

CLIENT ALERT

USING YOUR ESOP TO ACQUIRE ANOTHER COMPANY

ESOPs are extremely versatile corporate finance tools. They create a market for privately held stock, afford tax advantages to the sponsoring company and its shareholders, and motivate employees by rewarding them for their contributions to the sponsor company's growth.

An additional benefit of ESOPs is often overlooked. An ESOP can be used in a corporate acquisition, to enhance the purchaser ("Purchaser") company's ability to acquire a target company ("Target"), or to allow Target's management and employees to acquire Target.

Deduction for Purchase Price

Generally, Purchaser cannot deduct the purchase price it pays to acquire the stock of Target. Accordingly, Purchaser generally prefers to buy

the assets of Target, because this allows Purchaser to deduct more of the purchase price. However, a sale of Target's assets will usually result in substantially higher taxes to Target's shareholders. Accordingly, Target's shareholders generally prefer to sell their stock. Target's shareholders are often willing to accept a lower price for their stock of Target, than Target would accept in a sale of its assets. Purchaser may also prefer to buy the stock of Target because Target may have licenses and contracts that cannot easily be transferred in an asset sale. By using the ESOP to acquire the stock of Target,

Purchaser can give Target's shareholders what they want and receive a deduction equal to the purchase price. The resulting improvement in cash flows may improve Purchaser's ability to obtain financing for the transaction.

Non-Recognition of Gain on Sale

An acquisition transaction can often be structured to allow Target's shareholders to pay no tax at all on their sale of Target's stock. As a result, Purchaser may be able to negotiate an even lower purchase price for Target's stock.

Purchaser's ability to deduct the purchase price for Target's stock, and Target's shareholders' favorable tax treatment on the sale of Target's stock, may allow Purchaser to pay a higher price for Target than Purchaser's competitors could afford to pay, and may



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allow Target's shareholders to accept a lower price for Target than they would otherwise be willing to accept. Together, these factors may bridge the price gap, bringing about a deal that would otherwise be unrealistic.

Using Non-Cash Benefits in Compensation for Target's Employees

Regardless of how the acquisition is structured, following the acquisition, Target's employees will become participants in the ESOP. This may allow Purchaser to negotiate favorable employment terms that reduce the cash cost of compensation, further enhancing Target's profitability.

Creating New, Unallocated ESOP Shares

If Purchaser's ESOP has allocated most or all of its shares, an acquisition could add a pool of new, unallocated shares to the ESOP. This can reinvigorate the ESOP as a benefit to both Purchaser's and Target's employees.

Using an ESOP for a Spin-off.

Another possibility is that Target's management may want to purchase

Target but may lack the cash to do so. By using an ESOP to purchase all or a part of Target's outstanding shares, the tax savings, employee benefits and compensation advantages may make the transaction possible. The vested 401(k) and profit sharing accounts of Target's employees may even be available to fund a portion of the purchase price.

Conclusion

Properly structured, an acquisition using an ESOP can provide tax benefits to both Purchaser and Target or its shareholders, improve Purchaser's ability to obtain financing for the transaction, provide valuable employee benefits for the employees of both Purchaser and Target, and even make existing pension funds available for a portion of the purchase price.

If you are considering using your ESOP in an acquisition, please contact Steve Greenapple (sgreenapple@sfeglaw.com) to discuss these issues.

Coming Up in the Next Issue of the SFE&G Client Alert!

Voluntary Correction Programs

The IRS recently revised the rules of the Employee Plans Compliance Resolution System (EPCRS) program, a program that enables sponsors of retirement plans to correct plan mistakes and avoid the significant costs that go along with disqualification. The DOL also recently revised its own correction program - the Voluntary Fiduciary Correction Program (VFCP), which plan fiduciaries can use to correct fiduciary breaches without incurring ERISA penalties.

So what does this mean for you? In the next issue of the SFE&G Client Alert, attorney Mark Kosow explains how this could benefit your company's ESOP and other retirement plans.

Responding to DOL Audits

The Department of Labor has increased the number of ESOPs that it audits each year, so you may receive a "greetings from your government" letter. This article will tell you what should you do *first*, what you absolutely should *not* do, what the DOL is looking for, and how you should organize your responses to ensure that the process goes smoothly and with as little disruption to your business as possible.

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Role of the Plan Administrator & ESOP Administration Committees

**Guest Column by Brian Wurpts,
Vice President of Plan Record-
keeping for SES Advisors, Inc.**

Do you know who your ESOP Plan Administrator is?

If you answered “SES” or “our ESOP record keeper” you’re not alone. But in reality, the role of the Plan Administrator (“PA”) is much broader than the services provided by a third party administrator (or “TPA”).

Your ESOP document either specifically identifies your Plan Administrator or the process for appointing one. If the Company’s Board of Directors does not appoint a Plan Administrator, the Company itself is generally considered the PA. So, who at the Company carries out PA functions if you haven’t appointed someone? For most ESOP sponsors, it’s Management (typically including representatives from accounting/finance and human resources). Sometimes it’s the Plan Trustee. But if a Plan Administrator is not appointed, the fiduciary duty and accountability may fall on anyone who makes a decision on behalf of the Plan, including the Company’s Board of Directors. Therefore, it’s often beneficial to assign the role. This article discusses the responsi-

bilities of a Plan Administrator and whether it makes sense to formally appoint an individual or committee.

Responsibilities of the ESOP Plan Administrator

The Plan Administrator or ESOP Administration Committee has a legal duty, as a named fiduciary, to act in the best interests of plan participants and exclusively for the purpose of providing benefits to the participants and their beneficiaries.

PAs also have a duty to:

- act prudently – with the care, skill and diligence that a prudent person would use;
- follow plan documents;
- disclose required information; and
- to defray plan expenses.

Your plan document also describes the PA’s responsibilities. A search of a typical ESOP document found over one hundred twenty references to the term. (For those of you who use an SFE&G document, you’ll find detailed information in article ten.) Here are a couple of key concepts:

-The Plan Administrator shall have exclusive discretionary responsibility and authority to control and manage the operation and admini-

stration of the Plan, including the interpretation and application of its provisions, except to the extent such responsibility and authority are otherwise specifically allocated.

-The Plan Administrator shall keep whatever records may be necessary to implement the Plan and shall furnish whatever reports may be required by the Trustee and whatever information may be necessary properly to administer the Trust.

The PA has the authority and the responsibility to interpret the plan document and its rules. The PA is also responsible for keeping the plan’s records, providing information necessary to allocate contributions and trust earnings, and verifying the accuracy of the data.

Other responsibilities typically assigned to the Plan Administrator include:

- distribution and retention of beneficiary forms;
- distribution of Summary Plan Descriptions (and modifications thereof);
- determination of plan’s distribution policy;
- distribution of Summary Annual Report and annual benefits statements;
- responses to requests for benefits;
- preparation of distribution forms and tax disclosures to eligible participants;
- review of domestic relations orders;

Role of the Plan Administrator & ESOP Administration Committees

- collection and preparation of data used in annual allocations (and audit thereof);
- review/approval of annual allocation report;
- authorization of plan expenses;
- filing of government reports (e.g., 5500); and
- selection/retention of plan advisors.

Most ESOP sponsors hire advisors to assist the Plan Administrator with these responsibilities: an ESOP TPA, a plan auditor, and corporate/ERISA counsel. But there are aspects of these responsibilities for which hiring advisors would be impractical. For example, a TPA processes plan records and calculates allocations, but generally does not set the Plan's distribution policy or interpret the plan document.

Interactions between the Plan Administrator and the Plan Trustee(s)

The Plan Administrator and the Plan's Trustee(s) work closely in the administration of the Plan and Trust. Sometimes an ESOP sponsor will appoint the Trustees to the ESOP Administration Committee. Some these responsibilities overlap, there are distinctions:

Trustee Responsibilities Distinct from the Plan Administrator's

- prudently invests Trust assets
- reviewing/approving the valuation of Trust assets
- disbursing plan assets;
- voting ESOP shares on all matters in which shareholders are permitted to vote; and
- providing financial information necessary to administer the Plan.

The fiduciary duties shared by the Trustee and the Plan Administrator align these roles to some extent. But there are occasions when a Trustee and Plan Administrator might find themselves at odds. Fortunately, the plan document and the law usually give us guidance as to "where the buck stops" on any issue.

Appointing a Plan Administrator or ESOP Administration Committee

The Board of an ESOP sponsor should carefully consider appointing an ESOP Administration Committee. In doing so, it should assess the qualifications of the individuals, their ability to act in the best interests of Plan Participants, and their ability to separate these decisions from the responsibilities of their position with the Company

(even when those decisions conflict). The Board should also consider whether fiduciary insurance for the individuals is appropriate or whether the indemnification provisions in the plan document are sufficient to protect the PAs from acts done in their capacity as fiduciaries.

Appointing a plan administrator or administrative committee helps to ensure that if the Plan Administrator's decisions are questioned, the responsibility for those decisions is clearly defined and the process for making the decisions is consistent and documented. The simple function of appointing an ESOP administration committee often introduces a desirable level of formality in these matters. Committees tend to be more process-driven than individuals. Regular meetings and a process of documenting decisions are essential to a good compliance program

-If you have any questions regarding the role of an ESOP plan administrator or administration committees, please contact Brian Wurpts at 215.508.1600 ext. 227 or bwurpts@sesadvisors.com.



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