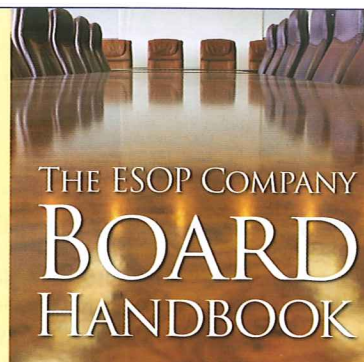


Considerations for the Sale of Company Stock to an ESOP

By Stephen P. Magowan

Editor's Note: In the last several years, the boards of ESOP companies have become more active and independent than in the past. While many companies still have boards consisting of the company's owner and (if different) its CEO along with friends and family, more companies have independent board members and/or other employees on the board. Along with that has come an increased focus on operating the boards more prudently. The NCEO has just published a book titled *The ESOP Company Board Handbook* to help companies set up and manage their boards more effectively. Below is an excerpt from a chapter by Stephen P. Magowan of SES Advisors.



The agreements relating to the ESOP purchase and sale transaction require the direct attention of and consideration by the board. The board cannot simply rubber-stamp the documents presented to it. The board, of course, will need to understand the financial implications of the transaction and whether the company can handle taking on the debt required by the transaction. But the board must also undertake to understand the more mundane aspects of the transaction.

In particular, the board should take care to review what representations and warranties the company is making in the purchase and sale documents to the ESOP buyer and to any lenders and what level of indemnification the company is giving the ESOP buyer and the lenders. This review is required as a matter of the board's prudent exercise of the duty of care because the corporation cannot make these representations unless the board authorizes it to. As a matter of law, the board authorizes these representations and warranties when it makes resolutions approving the transactions associated with the ESOP purchase.

As part of the board's review of deal documents, it should receive an overview of the company's representations and warranties. This will consist of a laundry list of items including that the company has paid its taxes on a timely basis; that the company's financial statements are accurate; that the company is not under investigation for any wrongdoing; and that the company is not in violation of any environmental laws. The board may designate the respon-

sibility to undertake this review to an ad hoc committee. The board's role is to make sure that it is comfortable with the company making the representations, and the board may wish to ask for company officers to sign certifications about certain representations. For example, it may want the chief financial officer to sign a Sarbanes-Oxley style certification about the company's financials.

The board also has to undertake a review of any significant contracts beyond the purchase and sale agreement, such as leases with related parties and employment agreements. The board also must review the terms of all financing arrangements incurred in the transaction with any lending institution and any sellers (i.e., through seller notes). The board's role here is to ensure that the company is, in short, getting a reasonable deal. The board's perception of itself in these actions should be that of a careful overseer of the fortunes of the company. The board in this matter is representing the company and must determine whether, as a whole, the transaction will be fair to the company.

Some questions a board should wonder about are: How far into the future must the board prognosticate? How deep should a board get on such issues as repurchase obligation? Does a truly independent board require separate legal representation? There are no simple answers to these questions, but some rules of thumb may be helpful.

As to projections, I think anything beyond five years is entirely guesswork, so there should be no obligation to go beyond that.

Projections of three to five years should be adequate, but the board should revisit such projections on at least an annual basis after the transaction is done.

I believe boards should always be looking at the repurchase obligation. The only question is what level of study should be done. If a company has had an ESOP for a long period of time and is going from minority to majority ownership (for instance from 35% ownership to 100%), it should get a repurchase study performed. If the transaction is a minority transaction that will be financed over time, a full-blown study is not generally necessary before the transaction, but it should be performed as more and more employees become vested. If a company stock redemption is occurring in connection with the transaction, the board should inquire as to how that redemption structure will affect the repurchase obligation, if at all.

What about separate legal representation? In general this should not be necessary, in that the company's counsel serves the wishes of the majority of the board of directors. However, if a transaction is complex and if the independent outside board members are being asked to vote separately on the transaction because of conflict of interest concerns, then I believe that a good argument can be made that having separate ESOP counsel to advise these board members would serve to create a more independent process and one more likely to enjoy the shield of the business judgment rule. ■