

ESOP CHECK-UP

EVALUATING HOW AN ESOP
IS WORKING



Mac
Atlantic
Mid-Atlantic
ESOP
CHAPTER

SPEAKERS



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AGENDA

Plan sponsors and fiduciaries have an obligation to continually monitor ESOP operations to make sure the plan is being operated for the exclusive benefit of the plan participants and meeting all regulations and current corporate strategic objectives.

This presentation will focus on certain areas of fiduciary responsibility:



LEGAL



VALUATION

LEGAL CHECK-UP

Are ESOP documents in compliance with the law?

Is your exempt loan in compliance with law and regulations?

Are you operating your ESOP consistent with the Plan documents?

Are you reviewing your advisors' services and fees?

PLAN DOCUMENTS

- Your Company's counsel should be monitoring the changes in ERISA and tax laws applicable to your Plan
- In new era without IRS Determination Letters, IRS will issue annual Lists of Required Modifications ("LRMs") providing for what the IRS considers a "mandatory" amendment and what "may" need to be amended

PLAN DOCUMENTS

- First two LRMs (below) were released and neither affected ESOPs:

Year	Required Amendments List	General Plan Amendment Deadline
2016	Notice 2016-80	December 31, 2018
2017	Notice 2017-72	December 31, 2019

- For Form 5300 applications submitted after December 31, 2017, the plan should be amended to comply with the applicable IRS LRMs and it should incorporate all previously adopted amendments.

COMMON ISSUES

1

Compensation

Is the TPA using correct wages? Is inclusion of overtime & bonuses discriminatory?

2

Contributions

S-Corps- 25% limitation includes interest

3

Allocations

If ESOP stock is purchased in stages, is the TPA maintaining separate stock accounts?

COMMON ISSUES

4

Vesting

Are “years of service” being calculated consistent with the Plan definition?

5

Distributions

Are shares redeemed from the ESOP based on updated appraisal?

6

Diversification

Calculated incorrectly (or not at all)

7

S-Corporation ESOPs

“Synthetic Equity” granted without “abuse avoidance” testing
(NOTE: Cannot be fixed retroactively)

ESOP OPERATIONAL ISSUES

- Unwitting fiduciary – Do all of your internal ESOP Trustees, members of ESOP Administrative Committee and Board Members realize that they are ERISA fiduciaries?
- Do your fiduciaries (witting or unwitting) know the implications and standards for their decisions and actions with respect to the ESOP?
- If your ESOP provides for committees (ESOP administrative or ESOP communications), are the tasks being performed?

MATURE ESOP ISSUES

- Repurchase liability study
- Benefit levels and available options?
 - Changes to distribution policy
 - Renegotiation of “Internal Loan” term
 - “Releveraging”
 - Segregation
 - Should diversification be made more liberal?
- Dealing with “have” and “have not” issues?

EXEMPT LOANS

Loan Documents

- Acceleration of payment in full upon default
- Payment of legal fees and collection costs by ESOP
- Over collateralized – leveraged & non-leveraged shares
- Stock Release Calculation/Inconsistent provisions in Loan Agreement and Pledge Agreement

Purchase/Redemption Transactions

- Initial and/or redemption price exceeds “adequate consideration”
- ESOP note issued is in excess of a reasonable rate of Interest; transaction as a whole fails fairness test.

ADVISOR SERVICES & FEES

- Vendor Fee Disclosure to plan sponsor required when ESOP pays service providers from plan assets
- Basic Rule: Use of plan assets to pay service providers is not a “prohibited transaction” if:
 - Contract or arrangement is a reasonable arrangement
 - Services provided are necessary for plan operation
 - No more than reasonable compensation is paid for the services



BEST PRACTICES

Establish an objective review process to periodically review your service providers services and fees.

- Analyze for conflicts of interest
- “Benchmarking” – Compare competitor services and costs
- Analyze both direct compensation and 3rd party “indirect” compensation
- Review scope and quality of the services to be delivered and reasonableness of the fees in relation to the services provided (e.g., consider periodic “peer review” of valuation)
- Disclosure of fees to ESOP participants may be required if the ESOP includes participant-directed investments

SUMMARY

- The duty to monitor, negotiate, and minimize expenses applies to any plan that uses plan funds to pay for services. Typically, but not always, ESOP expenses are not paid by or from the plan, but by the employer. Nevertheless, a regular review of plan expenses is part of prudent fiduciary process.

VALUATION CHECK-UP

Have all transaction elements
been addressed?

Do you have an updated
repurchase obligation?

Have you reviewed the
valuation report thoroughly?

Have you documented your
valuation diligence?

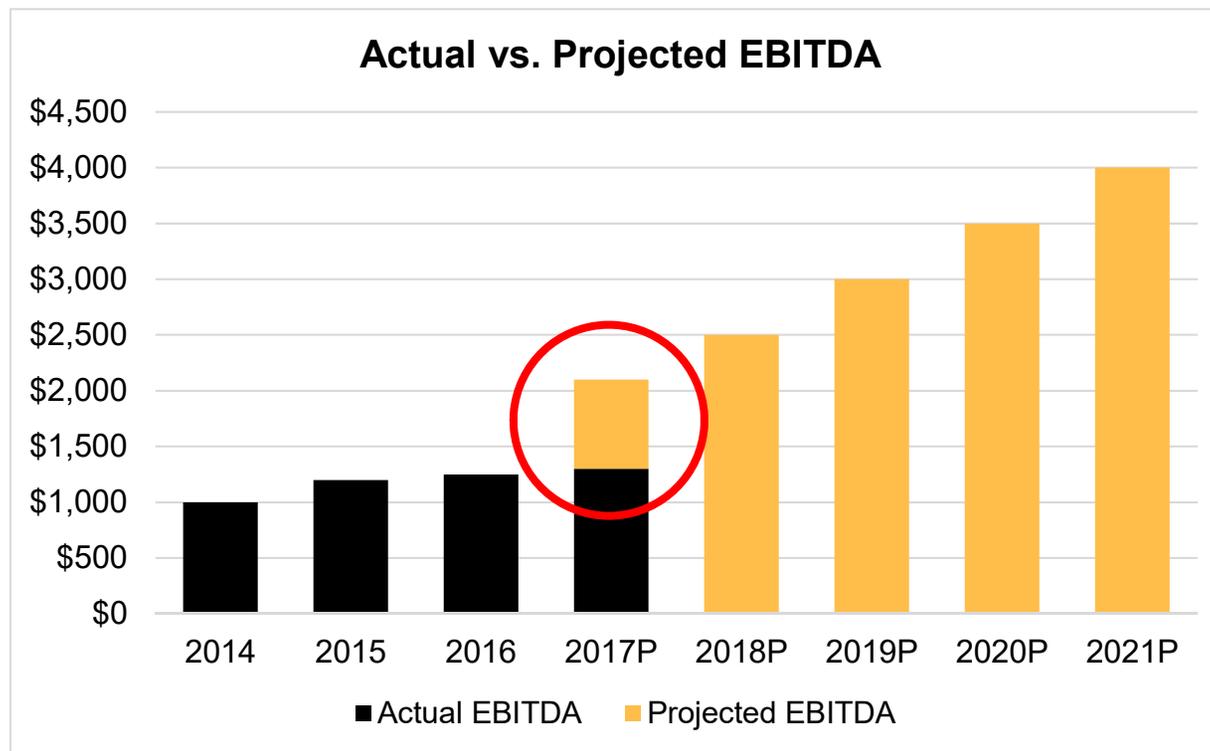
TRANSACTION ELEMENTS

Have all transaction elements been addressed?

- Retention SARs
- Performance SARs
- Warrants
- Earn-outs
- Performance bonuses

PERFORMANCE

How did the company perform against the projections used in the transaction?



REPURCHASE OBLIGATION

Companies with mature ESOPs should periodically revisit their repurchase obligation strategy/cash requirements to remain sustainable.

- Tax reform may cause an increase in value without a commensurate increase in actual cash flows

VALUATION REVIEW

1

Does the appraiser really understand your business?

Accurate description of business and how the economy and industry impact operations

2

Reasonable valuation approaches

The strongest valuations consider multiple methods (income, market, and/or asset)

3

Reasonable Comparable Public Companies and Transactions

While they may be larger and more diversified, they may operate similarly and be impacted by the same external factors

VALUATION REVIEW

4

Realistic Projections

Should not be overly aggressive or conservative

5

Consider Dilutive Securities

SARs, options, and warrants may be dilutive to the ESOP

6

Consistency

Compare report to prior year report



ESOP valuations should be prepared relatively consistently year-over-year:

- Financial statement adjustments
- Methods considered
- Discount rate
- Public comparable companies
- Comparable transactions
- Equity adjustments

IMPACT ON BENEFITS

The stock value may result in benefits that are higher or lower than target benefits

High Value	Low Value
<ul style="list-style-type: none">• Impacts Repurchase Obligation• May set unrealistic benefit level precedent• May impact ability to consider offer to be acquired	<ul style="list-style-type: none">• Poor employee morale• Impact employee retention• May need to supplement with alternate form of compensation

DOCUMENTATION

Document Everything

- Request appraiser to formally present the valuation report.
- Document questions you ask the appraiser and the responses.
- Request a peer review periodically or if uncomfortable with the results.
- In a DOL audit, proper documentation of the fiduciary process will prove that you performed the required diligence.

COMMUNICATION

- **Three documents are required:**
 - **Summary Plan Description**
 - **Annual benefit statement**
 - **Summary annual report**
- **Various levels of ESOP understanding within one firm**
- **Take time to meet with your Board of Directors, Human Resources team, and/or ESOP committee to determine if the required documents are enough to effectively communicate employee ownership and serve as an incentive for enhanced performance.**

Q & A

THANK YOU!

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