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Preparing for the Sale of an ESOP Company

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Generally, the idea of selling is not a priority for the senior management team or board of directors (board) at a successful ESOP-owned company. Indeed, when an ESOP is created, the typical expectation is that the ESOP will remain in place indefinitely and the employee-owners will continue to benefit over time as their ESOP accounts accumulate company shares.

Still, there are cases when ESOP-owned companies are sold. Typically, if an ESOP-owned company is contemplating a sale of the business, it is not usually because the company is proactively seeking a buyer. Rather, most successful ESOP companies that are considering a sale have received an unsolicited purchase offer from a private equity firm or a competitor in the same or a similar industry.

That said, there may be circumstances that result in an ESOP-owned company affirmatively seeking out a potential buyer. In those cases where the company wishes to be sold, the board typically hires an investment banking firm to actively solicit bids and to assist with negotiations with interested buyers.

In any event, whether dealing with a solicited or unsolicited offer, the company's board should be prepared to review and respond to the offer. This is true since the board not only has a responsibility to protect the assets of the company but also should ensure that the shareholders receive the highest

When initially considering how to respond to an unsolicited offer, the Board may choose to discuss a possible sale directly with the potential buyer. Alternatively, the Board may decide to engage an investment banking firm to help evaluate the company's options with the regard to a possible sale. For instance, an investment banker can help the company assess whether the purchase offer is in line with, above, or below market pricing; if the terms of the potential sale can be improved; or if the company would be better off going to market in search of other purchase offers.

Regardless, in order to ensure the integrity of any sale that takes place, it is important for all parties involved to engage independent advisors to safeguard their interests and make certain all required steps occur.

return on their investment. As a result, some boards choose to establish a committee to review purchase offers. If no such committee is formed, the full board will need to formulate a plan to respond.

More often than not, if the management team and/or the board have a negative reaction after considering a bona fide offer, the possibility of a sale will likely end at that point. On the other hand, if they are interested in exploring the possibility of a sale further, the company and the potential buyer usually exchange confidentiality agreements - also known as non-disclosure agreements - and will then customarily share cursory information about their businesses in order to gain a better understanding of each other. This could include, for example, summary operational and financial information. Under no circumstances should the company provide a potential buyer a copy of the annual ESOP valuation.

At that point, if the board and senior management remain interested in moving forward with a possible sale, they should involve the ESOP trustee in the sale discussions and negotiations. The board and the trustee also need to determine if, in order to satisfy their fiduciary responsibilities, a broader sales and marketing process would be advisable and whether it is feasible that a higher sales price may be achieved.

Regardless, in most cases, should the board determine that it wishes to pursue a bona fide purchase offer, the board is tasked with negotiating the terms of the offer. However, the board and the ESOP trustee (and its advisors) should communicate early and often in the negotiation process. This is because, even though the board may take the lead in the negotiations, the ESOP trustee has the final say in approving the deal on behalf of the ESOP.

Ultimately, there may be a number of possible reasons an ESOP company decides to sell - including circumstances that are unique to the company. However, we have found that some of the more common reasons an ESOP-owned company's board elects to sell include the following:

An offer is considered "bona fide" if:

- *The proposed consideration is nominally adequate*
- *The other terms of the proposed deal are fair, reasonable and treat all shareholders equitably*
- *The potential buyer has the financial ability to pay the proposed purchase price*

- Monetary Benefits – A sale can result in a significant increase in the value of ESOP shares, especially if the buyer pays a market premium. According to the National Center for Employee Ownership, in many sale transactions, participants see their ESOP share value rise in the range of 25% to 100%. Notably, we have found that an ESOP trustee will generally only agree to sell the company if there is an appropriate premium attached to the previous share price. As a result of a sale, not only does the per-share price for ESOP stock usually increase, but a sale can also help the company gain liquidity and fund participants' ESOP accounts; in turn, this may help address any difficulties the company is experiencing with its repurchase obligation.

- Added Capabilities – If an ESOP company finds a new investment partner, strategic or otherwise, they often gain capabilities that they did not have before the sale. For example, the buyer may bring human capital talent, organizational structure, purchasing power, and cross-selling opportunities that will help propel the company to the next level of success.

- Market Trends – If the industry in which the ESOP company operates is experiencing a high degree of volatility, the company may determine it is best to sell in order to protect the company's - and the ESOP's - assets. Further, if there is an industry trend toward consolidation - as a result of which many of the company's competitors are being acquired - a sale may be a good option in that it may allow the seller to remain competitive in the industry.

- Management Succession Issues – If the company's senior management team is nearing

retirement age and the company lacks strong internal candidates to succeed the existing senior management, the company may decide to sell in order to capitalize on the current performance of the company.

At the same time, there are a number of reasons that an ESOP-owned company's board may decide against selling, including the following:

- **Loss of Company Culture** – The culture of a successful ESOP-owned company is often unique. There is a risk that, if the business is sold to a new owner, the culture of the two companies will clash and the ESOP company's culture will not be preserved, which can impact the morale of the staff. In our experience, the loss of culture can result in a sale that is not as successful as the parties anticipated.
- **Change in Governance** – When a sale occurs, there will most likely be a new senior management team – or at least part of the team will be new – as well as a new board. Some ESOP companies are reluctant to sell because of the uncertainty related to how this new group of leaders will act and whether they will be effective and accepted by the employees.
- **Job Loss/Consolidation** – When a sale takes place, there is always a possibility that the buyer may shut down facilities or reduce the number of staff, especially when they have their own. While the ESOP company may be aware of these plans prior to a sale, there is also the chance that the buyer will not disclose their intentions until after the sale is complete - sometimes not until months or more after the deal closes.
- **The Potential for Added Value** – While the pricing of the deal may seem attractive on the surface, some ESOP companies actually have the potential to sell at a higher price and, thus, further enhance the value of the ESOP accounts. ESOP trustees and ESOP investment bankers are aware of this possibility, and it frequently is a negotiating point that can lead to the company to rejecting the offer.
- **Confidentiality and Closing Risks** – When a company is involved in a sale process, there is a chance that the sale will not be finalized. However, as part of the sale process, the company usually provides the potential buyer access to confidential information about the business. If the deal does not ultimately close and the potential buyer is a competitor, there may be a concern that the potential buyer will use that confidential information to compete more effectively with the company.

Notably, after considering the pros and cons related to a sale, the board may decide to accept a purchase offer. However, before a sale can be finalized, the trustee has to vote the ESOP stock either in favor of or against the deal. In addition, depending on the type of sale, the vote may need to be passed through to the ESOP participants.

There are two basic types of sales: a purchase of assets and a purchase of stock. With a purchase of assets, the buyer receives the company's assets and may or may not take on the company's liabilities. In comparison, if the buyer purchases the company's stock, they take on the liabilities as well as the assets.

Although the plan document will have more specific directions, in general, if the buyer proposes a purchase of stock, the trustee can decide whether or not to move forward without input from the participants. However, if the buyer wishes to purchase the company's assets, the vote is typically required to be passed through to the plan participants who will need to cast a ballot in favor of or against a sale of the company's assets.

In that case, the company will need to provide participants with a descriptive memorandum outlining detailed financial information, what will happen if the sale takes place, when the sale will take place, and how much money participants are expected to receive as a result of the sale. Participants will be given a date by which their vote must be cast. The votes will then be tallied by the plan administrator or a law firm, and the results will be provided to the trustee. The possibility of a participant vote should be raised early in the process because it adds time to the closing

schedule that non-ESOP investment bankers and acquirers may not anticipate.

Notably, since the trustee's ultimate responsibility is to act in the best interest of the ESOP, if the trustee determines that the outcome of the participants' vote is not actually in the ESOP's best interest, the trustee can theoretically supersede the participant vote if the trustee believes it would be a breach of their fiduciary duty to follow the participants' vote. However, this is extremely rare.

If a sale ultimately takes place, in most cases, the ESOP will be terminated. However, before the ESOP can be completely terminated, all participants - including those who are no longer employees of the company - will need to be paid. In our estimation, on average, it takes about two years to conclude the operations of an ESOP, and participants are often not paid in-full for a year or more after the sale transaction closes. As a result, the trustee will remain in place until all of the ESOP termination activities are complete.

During that time, the company will be involved in several activities, such as completing the necessary paperwork for the IRS; working with the plan administrator to allocate participant shares; and demonstrating that all participant distributions have been made. If there are participants that cannot be located, the company must also show that it made a good faith effort to find those people.

Contingent consideration, payments for non-compete agreements, escrows and holdbacks are some possible issues which may arise post-closing. There are normal, commercially acceptable deal elements, but they can complicate the distribution of proceeds and, in particular, the proceeds flowing to ESOP participants. Companies should hold a detailed session on these issues with their corporate and ESOP counsel at an early stage. It is quite possible that the structure of the transaction could be adjusted to lessen the impact of these items.

In the end, although there are several issues and special considerations in the sale of an ESOP-owned company that are not typically present in traditional M&A transactions, a company properly prepared for sale by an investment bank with ESOP expertise can move forward successfully and can benefit both the company and the ESOP participants.

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