premium) for the target in light of the aforementioned factors
  - Structuring the consideration paid to potentially be partially contingent on the achievement of projected growth or improvement (earn-outs)
- Pricing and financing of the transaction
  - Rigor of the valuation and pricing process
  - Leverage and solvency considerations

Valuation Considerations

- What are the factors to consider in the determination of the price to be paid for the Target?
  - Understand the Target’s business and its history
  - Analyze the financial condition of the Target
  - Consider the earnings power of the Target
  - Quality of earnings analysis?
  - Analyze the business and market risks of the Target
  - Identify potential revenue and cost synergies
  - Consider the earnings multiples and discount rate used for your company’s stock
  - Analyze the forecast for the Target and prepare a combined forecast for the Target and your company
  - Consider whether the acquisition will be dilutive to your company’s earnings
  - “Earn out” structure may be appropriate to deal with potential dilution

Valuation Considerations (cont.)

- What is the difference in the role of the Financial Advisor in a Corporate versus ESOP transaction?
  - A financial advisor in a corporate transaction may be engaged by the board of directors to render a fairness opinion or solvency opinion to the board. This will provide some protection to the board of directors under the "Business Judgment Rule"
  - A financial advisor to the ESOP trustee in an ESOP transaction is engaged by the trustee to render a fairness opinion to the trustee. An ESOP trustee is governed by ERISA.
    - The board may also request a reliance copy of the fairness opinion rendered to the ESOP trustee
    - The ESOP trustee may also request certain financial analyses in lieu of a fairness opinion

Closing Considerations

- Financing
- Approvals/Consents
  - Government
  - Third Party
  - Lender
- Payoff of Indebtedness of Target
- Tax Clearance Certificate
- Hart Scott Rodino
- Timing of signing of Definitive Agreement and actual funding

Integration Considerations

- Commit to one culture and one “brand”
  - Have an integration team
  - Have a plan
- Identify surviving IT as part of deal or immediately thereafter
- Identify surviving payroll and benefits servicer as part of deal or immediately thereafter
- Make all big changes as soon as possible following closing
- Identify strengths and weaknesses of acquirer and target and be willing to evolve

Company as Acquirer: Purchase Agreement

- Post-closing adjustment for net working capital at closing
- Target representations, warranties and indemnifications enforced with escrow provisions
- Target must be in compliance, except as indicated on schedules to the Agreement
- Consider recourse against “deep pocket” party
- Claw-backs & indemnifications should exceed escrow
- Address post-Closing integration issues

Company as Acquirer: Governance Issues

- Corporate acquisitions generally require Board but not shareholder approval (merger exception)
- Shareholder approval required to authorize additional shares if necessary as part of acquisition
  - If majority ESOP-owned, consider Fairness Opinion by financial advisor to ESOP
  - Fairness Opinion by Company financial advisor to Board advisable
  - Possible ESOP pass through vote
- Board composition post-transaction
- Corporate acquisitions governed by “business judgement” rule

Basic Acquisition Structures

- Asset purchase generally favored by buyers:
  - Step-up basis of assets to purchase price
  - Limit liabilities to those assumed in APA
  - If C-Corp, seller/shareholders may face double tax
  - If S-Corp, seller/shareholders may face recapture tax
- Stock purchase generally favored by sellers:
  - Buyer takes target subject to target's liabilities, except as limited by SPA
  - If C-Corp, no double tax on gains
  - If S-Corp, no recapture tax
  - Section 338 election permits buyer of S-Corp to treat taxable stock purchase as asset purchase for federal tax purposes (Section 1042 not applicable for sellers because target is an S-Corp and ESOP is not buyer of the shares)

Basic Acquisition Structures (cont.)

- Merger has attributes of stock and asset transaction:
  - Cash (not tax exempt) mergers in which Target shareholders get cash
  - If forward merger, Buyer gets Target assets and liabilities
  - If reverse merger, Buyer shareholders get Target stock
  - If triangular merger, Buyer Sub used as merger vehicle
- Section 1042 for Target shareholders:
  - Defer or avoid applicable capital gains taxes upon sale to C-Corp ESOP
  - Generally requires sale to C-Corp Target ESOP (not safe harbor)
  - Target eventually becomes subsidiary of Buyer
  - Consider potential dilution risk to Buyer
- Contingent and earn-out structures:
  - Reduces financing requirement and financial risk of Buyer
  - Provides up-side gain potential for Seller(s)
  - Seller financing with warrants may provide similar benefits

Related Tax Considerations

- Purchase of stock of C-Corp Target by S-Corp Buyer:
  - Post-closing, Buyer makes Q sub election for Target
  - Target subject to built-in gains (“BIG”) tax for 10 years after S-Corp election **if there is a subsequent sale of assets** (e.g., inventory, receivables, equipment, etc.) for a gain
  - BIG tax is corporate level tax for S-Corp Target (as with C-Corp)
  - BIG tax would not apply if Target has been S-Corp for at least 10 years or if Target stock is sold
- Income earned/sourced outside of U.S. taxable even with 100% S-Corp ESOP
  - Applies to ESOP sponsor and subs (U.S. and foreign)
  - Establish appropriate transfer prices between entities
- Income in certain states (i.e., TN, OH, CA) subject to tax, even if 100% ESOP S-Corp

Advanced Acquisition Structures I

- Asset Purchase
  - Generally avoids inheriting contingent or unknown liabilities
  - Exception for certain taxes (i.e., property tax, payroll taxes, etc.)
  - Step-up in basis in purchased assets provides additional tax depreciation & amortization (less important if buyer is 100% S-Corp ESOP)
  - Could create some BIG tax if the target converted from C to S-Corp within last 10 years
- Stock Purchase
  - Generally more tax and risk beneficial to seller--may result in lower price (especially if target is a C-Corp)
  - Generally requires more diligence to reduce risk related to contingent or unknown liabilities
  - BIG tax issues if, post acquisition, target converts from C to S-Corp via Q-Sub election and assets sold within a 10-year period after conversion (BIG tax would apply even if Acquirer is 100% S-Corp ESOP)

Advanced Acquisition Structures II

- Mergers with Cash Consideration
  - Forward Merger: Target merges into Buyer (or into Buyer Sub if triangular)
    - Buyer (or Buyer Sub) gets Target assets and Target stock cancelled
    - Buyer (or Buyer Sub) gets Target liabilities (as in stock transaction)
    - Target shareholders get cash or Buyer stock (Target stock cancelled)
    - Dissolution of Target not necessary (Target ceases to exist)
  - Reverse Merger: Buyer (or Buyer Sub if Triangular) merges into Target
    - Buyer shareholders get Target stock and Buyer stock cancelled (if not triangular)
    - Buyer gets Target stock and Buyer Sub stock cancelled (if triangular)
    - Target gets assets and liabilities of Buyer or Buyer Sub
    - Target shareholders get cash
- 1042 Transactions
  - Seller(s) can defer or potentially avoid applicable capital gains taxes on sale to an ESOP sponsored by a C-Corp
  - More attractive because of increase in federal capital gain rates to 23.8% for higher income taxpayers
  - Relatively complex and costly -- weigh cost/benefits based on transaction size, etc.
  - Tax advantages to seller may reduce purchase price

Advanced Acquisition Structures III

- Section 1042 Benefit for Seller(s) (S-Corp Buyer and C-Corp Target)
  - Target parallel ESOP formed
  - Seller stock sale to Target ESOP
  - Corporate reverse triangular merger
  - Forward ESOP merger
  - Leveraged ESOP transaction
  - Section 1042 election
  - Not safe harbor
- Section 1042 Benefit for Seller(s) (C-Corp Buyer and C-Corp Target)
  - Seller exchanges Target stock for Buyer stock in "Type B Reorganization"
  - Seller sells Buyer stock to Buyer ESOP
  - Section 1042 election
- Risk Mitigation Devices for Acquirer
  - Subsidiary as debtor with guarantee by acquirer
  - Subordinate promissory notes to seller
  - Contingent promissory notes to seller
  - Part of return on notes to seller based on performance (through warrants)
  - Earn-out based upon performance covenants
  - Joint venture with seller and purchase option

ESOP as a Transaction Party

- Merger of Acquirer (or Sub) and Target
- Buyer of Target Stock
- Buyer of Exchanged Stock
- Merger of Target ESOP
  - Separate Target ESOP trustee and Target ESOP financial advisor
- Seller of Target Stock
- Pass-Through Vote Issues
- Relative Fairness Issues

Best Practices: Independent Trustee

- Check for Fiduciary Conflicts
- Review Board Procedures
- Interview Management
  - Rationale for Acquisition
  - Change in Company Value
  - Price protection for ESOP distributions in near term
  - Repurchase Obligation
- Consult with Independent Advisors
  - Financial Advisor
  - Legal Counsel
- Fairness Opinion or Supporting Analysis

Best Practices: Inside Trustee

- Recuse if Conflicted – Retain Special Fiduciary
- Independent Financial Advisor
  - Valuation
  - Fairness Opinion or Supporting Analysis
- Retain Services of Counsel
  - Due Diligence
  - Transaction Structure and Document Review
- Document
  - Rationale for Acquisition
  - Basis for Projections
  - Effect upon ESOP Assets
  - Repurchase Obligations

ESOP Issues for Target

- Inclusion of Target Employees
  - Eligibility
  - Vesting
  - Availability of stock allocations
  - Effect on ongoing stock allocations from prior leveraged ESOP transaction
- Effect upon Repurchase Obligation

Postscript

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Michael Harden

Erin Turley

Overview: Erin Turley is a partner in the firm's Benefits, ESOPs and Executive Compensation Group and is a nationally recognized ERISA and ESOP attorney.

ESOP Practice: Ms. Turley's ESOP practice focuses on the design and implementation of ESOP transactions and providing ongoing legal counsel to ESOP owned companies. Ms. Turley's extensive experience in ESOPs and has involved in hundreds of ESOP transactions including leveraged buy-outs, mergers, acquisitions, and the structuring and financing of ESOPs using private equity. Ms. Turley also has extensive experience in representing lenders to ESOP owned companies in designing and negotiating credit facilities specifically tailored to the needs of ESOP owned companies.

ERISA Practice: Ms. Turley's ERISA practice focuses on ERISA compliance with respect to employee benefits, including qualified plans, nonqualified plans, and executive and deferred compensation and welfare benefit plans; and on regulatory compliance with the Internal Revenue Code, ERISA, COBRA, HIPAA, and PPACA. Ms. Turley advises employers in the design, implementation, and administration of tax-qualified and nonqualified retirement plans and health and welfare benefit plans and regularly represents clients before the Internal Revenue Service and the Department of Labor in audit and correction matters. Ms. Turley has advised employers with respect to issues raised in connection with corporate mergers, acquisitions, and divestitures as they relate to the various benefit plans maintained by the affected corporate entity or entities.

Professional Background: Ms. Turley joined K&L Gates in 2011. Ms. Turley is an active writer on ERISA and ESOP issues and speaks on ERISA and ESOPs issues, including fiduciary liability issues, across the country. Ms. Turley is a regular speaker at the national meeting of American Bar Association. Ms. Turley is also a regular speaker at the semi-annual meetings of The ESOP Association and the annual meeting of The National Center for Employee Ownership.

Christopher L. McLean

Christopher is in the ESOPs & Employee Benefits Group where he advises clients on a broad range of issues relating to qualified and nonqualified plans and corporate transactions.

Christopher's practice focuses primarily on the design, implementation, maintenance and compliance of employee stock ownership plans ("ESOPs") as well as a variety of nonqualified executive compensation plans.

Christopher has worked with ESOP Sponsors and ESOP Trustees in a wide range of corporate ownership succession transactions, including leveraged buyouts, corporate stock repurchases and corporate reorganizations.