ESOP Trustee Considerations in Multistage Stock Purchase Transactions

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One of the most ambiguous issues in multistage employee stock ownership plan ("ESOP") stock purchase transactions is the level of control to apply in the valuation of the sponsor company shares being purchased. An ESOP trustee should carefully address this issue to ensure that the ESOP does not pay more than fair market value for the sponsor company shares being purchased. At the same time, an ESOP trustee should have a reasonable understanding of the selling party's perspective, to allow for the best chance of completing a stock purchase transaction that is beneficial to the ESOP. Further, the ESOP trustee should ensure that the ESOP participant shares are redeemed appropriately—before and after a secondary securities purchase or sale transaction.

Introduction

It is common that the initial stock purchase in the formation of an ESOP ("initial ESOP transaction") involves less than 100 percent of the sponsor company's equity. The non-ESOP owners of the sponsor company may not be ready to sell their entire ownership interest. Also, the sponsor company management may not want to take on the leverage required for a single 100 percent ESOP stock ownership transaction.

Although multistage ESOP stock purchase transactions are common, they may involve a number of additional considerations.

When an ESOP makes a secondary purchase of sponsor company shares ("secondary transaction" or "secondary purchase"), the ESOP trustee may not be sure what level of value (control versus noncontrol) is appropriate for the shares being acquired. This issue can be mitigated with careful planning prior to the initial ESOP transaction.

The ESOP trustee may indicate that the ESOP has no future intention to acquire control of the sponsor company. Alternatively, the ESOP trustee may indicate the ESOP's intention to gain control of the sponsor company over time—and to structure the initial ESOP transaction with a binding purchase option to guarantee that such an intention may be realized.

However, multistage ESOP stock purchase transactions are not always mapped out from the start. The non-ESOP owners of the sponsor company may not have made their future ownership intentions clear at the time of the initial ESOP stock purchase transaction.

The ESOP trustee may be unexpectedly presented with a sponsor company stock acquisition opportunity—having had no plan to gain control of the sponsor company over time when the initial ESOP stock purchase transaction occurred. In these cases, an ESOP trustee should take special care in the treatment of secondary stock purchase transactions.

First, this discussion addresses how structuring the initial ESOP stock purchase transaction can affect control pricing considerations in a secondary stock purchase transaction down the road.

Second, this discussion addresses three different scenarios that an ESOP trustee may encounter when the ESOP makes a secondary stock purchase of an ownership interest in a sponsor company.

These three scenarios include the following:

1. An ESOP owns a controlling interest position in a sponsor company and makes a

secondary stock purchase of a noncontrolling ownership interest.

2. An ESOP owns a noncontrolling interest in a sponsor company and makes a secondary stock purchase of a controlling ownership interest.
3. An ESOP owns a noncontrolling interest in a sponsor company and makes a secondary purchase of a noncontrolling ownership interest swing block of shares, resulting in the ESOP owning control after the secondary stock purchase transaction.

Finally, this discussion addresses additional issues that an ESOP trustee may encounter regarding ESOP participant share redemptions before and after secondary stock purchase transactions.

These issues include the following questions:

1. At what level of value should the sponsor company redeem an ESOP participant's shares?
2. What is the effect on the value of the ESOP-owned sponsor company stock if the ESOP loses its ownership control position over time?

There are many issues that an ESOP trustee should address when considering a secondary stock purchase transaction. This discussion attempts to bring some clarity to one of the more ambiguous valuation issues: the level of ownership control.

Initial Structuring of a Multistage ESOP Stock Purchase Transaction

When the result of an initial ESOP sponsor company stock purchase transaction is 100 percent ownership and control in fact, then a control level of value is often appropriate and easily justifiable. When the result of the initial ESOP stock purchase transaction is less than 100 percent ESOP ownership, then the issue becomes more complicated.

If structured with intention and clarity regarding current and future aspects of ownership control, even an initial ESOP transaction involving a noncontrolling ownership interest may justify some level of control price premium.

This section addresses a wish list of provisions that can be structured into an initial ESOP stock purchase transaction to increase the level of ESOP ownership control. Each additional provision that is included will add to the appropriateness of an ownership control level of value.

First, an initial ESOP stock purchase transaction may include an ESOP option to purchase a controlling ownership interest in the sponsor company at a later date. The "later date" should be within a reasonable period of time, and at a minimum, shortly after the initial ESOP stock acquisition loan is repaid.

If this provision is included to support the use of a control level stock purchase price, then (1) the purchase option should be binding and (2) the ESOP should not have to pay any additional consideration for the stock purchase option.

Additionally, the ESOP should have realistic financing options to facilitate the implementation of the stock purchase option. The sponsor company selling shareholders may either guarantee seller financing or agree to facilitate third-party financing.

Second, an initial ESOP stock purchase transaction may be structured in a way that results in voting control for the ESOP trustee. This voting control result may be achieved:

1. through an initial ESOP stock purchase transaction involving a control block of sponsor company voting shares or
2. through the grant of a proxy to the ESOP trustee giving voting control over a control block of sponsor company voting shares.

Third, if not given outright voting control, the plan document may grant an ESOP trustee voting control over third-party acquisition offers. The ESOP trustee is then able to accept or veto any future stock purchase/sale transactions based on the best interests of the ESOP participants. Without this right, it is difficult to justify that the ESOP trustee has any significant level of ownership control.

Fourth, a plan document may require that the ESOP participant shares receive at least as favorable a purchase price and purchase terms as the non-ESOP shares in the event of a third-party acquisition. This provision should also include an ESOP trustee right to veto any third-party transaction that does not include the ESOP shares.

That is, if the non-ESOP controlling shareholders decide to sell their sponsor company shares to a third party, then the buyer may also need to agree to purchase the ESOP shares at the same price and terms.

Finally, if an initial ESOP stock purchase transaction occurs at a control level of value, the plan documents should specify that ESOP participant shares be valued at a control level of value for future stock redemption purposes.

These provisions range from strong support for a controlling level of value (i.e., the ESOP trustee voting control immediately following the initial ESOP stock purchase transaction) to a minimum requirement for any level of control price premium (i.e., a guarantee that the ESOP participant shares will be redeemed at the same level of value). The circumstances of each initial ESOP stock purchase transaction will be different.

However, these provisions address important aspects of control, and each aspect should be considered when purchasing sponsor company shares at a control level of value.

The proposed Department of Labor regulations[1] provide that a control price premium is only justified:

1. if actual voting control and control in fact are passed to the purchaser with the initial ESOP stock purchase transaction <u>or</u>
2. if such control will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the stock sale.

Therefore, if each of the control provisions mentioned here are included in an initial ESOP stock purchase transaction, specifically a binding agreement to allow the ESOP to acquire ownership control in a reasonable period of time, then an ESOP trustee may be justified in paying a control level of value throughout a multistage ESOP stock purchase transaction.

However, if control provisions were not implemented in the initial stock purchase ESOP transaction, then an ESOP trustee should tread carefully in secondary stock purchase transactions. The following three transaction scenarios present situations where the level of control may be in question.

Scenario 1: An ESOP Owns a Controlling Interest in a Sponsor Company and Makes a Secondary Purchase of a Noncontrolling Ownership Interest

For scenario 1, let's consider an ESOP that purchases a 70 percent ownership interest in a sponsor company in the initial ESOP stock purchase transaction. At a later date, the ESOP then purchases the remaining 30 percent ownership interest, resulting in 100 percent ESOP ownership of the sponsor company.

In scenario 1, the level of control at which the secondary, noncontrolling ownership interest transaction takes place can depend on the terms of the initial ESOP stock purchase transaction. One way to justify a control level of value throughout a multistage ESOP transaction is for the selling shareholders to grant the ESOP a binding option to purchase the remaining shares at a later date.

Typically, a binding option to purchase additional sponsor company shares benefits an ESOP. This is because it guarantees to the ESOP the option to gain control in the future. However, in scenario 1, when the secondary stock purchase is a noncontrolling interest, this ESOP purchase option may also benefit the selling shareholders.

An initial ESOP stock purchase transaction may be structured as a multistage purchase, with a control level of value throughout. This can be thought of as a single control transaction, with the addition of an ESOP trustee's option not to proceed.

A control level of value may be justified here if the secondary purchase option is (1) binding and (2) structured to realistically occur within a reasonable period of time.

Allowing a multistage ESOP stock purchase transaction to be structured with a control level purchase price throughout may help facilitate the formation of an ESOP. If a control level purchase price is not guaranteed throughout the multistage ESOP stock purchase transaction, then the non-ESOP shareholders may decide to sell to a third party in order to receive a control price for their shares.

As long as the ESOP trustee is granted sufficient control rights, a binding purchase option, and other guarantees, a multistage ESOP stock purchase transaction at a control level purchase price may be beneficial for all parties involved.

If the secondary purchase in scenario 1 is a standalone transaction and not part of a multistage stock purchase transaction of a controlling ownership interest, then the ESOP should only purchase the block of shares at a noncontrolling ownership level of value. This is true even if the result of the secondary transaction is 100 percent ESOP ownership.

The price at which an ESOP trustee may purchase shares is based on the fair market value of those shares. The test of fair market value for any ESOP purchase is based on a hypothetical willing buyer and a hypothetical willing seller.

In scenario 1, although the ESOP owns a controlling interest in the sponsor company, the secondary purchase involves a noncontrolling ownership interest. A hypothetical buyer would not pay, and a hypothetical seller would not expect to receive, a control level of value for a noncontrolling ownership interest that did not change either party's level of control over the sponsor company.

Scenario 2: An ESOP Owns a Noncontrolling Interest in a Sponsor Company and Makes a Secondary Purchase of Controlling Ownership Interest

For scenario 2, let's consider an ESOP that purchases a 40 percent ownership interest in a sponsor company in the initial ESOP stock purchase transaction. At a later date, the ESOP then purchases the remaining 60 percent ownership interest, resulting in 100 percent ESOP ownership of the sponsor company.

In scenario 2, the secondary stock ownership transaction involves the purchase of a controlling ownership interest that results in 100 percent ESOP ownership of the sponsor company. Therefore, when this situation arises, an ESOP trustee can clearly pay a control level of value in the secondary stock ownership transaction.

However, the level of control at which the initial, noncontrolling ownership interest transaction may take place depends on the structure and circumstances of the initial ESOP stock ownership transaction. Much like scenario 1, in scenario 2 the initial ESOP transaction may be structured as a multistage purchase, with one controlling ownership interest purchase and one noncontrolling ownership interest purchase.

If an ESOP purchase option provision is present, both the scenarios appear to involve the same underlying principle, multiple stock purchase transactions and the guarantee of 100 percent ESOP ownership, if the ESOP trustee chooses.

However, when the initial ESOP stock purchase transaction involves a noncontrolling ownership interest, a multistage transaction may have to meet additional criteria in order to justify a control level of value throughout.

Even if an ESOP trustee has a binding option to purchase a controlling ownership interest at a later date, when the initial ESOP stock ownership transaction involves a noncontrolling ownership interest, the level of control that the transaction should take place at depends on the following factors:

1. The level of voting control that the ESOP trustee has immediately following the stock purchase transaction
2. The ESOP's ability to secure financing for the secondary stock purchase transaction
3. The ability of the ESOP trustee to cause the sale of the sponsor company
4. The rights and privileges of ESOP participant shares in the event of a sale to a third party.

In scenario 2, if there is no guarantee of ESOP control at a later date, the initial, noncontrolling ownership interest transaction should take place at a noncontrolling ownership interest level of value.

In scenario 2, it is most likely appropriate for an ESOP trustee to purchase the second controlling ownership interest block of shares at a control level purchase price. This is because the ESOP gains control in fact as a result of the second stock purchase transaction.

Scenario 3: An ESOP Owns a Noncontrolling Interest in a Sponsor Company and Makes a Secondary Purchase of a Noncontrolling Ownership Interest, Resulting in ESOP Control

For scenario 3, let's consider an ESOP that purchases a 40 percent ownership interest in a sponsor company in the initial ESOP stock purchase transaction. At a later date, the ESOP then purchases a 30 percent ownership interest resulting in 70 percent ownership in, and control of, the sponsor company.

This discussion has already presented the option of structuring a multistage stock purchase transaction at the outset. Therefore, in this section we will only consider a situation where no control considerations were made at the time of the initial ESOP stock purchase transaction.

In any transaction, we know that an ESOP trustee can pay no more than fair market value for the ownership interest that the ESOP acquires. We also know that the definition of fair market value considers both a hypothetical willing buyer and a hypothetical willing seller.

If only considering the block of shares changing hands in scenario 3, a noncontrolling block of shares, one may argue that a hypothetical seller would only expect to receive a noncontrolling ownership interest level of value for their shares.

However, a well-informed hypothetical buyer would know that the transaction will result in a change of control and a controlling ownership position.

According to guidance from the proposed Department of Labor regulations,[2] an ESOP may pay a control price premium only to the extent a third party would pay a control price premium. The guidance further suggests that the payment of a control premium is unwarranted unless the ESOP obtains both voting control and control in fact as a result of the stock purchase transaction.

Both of these criteria are met in the secondary stock purchase transaction in scenario 3. First, empirical evidence suggests that acquirers pay control premiums for noncontrolling blocks of stock that result in post-transaction controlling ownership interests. Second, in scenario 3, the ESOP gains both voting control and control in fact as a direct result of the secondary stock purchase transaction.

Even if an ESOP trustee purchases the swing block of shares at a control level of value, any additional purchases of noncontrolling ownership interests should take place at a noncontrolling ownership level of value.

The exception would be if the swing block purchase was part of a multistage stock purchase transaction of a controlling ownership interest, where a control level of value was negotiated at the outset and the ESOP has a binding option to acquire the remaining shares in a reasonable period of time.

At What Level of Value Should the Sponsor Company Redeem ESOP Participant Shares?

One of the most important considerations for an ESOP trustee is the consistent and fair treatment of ESOP participant shares.

If an ESOP owns a noncontrolling ownership interest in a sponsor company without control rights and with no plan in place to bring the ESOP ownership to an ownership control position, the sponsor company likely redeems ESOP participant shares at a noncontrolling ownership level of value.

However, if an ESOP ever pays a control level of value to acquire non-ESOP shares, the trustee should ensure that ESOP participant shares are also redeemed at a control level of value from that point forward. Even if the ESOP paid a control level of value to acquire a noncontrolling ownership position as part of a multistage transaction, ESOP participant shares should also be redeemed at a control level of value.

An ESOP trustee may encounter a conflict between (1) the consistent treatment ESOP participant shares over time and (2) the obligation to redeem ESOP participant shares at a control level of value (after the ESOP has acquired a control position or paid a control level of value for non-ESOP shares).

The following simplified example illustrates this conflict. Rusty Company ("Rusty") forms an ESOP with a 40 percent ownership interest in the company. Rusty ESOP does not have voting control or control in fact over the company.

> **"One of the most important considerations for an ESOP trustee is the consistent and fair treatment of ESOP participant shares."**

The initial ESOP stock purchase transaction did not grant any binding purchase option for the Rusty ESOP to acquire a controlling ownership interest in the sponsor company. Over the next four years, Rusty ESOP participant shares are redeemed at a noncontrolling ownership level of value.

Four years later, the Rusty ESOP trustee is confronted with an unexpected opportunity to purchase an additional 30 percent ownership interest (swing block) in Rusty at a control level of value.

The Rusty ESOP trustee determines that the transaction is in the best interest of the ESOP participants and proceeds with the purchase. The resulting 70 percent ownership interest provides the Rusty ESOP with voting control and control in fact of the sponsor company.

The Rusty ESOP trustee is now confronted with the following problem. The Rusty ESOP now owns a control position and participant shares should be redeemed accordingly.

However, the Rusty ESOP trustee also wants to treat Rusty ESOP participant shares consistently over time, and specifically considers participant shares redeemed at a noncontrolling ownership level of value prior to the secondary stock purchase transaction.

Regardless, the Rusty ESOP trustee should act appropriately based on the information currently available, which is that the ESOP now owns a controlling interest in the sponsor company and ESOP participant shares should be redeemed at a control level of value.

Ideally, an ESOP trustee will have a clear long-term plan of control versus noncontrol ESOP ownership prior to the initial ESOP sponsor company stock purchase transaction. However, an unexpected change of control may still occur.

If an ESOP trustee is made aware of a possible future transaction resulting in ESOP control, they may consider informing the ESOP participants of the possibility so that the participants may make informed timing decisions regarding retirement, diversification, or other relevant choices.

Further, if the ESOP trustee enters into a binding agreement to acquire control of the sponsor company in the future, they may advocate for participant share repurchases to occur at a control level of value beginning immediately, as opposed to after control is actually realized.

What If the ESOP Loses Its Controlling Ownership Position?

An ESOP's ownership position could decrease from a controlling interest to a noncontrolling interest (1) if the sponsor company continues to redeem ESOP shares over time without recycling those shares or (2) if the sponsor company issues additional non-ESOP shares as a means to raise capital.

The sponsor company may have legitimate business reasons to redeem shares rather than recirculating them through the ESOP. The sponsor company may also have legitimate business reasons to issue additional shares, such as an investment opportunity or financial distress.

However, an ESOP trustee should be careful if ceding a controlling ownership position. The proposed Department of Labor regulations[3] infer that it may be difficult to justify the ESOP ownership position as control in fact (and justify the ESOP purchasing an ownership interest at a control level of value) if an ESOP trustee could reasonably foresee that the ESOPs control position will be dissipated within a short period of time subsequent to the acquisition.

If the ESOP transition from a controlling ownership position to a noncontrolling ownership position is unavoidable or in the best interest of the ESOP participants, then the ESOP trustee should consider, at a minimum, securing a guarantee that future ESOP participant share redemptions will occur at a control level of value.

An ESOP trustee should consider securing this guarantee before approving any ESOP share redemptions, or non-ESOP share issuances, that would decrease the ESOP ownership position to below 50 percent or otherwise cause a loss of the ESOP control.

Conclusion

One of the most important duties of an ESOP trustee is to ensure that the ESOP does not pay more than fair market value to purchase a block of sponsor company shares. One of the important aspects of determining the fair market value of a block of sponsor company shares is the appropriate level of control.

Although the Department of Labor has provided some guidance in this area, the appropriate level of control to apply may not always be clear.

In most cases, when the block of shares being acquired is a controlling ownership interest, with voting control and control in fact, an ESOP trustee may purchase the shares at a control level of value. This could be an initial ESOP stock purchase transaction involving a controlling ownership interest or a secondary stock purchase transaction involving a controlling ownership interest.

If an ESOP has a binding purchase option to acquire a controlling ownership interest in the sponsor company, then a control level of value may be permissible for transactions involving both controlling ownership interests and noncontrolling ownership interests.

However, before paying a control level of value, an ESOP trustee should analyze the likelihood that the ESOP will actually acquire control in fact in a reasonable period of time. Additionally, an ESOP trustee should consider the level of control that the trustee can exert prior to acquiring control in fact.

Before paying a control level of value to acquire any block of sponsor company shares, an ESOP trustee should consider if a hypothetical third party would also pay a control level of value for the same block of shares. If the block of shares is a swing block, and if the result of the transaction is ESOP control in fact, then a control level of value is likely to be appropriate.

When a transaction does not result in a change of control, a noncontrolling level of value is likely appropriate. This is true even if the ESOP already owns a controlling interest in the sponsor company.

Finally, an ESOP trustee should ensure that ESOP participant share redemptions occur at an appropriate level of value. If the ESOP either has control in fact of a sponsor company, or has previously purchased shares at a control level of value, then the ESOP participant share redemptions should occur at a control level of value.

Notes:

1. Prop. DOL Reg. Sec. 2510-3-18(b)(4)(ii)(I)(1).
2. Ibid.
3. Ibid.

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