WHEN THINGS DON'T GO AS PLANNED

Negotiating Protections for the ESOP

In recent years, the most significant ESOP litigation has revolved around declines in company stock value post-transaction, often because, in retrospect, financial projections at the time of sale were too optimistic. At the recent NCEO annual conference, Fred Kaseff, senior vice president at GreatBanc Trust Company, and Mark Fournier, managing director at Stout Risius Ross, looked at ways these problems can be corrected post-transaction, a process that may help ESOP trustees stay out of trouble. In another session, Brian Yolles of StockShield, an equity risk management firm, looked at another approach to downside protection risk. This article is adapted from their presentations.

Some examples of how things may not turn out as expected include:

- Financial results are significantly lower than projections made at the time of the transaction
- Misrepresentation of the business, such as not describing likely risks or pending litigation
- Sale of the company post-transaction while shares are still in the suspense account

These and other problems can result in sellers getting more for the business than, in retrospect, it really was worth. Changes in business conditions are, of course, difficult to predict, but if the projections turn out to have been unrealistically optimistic in the first place, then getting something back for the ESOP may be appropriate or necessary.

Clawbacks

One way to protect the plan from overpaying because of unrealistic expectations is to have a clawback clause. This allows the buyer (the ESOP trust) to reduce the purchase price after closing if certain targets or thresholds are not met. It would usually be implemented as a reduction to the seller note face amount, which is far easier than subsequently pursuing cash from the seller (assuming no or insufficient escrow). Reductions can be made to non-purchase-price terms as well, such as seller note interest rate or warrant terms.

The clawback is subject to negotiation and includes:

- Maximum amount (cap)
- Duration of measurement period (typically 1-3 years)
- Relevant metric (revenue, EBITDA, etc.)
- A clawback adjustment formula (typically the implied transaction multiple times shortfall amount)

Clawbacks are more likely if the purchase price is at the high end of valuation range; if the company has limited or inconsistent earnings history; if there is significant customer concentration; and/or if the industry is volatile, cyclical, or in decline.

Misrepresentation

Misrepresentation of the business is usually addressed with representations and warranties that certain characteristics or conditions of the business are true. Representations and warranties are outlined in the purchase agreement and typically include that:

- Financial statements are accurate
- Taxes have been paid
- The company owns its assets
- All environmental, contractual, litigation, and other liabilities are disclosed

Breaches give rise to the buyer's (trustee's) right to pursue certain remedies, including either a reduction in the seller note face amount or a recovery of cash (generally from the escrow account established for transaction). The materiality of the breach is often a key issue and heavily negotiated.

Termination Before Loan Repayment

Finally, what happens if the company is sold during the term of the internal loan, with unallocated shares in the ESOP? The trustee wants loan forgiveness in full, driving more of the value from the sale to ESOP participants. The seller wants the ESOP to use the value of unallocated stock to pay off the remaining balance of the internal loan, driving more of the value from the sale to synthetic equity holders. The issue begins to resolve itself over time, as more ESOP shares are allocated and synthetic equity becomes more likely to be "in the money." But with longer ESOP loan terms becoming more common, the issue has become more important.

The typical resolution is that the trustee and sellers find middle ground, with partial forgiveness of the remainder of the internal loan if the company is sold. This result tends to preserve the originally anticipated value allocation between the ESOP and sellers (i.e. value not skewed to either ESOP or synthetic equity holders).

While this article focuses on trust protection, similar approaches could be used to protect the seller if the company does considerably better than projected.

Risk Pooling

Another approach is risk pooling. As part of such an arrangement, a small percentage of each new transaction could be contributed into a fund for the protection of participating ESOPs. If none of the participating ESOPs are challenged after a certain period of time (say six years), the pooled cash is refunded. If certain transactions are challenged, the fund is available to inject cash into the impacted ESOP(s). Acquiring this type of protection could help all parties demonstrate prudence as well as reduce the cost of fiduciary insurance.

Called a stock protection fund, this risk-pooling technique has been successfully implemented by investors with concentrated stock positions in public companies (individuals who do not want to, or cannot, sell their shares). Stockholders participate in order to help ensure their net worth is not decimated should their stock unexpectedly lose substantial value. The benefit is an estimated 80%+ reduction in risk while preserving all of the stock's upside potential. In the aftermath of the financial crisis, a stock protection fund eliminated all stock losses (paying 100 cents on the dollar). ■

This and other great ideas from the 2017 annual conference are explored in the new NCEO publication *Great Ideas from the NCEO's 2017 Annual Conference,* available soon at nceo.org/r/great2017.