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ESOPs: Working Together to Change the Face of Ownership

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Basic Financing

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I.

Introductory Summary of the Lending Environment

The economic and lending environment continues to be tight and has been very tight over the last three (3) years. As a result, the financing structure of an ESOP transaction has been changed in order to complete ESOP transactions. Basically, the following has occurred:

1. Senior lending markets have contracted and standards have tightened, such as:
 - 2004: 2.0 times EBITDA¹ (Senior Debt to EBITDA Ratio)
 - 2003: 2.0 times EBITDA (Senior Debt to EBITDA Ratio)
 - 2002: 2.5 times EBITDA (Senior Debt to EBITDA Ratio)
 - 2001: 2.5 times EBITDA (Senior Debt to EBITDA Ratio)
 - 2000: 3.5 times EBITDA (Senior Debt to EBITDA Ratio)
 - 1999: 4.0 times EBITDA (Senior Debt to EBITDA Ratio)
 - 1998: 6.0 times EBITDA (Senior Debt to EBITDA Ratio)
2. Senior lenders continue to base lending on asset-based loans criteria and not cash flow criteria loans; and
3. Senior lenders continue to limit the availability of mezzanine debt.

In addition, lenders are more involved in the structure of the transaction and require covenants that will impact the operation and corporate governance of the company. As a result of the S corporation ESOP benefits, some lenders are giving a company credit from a cash flow standpoint with respect to increasing the Senior Debt to EBITDA Ratio to 2.5 to 3.0. Also, ESOP transactions are being completed by using a combination of traditional and nontraditional financing sources:

- Senior Debt Financing
- Mezzanine Debt Financing
- Selling Shareholder Junior Note Financing

¹ A common benchmark used by lenders to make this determination is “EBITDA,” which means earnings before interest, taxes, depreciation, and amortization.

- Employees are permitted to use some of their Profit Sharing Money to acquire stock
- Private Equity Investment
- Employees are permitted to use some of their 401(k) Employee Deferrals to acquire stock
- Management Investment

In structuring an ESOP transaction in the current environment, it is important to properly address the following up front: (i) properly prepare pro-forma financial statements and cash flow forecasts as part of the structuring the ESOP transaction; (ii) assemble the proper team to structure all aspect of the ESOP transaction; and (iii) educate the lender about the structure and benefits of the ESOP transaction. It is important to recognize that there are specific statutory provisions under the federal laws regulating employee stock ownership plans (“ESOPs”), S corporations, and fiduciary rules applicable to fiduciaries of the ESOP and the corporation that have an impact of the loan and ESOP transaction structure. Structures used today are much different than the traditional structures used in the past. This outline provides information on general legal issues. Because of its generality, this outline and the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Also, this outline has been prepared for purposes of presenting this topic and does not necessarily reflect the views of Jenkins & Gilchrist or the national Jenkins & Gilchrist ESOP Group.

II. Background Information

A. History. During the 1980’s, Congress created a number of truly remarkable tax incentives designed to encourage employers both to establish employee stock ownership plans (or “ESOPs” as they commonly are called) and to borrow money in order to fund these plans. These tax incentives make the ESOP vehicle attractive not only as an employee benefit, but also as a tax-advantaged technique of corporate finance (which includes merger and acquisitions) and as a business and estate planning tool. Largely as a result of the new tax incentives, ESOPs are being adopted by an increasing number of companies, both large and small. The number of ESOPs has increased from approximately 1,600 in 1975 to over 10,000 in 2002, and the number of employees participating in these plans has increased from approximately 250,000 in 1975 to over 10 million in 2002.² Moreover, most of these plans are established with the use of borrowed funds.

The tax incentives that Congress has enacted to encourage the establishment of ESOPs make them attractive for a variety of purposes. In its simplest form, an ESOP is a tax-qualified employee benefit plan that provides a special kind of benefit to employees – an ownership

² Source: National Center For Employee Ownership.

interest in their company. Employee productivity may increase after the establishment of an ESOP because the employees can benefit directly from increased profitability of their company.³

An ESOP also can serve as an important business and estate planning technique for owners of private corporations, who can sell some or all of their stock to an ESOP on a tax-free basis. A private business owner can use a tax-free sale of stock to an ESOP to effect a successful ownership succession plan or to achieve tax-free diversification of wealth.⁴ In either case, the funds to finance the ESOP stock purchase normally will be borrowed, and additional tax benefits are provided for loans to ESOPs.

ESOP loans can be used not only to finance stock purchases from existing shareholders, but also to finance virtually any kind of corporate transaction, including management buyouts and acquisitions and divestitures. If a corporation uses an ESOP to obtain a loan, it will be entitled to take tax deductions with respect to both the interest and the principal payments on the loan, instead of deducting the interest only, as in the case of a conventional corporate loan. This important tax incentive for ESOP loans make these kinds of loans advantageous by increasing the borrower's cash flow as compared to a direct corporate loan. The increased cash flow available for additional debt service should either enhance the creditworthiness of the borrower or increase the amount that a financial institution is willing to lend.

Although ESOPs are spreading rapidly and being adopted by a growing number of companies, they often are overlooked in planning for corporate transactions and can be misunderstood by lenders and borrowers. For commercial lenders looking to provide creative solutions to their customers' financing and business needs, the ESOP concept has much to offer. Commercial lenders who understand how ESOPs work have a competitive advantage, not only because of the available lending opportunities, but also because those lenders can distinguish themselves from their competitors by presenting a creative tax-savings opportunity to existing and potential customers.

B. S corporation ESOPs. Effective January 1, 1998, corporations which sponsor ESOPs became eligible for the first time to make the election to be treated as an "S corporation" for federal income tax purposes.⁵ Expansion of the S corporation shareholder-eligibility provisions to include ESOPs has opened up possibilities for enormous tax savings for ESOP companies.⁶ The tax-savings possibilities can be illustrated most dramatically by considering a corporation all of the stock of which is owned by an ESOP. If that corporation makes the S election, there will be no current federal tax on its annual income. The corporation itself will not

³ See Rosen, "An Introduction to Employee Ownership," Employee Stock Ownership Plans, ch. 1 (Harcourt Professional Publishing 2000); and Kruse, "Research Evidence on Prevalence and Effects of Employee Ownership," 14 J. of Employee Ownership L. and Fin. 65 (2002).

⁴ For a detailed discussion of how ESOPs can be used for these purposes, see Ackerman, "Innovative Uses of ESOPs in Estate Planning for Business Owners," 33 Miami Estate Planning Institute, ch. 12 (Matthew-Bender 1999).

⁵ I.R.C. §1361(c)(6).

⁶ For a thorough discussion of the rules relating to S corporation ESOPs and of the tax-savings and other planning opportunities with S corporation ESOPs, see, Ackerman, "ESOPs and S Corporations," Selling to an ESOP, ch. 8 (National Center for Employee Ownership, 7th Ed., 2002).

be subject to tax under the general S corporation rules⁷ and, although the income will be passed through to its sole shareholder (the ESOP), no shareholder-level tax will be imposed because the ESOP is a tax-exempt entity.⁸

C. Current Lending Climate. In light of the current economic and lending environment, many companies will structure a transaction that begins as: (i) a traditional C corporation ESOP 1042 Transaction (as defined below) (in order for the selling shareholder to be eligible to postpone the capital gains taxation); (ii) a 100% ESOP transaction where the selling shareholders sell 100% of their stock using a combination of senior debt, mezzanine debt and seller junior debt so the company gains the advantage of the cash flow savings by electing S corporation status for Federal corporate income tax purposes (“S corporation Status”) later; and (iii) a company electing S corporation Status as soon as legally and financially possible. In order for a transaction to take advantage of the benefits of the S corporation ESOP structure, there are many requirements that must be satisfied by the company. In a management buyout situation, many companies will structure a transaction as follows: (i) management uses a new S corporation leveraged ESOP company structure; or (ii) management uses a new leveraged S corporation, and a non-leveraged ESOP structure with 401(K)/Profit Sharing money used to provide capital.

III. General Description of an ESOP

A. Basic Legal Requirements. An ESOP must take the form of a detailed written plan adopted by the company sponsor.⁹ The plan document must set forth all of the provisions required for “qualification” of the plan under the Internal Revenue Code,¹⁰ including provisions relating to the following matters: eligibility for participation in the plan; allocations of contributions to the plan and of earnings on the plan assets; vesting of participants’ rights under the plan; distributions of benefits to participants; and procedures for claiming benefits.

In addition, a trust must be established to hold the employer securities and other properties contributed to or otherwise acquired by the plan.¹¹ The trustee is appointed by the company sponsoring the plan. Typically it is desirable to designate a bank or trust company to serve as trustee because of its experience in handling investment assets and in assuming fiduciary responsibilities.¹²

⁷ I.R.C. §1363(a).

⁸ I.R.C. §§401(a), 501(a), and 512(e)(3).

⁹ ERISA, § 402(a)(1).

¹⁰ Treas. Reg. § 1.401-1(a)(2).

¹¹ ERISA § 403.

¹² Alternatively, one or more individuals, including officers or employees of the sponsoring company, may be selected to serve as trustees; but they will be personally responsible to the participants in the plan for any breach of fiduciary duty or other violation of any of the myriad of laws and regulations that govern the administration of tax-qualified employee benefit plans. See ERISA §§ 404-406. For detailed discussions of the fiduciary responsibilities of ESOP trustees, see Kober “*Enron: Impact on ESOPs and Being a Fiduciary of an ESOP*,” 30 Tax Mgmt. Comp. Plan. J. 159 (2002); and Ackerman, “*Questions and Answers Regarding the Duties of ESOP Fiduciaries*,” 13 J. of Employee Ownership L. and Fin. 3 (2001).

B. General Tax Attributes of ESOPs. The basic tax attributes of an ESOP are similar to those of a qualified profit-sharing or pension plan:

1. Contributions to an ESOP are deductible by the sponsoring company (within applicable limits);¹³
2. Income earned by an ESOP is exempt from tax;¹⁴ and
3. The participants in an ESOP are not required to recognize any taxable income in connection with allocations of employer contributions or earnings to their accounts until their benefits are withdrawn from the plan.¹⁵

Contributions to an ESOP may take the form of stock of the sponsoring company, cash, or other property. If cash is contributed, the trustees of the ESOP may use the cash to purchase stock of the sponsoring company. There are limits on the amount that may be contributed to an ESOP, and these limits may be important in connection with “sizing” an ESOP loan if the company is a C corporation or the S corporation is less than one hundred percent (100%) owned by the ESOP. The maximum amount that a C corporation and an S corporation may deduct with respect to contributions to a non-leveraged ESOP is twenty-five percent (25%) of the compensation paid to all employees participating in the plan for the taxable year.¹⁶

In the case of a C corporation, all contributions used to pay interest are fully deductible¹⁷ and, in addition, contributions used to repay principal are deductible up to twenty-five percent (25%) of the compensation of the participating employees¹⁸, and reasonable dividend paid on the employer securities acquired with the loan are deductible (subject to Alternative Minimum Taxation). However, these increased limits do not apply with respect to the repayment of ESOP loans where the company sponsoring the plan is an S corporation.¹⁹

C. Requirements for Tax Qualification. The general requirements for qualification by an ESOP for the tax benefits described above are as follows:

1. Contributions must be made to a trust, which must be administered for the exclusive benefit of the participants in the plan and their beneficiaries;²⁰
2. Participation in the ESOP must be available to a broad cross-section of employees (but union employees may be excluded);²¹

¹³ I.R.C. § 404(a)(3).
¹⁴ I.R.C. § 501(a)(3).
¹⁵ I.R.C. § 402(a).
¹⁶ I.R.C. § 404(a)(3)(A).
¹⁷ I.R.C. § 404(a)(9)(B).
¹⁸ I.R.C. § 404(a)(9)(A).
¹⁹ I.R.C. § 404(a)(9)(C).
²⁰ I.R.C. § 401(a)(1), (2).
²¹ I.R.C. §§ 401(a)(3),(6), 410.

3. Benefits under the ESOP must not be provided on a basis that discriminates in favor of officers, shareholders, or highly-compensated employees (but benefits may be allocated in proportion to the relative compensation of participating employees);²²
4. The plan must comply with certain minimum vesting standards;²³
5. Distributions of benefits must begin by certain specified dates;²⁴
6. The plan must be intended as a permanent and continuing program,²⁵ and the terms of the plan must be communicated to the employees of the company;²⁶ and
7. The plan and trust must be administered in compliance with the general fiduciary rules applicable to all qualified plans.²⁷

IV. Deductibility of ESOP Loan Payments.

A. Exempt Loan. The major tax incentive for the creation of ESOPs is that if an ESOP is used to finance a transaction, both the interest and the principal payments on the loan will be tax-deductible. As a result, ESOPs can serve as a tax-advantaged technique of corporate finance. There are several legal requirements that a C corporation and S corporation must satisfy for an ESOP loan to be considered an “Exempt Loan”. (It should be noted that many transactions begin as a C corporation 1042 ESOP transaction and after a period of time the corporation elects S corporation Status.)

The fiduciary rules applicable to employee benefit plans generally prohibit a company that sponsors an employee benefit plan from lending money to the plan, guaranteeing a loan to the plan, or providing collateral for a loan to the plan.²⁸ However, a special exemption is provided for loans to ESOPs where the loan proceeds are used to acquire common stock of the

²² I.R.C. § 401(a)(4),(5). Compensation in excess of \$200,000 paid to any individual employee must be disregarded for this purpose. I.R.C. § 401(a)(17)(A). This \$200,000 limit is subject to cost-of-living adjustments. I.R.C. § 401(a)(17)(B).

²³ I.R.C. §§ 401(a)(7), 411. The longest period of time over which full vesting can be deferred is seven years. If a seven-year vesting schedule is selected, participants' rights to their benefits must be at least twenty percent (20%) vested after three years of service and must vest at the rate of at least an additional twenty percent (20%) per year thereafter. Alternatively, a tax-qualified plan may provide that participants' rights shall not vest at all for five years, but then the participants' rights to their benefits must be fully vested after the completion of five years of service.

²⁴ I.R.C. § 401(a)(9), (14).

²⁵ Treas. Reg. § 1.401-1(b)(2). An employer may reserve the right to amend or terminate the plan or to discontinue contributions to the plan. However, if a plan is terminated within a few years after it is first adopted for any reason other than business necessity, the termination may be treated as evidence that the plan was not intended to be permanent. This could result in retroactive disqualification of the plan.

²⁶ Treas. Reg. § 1.401-1(a)(2). This requirement can be satisfied by furnishing a "summary plan description" to employees after they become participants in the plan. ERISA § 102.

²⁷ ERISA § 404(a).

²⁸ I.R.C. § 4975(c)(1)(B); ERISA § 406(a)(1)(B).

sponsoring company.²⁹ These loans are referred to as "exempt loans." In order for an ESOP loan to qualify as an exempt loan, the loan must be without recourse against the ESOP. However, the loan may be guaranteed by the sponsoring company, and the company's securities acquired with the loan proceeds may be pledged as collateral.³⁰ In that case, the securities must be released in installments over the term of the loan.³¹

There are a number of other technical requirements that must be satisfied in order for a loan to an ESOP to qualify as an exempt loan. These requirements are designed to assure that the terms of the loan are fair and to protect the participants in the plan. Among the other requirements that apply to ESOP loans are the following:

1. The interest rate on the loan and the purchase price for the stock must not be so high that plan assets might be drained off;³²
2. The terms of the loan must be at least as favorable to the ESOP as the terms of a comparable loan resulting from arm's-length negotiations between independent parties;³³
3. In the event of a default, the value of the plan assets transferred in satisfaction of the loan must not exceed the amount of the default and, if the lender is a party-in-interest, plan assets may be transferred only to the extent of the failure of the plan to meet the loan payment schedule;³⁴
4. The loan must be for a fixed term,³⁵ and
5. The interest rate on the loan must be reasonable.³⁶

It is critical that all of the above requirements are satisfied. If a loan to an ESOP fails to qualify as an exempt loan, the loan does not qualify as an exempt loan, and therefore constitutes a "prohibited transaction" under ERISA and under the Internal Revenue Code ("Code"). As a result, the company will be subjected to substantial excise tax penalties.³⁷

²⁹ I.R.C. § 4975(d)(3); ERISA § 408(b)(3).

³⁰ Treas. Reg. § 54.4975-7(b)(5); Labor Reg. § 2550.408b-3(e).

³¹ Treas. Reg. § 54.4975-7(b)(8); Labor Reg. § 2550.408b-3(h).

³² Treas. Reg. § 54.4975-7(b)(3)(ii) and Labor Reg. § 2550.408b-3(c)(2).

³³ Treas. Reg. § 54.4975-7(b)(3)(iii) and Labor Reg. § 2550.408b-3(c)(3).

³⁴ Treas. Reg. § 54.4975-7(b)(6) and Labor Reg. § 2550.408b-3(f).

³⁵ Treas. Reg. § 54.4975-7(b)(8) and Labor Reg. § 2550.408b-3(h).

³⁶ Treas. Reg. § 54.4975-7(b)(7) and Labor Reg. § 2550.408b-3(g).

³⁷ I.R.C. § 4975. In addition, there may be some possibility that the lender itself could be subjected to liability for participation in a prohibited transaction. See, *Harris Trust and Savings Bank v. Salomon Smith Barney*, 530 U.S. 238 (2000). That case involved a broker-dealer which provided services to an ESOP trust and which sold worthless property to the trust. The plaintiff alleged that the purchase of the worthless property constituted a prohibited transaction under ERISA, and the Supreme Court held that even though the broker-dealer was not a fiduciary, it still could be sued for equitable relief under ERISA by reason of its participation in the transaction. No ESOP lenders have yet been subjected to liability under ERISA for making a loan which failed to satisfy

B. C corporation Deductibility of Dividends and Contributions

1. Conditions for Deduction. Generally, corporations are not permitted to deduct dividends to shareholders. However, an exception to this general rule is provided for dividends paid on shares of a C corporation held by an ESOP, which may be deducted under the following circumstances: (i) if they are paid in cash to plan participants; (ii) if they are paid to the plan and passed through to the participants within ninety (90) days after the end of the plan year; (iii) if they are applied by participants to purchase additional shares of the company; or (iv) if they are used to repay a loan incurred to purchase the company stock with respect to which the dividends are paid.³⁸

2. Contribution Limit. In general: (i) the C corporation may deduct an ESOP contribution equal to the interest on the ESOP loan plus twenty-five percent (25%) of covered payroll;³⁹ and (ii) the S corporation may deduct an ESOP contribution equal to twenty-five (25%) percent of Covered Payroll.⁴⁰ If the company's covered payroll is less than the amount necessary to tax effect the amortization of the outside indebtedness, it may be possible to increase the deduction by using tax-deductible dividends.⁴¹ The deduction for dividends paid on C corporation stock held by an ESOP can provide a useful mechanism for increasing the amount of the deduction. This may be important to a lender and doing the first year prior to converting the C corporation to an S corporation. As discussed above, the maximum amount that an company may contribute to an ESOP on an annual basis is limited by the compensation paid to the participants in the plan.⁴² In addition, there are limitations on the amounts which may be allocated to the account of any individual participant.⁴³

If it is necessary to use dividends to amortize an ESOP loan and where the corporation has other stockholders as well as the ESOP, it may be better to stay as a C corporation and to recapitalize the corporation so the ESOP holds convertible preferred stock or so-called "super" common stock. As a result, the dividends declared and paid on the stock held by the ESOP can be used to repay the indebtedness, and the distribution of nondeductible "wasted" dividends to the stockholders other than the ESOP can be avoided. It also may be in the lender's interest to require this kind of recapitalization as compared to electing S corporation Status where it is anticipated that the transaction will result in something less than a one hundred percent (100%) ESOP transaction. Most lenders normally will want to limit the payment of dividends to non

the exempt-loan requirements or for financing a prohibited transaction, but the *Harris Trust* holding raises the possibility that under certain circumstances, liability might be imposed on a lender in connection with a prohibited transaction.

³⁸ I.R.C. § 404(k).

³⁹ I.R.C. § 404(a)(9).

⁴⁰ I.R.C. § 404(a)(9)(C).

⁴¹ Moreover, because dividends paid on stock held by an ESOP constitute earnings of the trust fund, and because the limitations on annual allocations to individual participants' accounts imposed by the Internal Revenue Code apply only to contributions and forfeitures, stock released from pledge as a result of a loan repayment with dividends may be allocated to participants' accounts without regard to the individual-allocation limitations. S. Rpt. No. 313, 99th Cong. 2d Sess. 682 (1986).

⁴² I.R.C. § 404(a)(9).

⁴³ I.R.C. § 415.

ESOP shareholders and to the ESOP while its loan is outstanding if the dividends are not used to repay the indebtedness.

The ESOP dividend-deduction provisions of the Internal Revenue Code do not allow for an unlimited broadening of the deduction and allocation limitations for leveraged ESOPs. The dividend deduction may be disallowed if the Service determines that a dividend constitutes “in substance, an evasion of taxation.”⁴⁴ It is generally thought that this provision will be interpreted to limit the deduction for dividends paid on ESOP stock to dividends that are “reasonable” in amount.⁴⁵

C. S Corporation ESOPs.

1. Income Tax Savings. Effective January 1, 1998, corporations which sponsor ESOPs became eligible for the first time to make the election to be treated as an “S corporation” for federal income tax purposes.⁴⁶ Expansion of the S corporation shareholder-eligibility provisions to include ESOPs has opened up possibilities for enormous tax savings for ESOP companies⁴⁷ and some lenders recognize the cash flow benefits obtained by a properly structured ESOP S corporation transaction. The tax-savings possibilities can be illustrated most dramatically by considering a corporation all of the stock of which is owned by an ESOP. If that corporation elects S corporation Status, there will be no current federal tax on its annual corporation taxable income (except some states may not recognize S corporation Status). The corporation itself will not be subject to tax under the general S corporation rules⁴⁸ and, although the income will be passed through to its sole shareholder (the ESOP), no shareholder-level tax or unrelated business income taxation will be imposed because the ESOP is a tax-exempt entity.⁴⁹

Where an ESOP company has shareholders in addition to the ESOP, tax savings still will be available by electing S corporation Status, but the S corporation Status may have a negative impact on the corporation's cash flow. This is because, in most cases, S corporation shareholders will insist on the right to receive distributions necessary to cover payment of their taxes on the corporation's income. If distributions are required to be made to the shareholders other than the ESOP, a proportionately-equivalent distribution also will have to be made to the ESOP, even though it will incur no tax liability, because otherwise the economic rights associated with the ESOP's shares would be different from those associated with the other shares. This would

⁴⁴ I.R.C. § 404(k).

⁴⁵ The legislative history of the ESOP dividend-deduction provisions suggests that this reasonableness standard is to be applied by reference to the compensation paid to the participants in the plan. See Joint Committee on Taxation, “Explanation of Technical Corrections to the Tax Reform Act of 1986 and Other Recent Tax Legislation,” 158 (May 15, 1987). However, many practitioners believe that, at least with respect to ESOP dividends used to repay an ESOP loan, the reasonableness of the dividend will be determined by reference to dividends paid on comparable securities. See, e.g., Kaplan, Curtis, and Brown, 354-5th T.M., *ESOPs* at A-19.

⁴⁶ I.R.C. § 1361(c)(6).

⁴⁷ For a thorough discussion of the rules relating to S corporation ESOPs and of the tax-savings and other planning opportunities with S corporation ESOPs, see, Ackerman, “*ESOPs and S Corporations*,” Selling to an ESOP, ch. 8 (National Center for Employee Ownership, 7th Ed., 2002).

⁴⁸ I.R.C. § 1363(a).

⁴⁹ I.R.C. §§ 401(a), 501(a), and 512(e)(3).

violate the one-class-of-stock rule for S corporations and result in termination of the S election.⁵⁰ It is also important to note that distributions paid on the allocated company stock held by the ESOP cannot be used to repay the ESOP loan (discussed below).

While the S corporation Status needs to be closely reviewed for a rapidly-growing ESOP company that needs to retain earnings to fund future expansion, the S corporation Status would be advantageous where the corporation could declare dividends in an amount in excess of the non-ESOP shareholders' tax liability because it did not need to retain most of its earnings or is using the structure in combination with the non-ESOP shareholders estate planning needs. The S corporation Status also would be advantageous where the cash distributed to the ESOP can be used to fund other corporate obligations. This might be the case where the cash distributed to the ESOP on the unallocated company is used to pay down the ESOP loan (and thereby reduce the amount of required company contributions to the plan),⁵¹ and the remaining amount paid on the allocated company stock held by the ESOP is used to fund the corporation's repurchase liability (or where the corporation can sell more shares to the ESOP and then use the sale proceeds to provide funds for other business needs). Any of these uses by the ESOP of the distributions would require the approval of the ESOP trustee, who would have to determine that the proposed use of the cash is in the best interest of the participants in the plan.⁵²

In structuring management buyout transactions from a public or private parent corporation or from a bankruptcy court, many transactions are structured in a way that the employees have the opportunity to use 401(K)/Profit Sharing money to purchase all or a portion of the stock of an S corporation ESOP company. The loan is placed on the S corporation ESOP company and the ESOP is not leveraged.

2. *Limitations on Tax Benefits for S Corporation ESOPs.* There are three important tax benefits available for C corporations which sponsor ESOPs and their shareholders which are not available for S corporation ESOPs. First, an individual shareholder of an S corporation will not qualify for the tax deferral upon the sale of his or her stock to an ESOP that is available to individual shareholders of a C corporation under Section 1042 of the Internal Revenue Code ("ESOP 1042 Transaction").⁵³ Second, the increased limit for tax deductions for contributions to a leveraged ESOP, when used to pay principal and interest on an exempt loan to the plan, is not available for S corporations.⁵⁴ Third, S corporations are not entitled to deduct

⁵⁰ I.R.C. § 1361(b)(1)(D).

⁵¹ The Internal Revenue Service has taken the position that S corporation distributions on allocated shares (or on shares which otherwise are not pledged to secure the ESOP loan) may not be used to pay down an ESOP loan. PLR 199938052 (July 2, 1999). For a discussion of this issue and an argument contrary to the position of the Service, see Ackerman, "Technical Issues Under the New S Corporation ESOP Laws," 11 J. of Employee Ownership L. and Fin. 3 (1999).

⁵² ERISA § 404.

⁵³ I.R.C. § 1042(c)(1)(A). It may be possible to obtain the best of both worlds by arranging for shareholders to sell some or all of their shares while their company is a C corporation, so as to qualify for tax-free treatment, and then to arrange for the corporation to make the S election. See, Ackerman, "ESOPs and S Corporations," Selling to an ESOP, ch. 8 (National Center for Employee Ownership, 7th ed. 2002).

⁵⁴ I.R.C. § 404(a)(9)(C).

cash dividends paid on stock held by an ESOP that are used to pay principal or interest on the loan used to acquire the stock or that are passed through to the participants in the plan.⁵⁵

3. *Anti-Abuse S Corporation Rules.* In addition to the limitations on tax benefits for S corporation ESOPs, limitations have been imposed on the use of ESOPs by S corporations where only a small number of employees will receive significant benefits under the plan.⁵⁶ These rules prohibit allocations under the plan to “disqualified persons” if those persons own or are deemed to own more than fifty percent (50%) of the company's outstanding shares. In general, disqualified persons are individuals who own or are deemed to own ten percent or more of the shares held by an S corporation ESOP. A lender contemplating an ESOP loan to a corporation that is or will be electing S corporation Status will require the corporation to assure the lender through a covenant and default provision that the ESOP will be operated in compliance with the special S corporation anti-abuse rules.

4. *S Corporation Distribution Rules.* In 1998 and subsequent tax laws, Congress did not expand the law that permits a C corporations to deduct and use the payment of dividends on allocated and unallocated company stock held by an ESOP to repay the ESOP Loan. The rules applicable to S corporation ESOPs are as follows:

- a. *S Corporation Distributions Paid on Unallocated Shares.* Section 404(k) of the Code provides that an ESOP sponsored by a C corporation may use cash dividends on shares of company stock (whether allocated or unallocated) to make payments on the ESOP loan used to finance the purchase of such shares. S corporation distributions paid on shares of stock held in the unallocated stock (or suspense account) account may be used to repay ESOP indebtedness. The Internal Revenue Service distinguished the difference between the dividends declared and paid by a C corporation to an ESOP, and S corporation distributions paid by an S corporation to an ESOP.⁵⁷ The Internal Revenue Service ruled that S corporation distributions paid to an ESOP by an S corporation: (i) on allocated shares to ESOP participants cannot be used to repay an exempt loan (described in Code Section 4975(d)(3)); and (ii) on unallocated shares held as collateral for the exempt loan can be used to repay such loan. The treatment of S corporation distributions (in contrast to a dividend paid by a C corporation) differs with respect to the use of dividends and S corporation distributions paid on allocated shares to repay an exempt loan. Under Code Section 404(k)(5)(B), a C corporation is specifically permitted to use dividends paid to an ESOP on allocated shares to be used to repay an exempt loan without violating the prohibited transaction rules set forth in Code Section 4975(d)(3).

⁵⁵ I.R.C. § 404(k)(1).

⁵⁶ I.R.C. § 409(p). For detailed descriptions of the anti-abuse rules for S corporation ESOPs, see, Kober “*The New S Corporation ESOP*,” 30 Tax Mgmt. Comp. Plan. J. 36 (2002); and Ackerman, “*New Anti-Abuse Rules for S Corporation ESOPs*,” ESOP Report (July 2001).

⁵⁷ PLRs 199938052, 199948038 and 200014043.

- b. S Corporation Distributions Paid on Allocated Shares. S corporation distributions on allocated shares held by the ESOP cannot be used to repay the ESOP indebtedness. The Internal Revenue Service ruled it is not permissible to use earnings (*i.e.*, S corporation distributions) on allocated shares held by the ESOP.⁵⁸ If S corporation distributions are used, the payment of the ESOP loan from the allocated shares will trigger a prohibited transaction. The Internal Revenue Service did not address the use of earnings on allocated shares of company stock.⁵⁹ As a result, the ESOP loan will not qualify as an exempt loan under Section 4975. The Internal Revenue Service based its reasoning on Treasury Regulation Section 54.4975-7(b)(5). Even though the IRS has ruled in this manner, many practitioners feel that there is authority supporting a different conclusion that S corporation distributions paid on allocated shares held by the ESOP may be used by the ESOP trustee to repay the ESOP indebtedness. This is evidenced in prior private letter rulings where the Internal Revenue Service permitted the repayment of an ESOP Loan with earnings (C corporation dividends) on unpledged shares.⁶⁰

It should be noted that some ESOP practitioners are crafting language to set the maximum rate of return that is payable on allocated shares resulting in a larger portion of the S corporation distributions to be allocated to the unallocated shares. There is no authority supporting this type of provision. The risk is that this language may create a second class of stock, resulting in an inadvertent termination of the S corporation Status.

- c. Cash Flow Impact. Under certain circumstances, C corporations that have converted to S corporation Status maybe faced with cash flow demands as a result of the prohibition to use S corporation distributions on allocated stock to pay an ESOP loan. Many S corporations faced with this problem are considering the various alternatives to address the issue.

For example: Company X is a 100% owned ESOP. Company X's eligible payroll for contribution purposes is \$1,000,000.00. Company X borrowed \$10,000,000.00 from Bank Y, which was loaned to the ESOP qualifying as a securities acquisition loan permitting Bank Y to exclude fifty percent (50%) interest revenue under Code Section 133 ("ESOP Note"). Assume the annual payments are \$500,000.00 over twenty (20) years and interest is a five percent (5%) per annum (or \$250,000.00 per year for discussion purposes). Assume the ESOP is not top heavy and the \$250,000 dividend payment is reasonable. The ESOP Note has been paid down to \$5,000,000.00. Company X's deductible amount and cash impact is as follows:

⁵⁸ PLR 199938052
⁵⁹ PLR 199948038
⁶⁰ PLRs 7947020 and 8044074

C Corporation Situation:

<u>25% Contributions</u>	<u>Maximum Deductible Amount</u>			<u>Cash Flow Impact</u>
	<u>Dividends Interest</u>	<u>Paid to ESOP</u>	<u>Total</u>	
\$250,000	\$250,000	\$250,000	\$750,000	\$487,500

S Corporation Situation:

Assume Company X elects S corporation status and adds a money purchase feature to the ESOP to increase its contribution limit from fifteen percent (15%) up to twenty-five percent (25%) of payroll since the maximum amount deductible amount is fifteen percent (15%) of payroll (principal and interest) for S corporations. Assume one-half the stock held in the ESOP is allocated to participants.

<u>25% Contributions</u>	<u>Maximum Deductible Amount</u>				
	<u>Interest Payment</u>	<u>Total</u>	<u>S-Corporation Distributions on Unallocated Shares Used to Repay Debt</u>	<u>S Corporation Distribution on Allocated Shares</u>	<u>Cash Impact</u>
\$250,000	-0-	\$250,000	\$500,000	\$500,000	\$1,250,000

As a result, Company X will be required to make S corporation distributions on allocated shares that cannot be used to repay the ESOP indebtedness. The cash accumulated in the ESOP from this result can be used to fund repurchase liability since the cash accumulated on S corporation distributions on allocated shares held by the ESOP can be used by the ESOP trustee to purchase shares of stock from participants requesting distributions. Options available:

- i. Accumulated cash in the ESOP is used as an incentive cash program available for repurchasing shares;
- ii. Refinance existing loans⁶¹;

⁶¹ It should be noted that the IRS has put on hold any private letter rulings with regard to the refinancing of existing ESOP loans. However, it must be pointed out that the IRS is working with the Department of Labor (“DOL”) in coming up with some type of ruling providing a set of factors which a fiduciary of an ESOP should consider in refinancing existing ESOP loans. In regard to our example, PLR 9847005 (August 11, 1998) provided that a refinancing of an ESOP loan would not cause the lenders to lose their fifty percent (50%) interest inclusion under former Code Section 133 and that the ESOP company could continue to deduct dividends paid on the shares of company stock acquired with the proceeds of the original ESOP loan under Code Section

- iii. Payoff Bank Y loan and refinance ESOP loan;
- iv. Fix return on allocated shares of S corporation distributions (this provision is untested and risky); or
- v. Purchase additional shares from the company.

V.
ESOP Loan Structure

The most common way to structure an ESOP loan, is for the lender (and the mezzanine lender) to make a loan to the company (the “outside loan”), to be followed by a second “inside” loan from the company to the ESOP (“ESOP Loan”). The outside loan is secured by the assets of the company (see below at the Diagram). The stock purchased by the ESOP typically is pledged back to the company to secure the ESOP Loan, and the company's security interest in the shares purchased by the ESOP may be assigned to the lender group as additional security for the outside loan. If a mezzanine lender is used or seller shareholder junior note financing is used, the loan structure will include warrants or cash appreciation rights. The warrants and cash appreciation rights will be structured to avoid the second class of stock issue for S corporations. However, such instruments maybe considered synthetic equity for purposes of the anti-abuse S corporation law.⁶² Lenders prefer this type of structure since the company cash flows will be the source of the loan repayments, and the company’s assets provide the principal security (rather than relying on the more indirect protection of a secured guarantee if the loan was made directly to the ESOP).

It will be very important to the lender group that the corporation: (i) retains its S corporation Status, or if the corporation is a C corporation that the terms of the ESOP Loan mirror the terms of the outside loan so there is no cash flow tax leakage; and (ii) retains all of the cash from operations to repay debt or expand the business (no cash flow leakage to shareholders or to the selling shareholders). If the company is a one hundred percent (100%) S corporation ESOP owned company, the lender and company will prefer to arrange for the ESOP Loan to be amortized over a longer term than the outside loan to slow down the repurchase liability to avoid any cash flow leakage. If the company is a C corporation and the term of the ESOP Loan is extended beyond the term of the outside loan, the tax deductions of the company will not match the payments on the outside loan. The full amount of the loan will remain tax deductible, but the term over which the tax deductions are claimed will be spread over a longer period of time. A

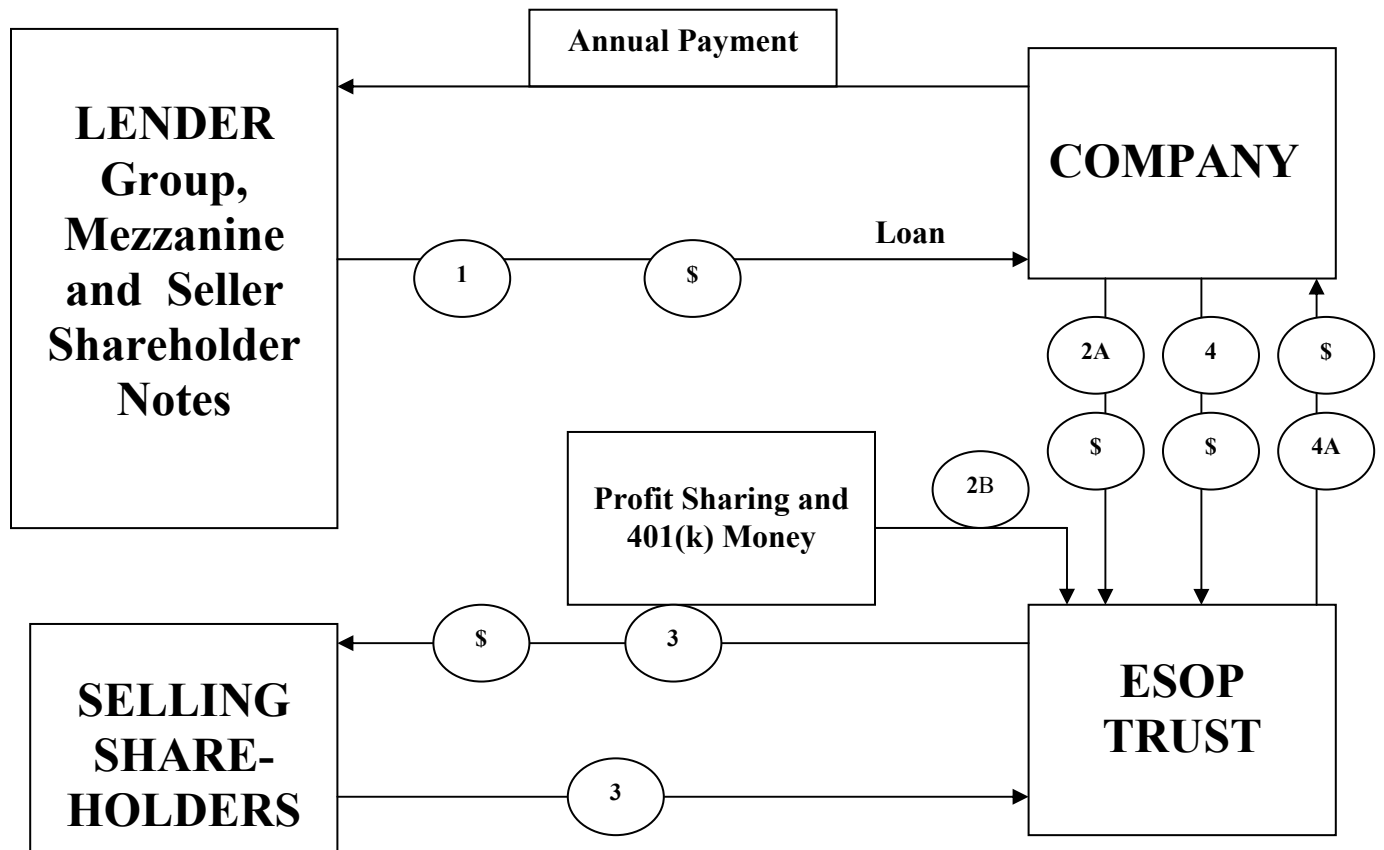
404(k). It is important to note that the PLR was issued in 1998 to a C corporation. It should also be noted that most of the private letter rulings that have been issued in the ESOP refinancing deal with companies that have either sold off divisions creating a windfall to the remaining employees or companies that have been struggling from a financial standpoint. Therefore, proper counsel and fiduciary guidance must be considered prior to extending the terms of the loan in order to avoid violating the exclusive benefit rule, as well as any other tax related rule which would create a prohibited transaction or plan disqualification.

⁶² IRC § 409(p).

one hundred percent (100%) owned S corporation ESOP company is not subject to federal income taxation.

DIAGRAM

ESOP STRUCTURE



(1) Lender Group loans money to Company (“Outside Loan”). (2A&B) Company lends money to ESOP (“ESOP Loan”) and Employees transfer money to ESOP. (3) ESOP buys stock from existing shareholders. (4) Company makes annual tax-deductible contributions to ESOP, which in turn (4A) makes annual payment due on inside loan. (5) Company makes annual payments due on outside.

VI.
Loan Structure Considerations

As part of the ESOP loan structure, most ESOP professionals structuring the transaction and lenders (as well as the other non-traditional financing sources) will take into account the following factors.

A. *Board and Corporate Governance Strength.* Lenders will assess a company's corporate governance procedures which will involve a review of who is serving as board of directors, the corporate documents establishing corporate governance and the procedures in place dealing with the oversight of the reporting of the financial statements and the handling of conflict of interest situations. Many lenders today place a lot of weight on corporate governance and best corporate practices. In addition, lenders look favorable upon companies that have proper committees in place, such as the following:

1. *Audit Committee.* The Audit Committee is responsible for the: (i) engagement of the CPA firm performing the audit, review, or compliance of the financial statements of the company; (ii) evaluating the CPA firm's performance and management's performance to provide meaningful, timely, and accurate reporting; and (iii) recommending changes to the board of directors relating to the preparation of the financial statements. In addition, the Audit Committee works directly with the board of directors and has the power to engage legal counsel and other professional expertise on an as needed basis. The committee typically consists of two (2) outside Directors and one (1) inside Director.

2. *Nomination Committee.* The Nomination Committee is responsible for: (i) nominating and developing general criteria regarding the qualifications and selection of the Directors; (ii) evaluating the performance of the Directors; and (iii) recommending candidates for the Directors. The committee typically consists of two (2) outside Directors and one (1) inside Director.

3. *Compensation Committee.* The Compensation Committee: (i) reviews and makes recommendations to the Directors concerning salaries and incentive compensation (*i.e.*, Synthetic Equity) for executive officers and certain employees; (ii) considers and evaluates overall compensation policies and strategies for the company; and (iii) engages a firm to perform compensation studies with respect to compensation programs for the executive officers and certain employees. In addition, the Compensation Committee approves all Synthetic Equity programs and determines that such programs do not violate the Anti-Abuse S corporation ESOP Rules. The committee typically consists of two outside Directors and one inside Director.

4. *ESOP Committee.* The ESOP Committee directs the ESOP trustee to vote and take certain actions with to the ESOP for administrative matters. The committee typically consists of five individuals (who do not serve on the Board of Directors).

5. *Corporate Governance Conflicts Committee.* The Corporate Governance Conflicts Committee is responsible for: (i) governance functions that involve an interpretation of

the Bylaws, a committee charter, or other corporate governance documents; (ii) addressing conflict of interest situations; and (iii) development and succession planning. The committee typically consists of the two (2) outside Directors.

B. Management Strength. The strength of the company's management team is an important consideration for the lender in any commercial loan transaction. This is an especially important concern in ESOP transactions where the ESOP is being employed to implement an exit strategy for shareholders active in the management of the borrowing company. The lender will investigate the experience and qualifications of the existing and new management team and is satisfied that the management team are capable of operating the company's business profitability. The lender will review the terms of employment of the management team and may want to assure that their compensation is adequate (and not excessive) and that incentives are provided for them to remain with the company. In addition, the lender may want to require the management team to sign new employment agreements with appropriate covenants not to compete. If the sellers are planning to continue their active involvement in the affairs of the company's business, the lender may require them to enter into written employment agreements setting forth the terms of compensation and employment.

C. Industry Analysis. Lenders will include an assessment of the company's industry and specific consideration of trends in the industry and the company's competitive position within the industry. In the case of an ESOP Loan, the lender may take into account that future declines in the company's business position will affect not only its financial health, but also may result in scrutiny of the ESOP transaction.

D. Cash Flow. In underwriting any proposed extension of credit is the determination of the company's cash flow that will be available for debt service. In the case of any particular loan proposal, adjustments to the EBITDA benchmark may be necessary or appropriate. For example, the lender may adjust for the selling shareholder's compensation or consider other claims to which the company's cash flow will be (or will not) subject, in addition to debt service. Among other things, this might include amortization of preexisting debt, anticipated capital expenditures, lease payments, and maintenance and repair expenses.

In the case of an ESOP Loan, there typically will be several other adjustments that should be made in the calculation of available cash flows. If the purpose of the ESOP loan is to fund the buyout of a retiring shareholder, that shareholder's compensation will cease to be an ongoing expense. Therefore, it would be appropriate to add the selling shareholder's compensation and other compensation in determining available cash flow. Even if selling shareholders are not retiring, they may agree to reduce their compensation levels in connection with the implementation of the ESOP, in which case an add-back for agreed-upon compensation reductions would be appropriate. It also is common in connection with leveraged ESOP transactions for the company to reduce its contributions to other employee benefit plans. Therefore, another appropriate add-back in the case of an ESOP transaction is historical employee benefit expenses to the extent that they will be replaced by the ESOP benefit.⁶³

⁶³ See Josephs at 10.

E. Tax Savings. The lender's cash-flow projections will include the tax savings anticipated from the deductions to which the borrower will be entitled in connection with the payoff of the ESOP Loan or the savings resulting in being an S corporation company. The lender will want to confirm that the transaction is structured in such a way as to assure that the loan will qualify as an exempt loan and the company is an S corporation (or the C corporation is eligible to deduct principal and interest of the outside loan). Among other things, the lender will request confirmation that the ESOP is tax-qualified and that the terms of the loan satisfy all of the requirements for qualification as an exempt loan.

If the lender's cash-flow projections are based on the assumption that the company is or will elect S corporation Status, the lender will want confirmation that the S election has been or can be properly made and that the company's ownership and capital structure comply with the rules applicable to S corporations, including the new "anti-abuse S corporation" rules.⁶⁴

F. Debt-Paying Capacity. A company may become highly leveraged after completing an ESOP transaction. An ESOP company generally can afford to take on more debt than it would be able to carry in the absence of an ESOP, because an ESOP loan can repaid with pretax dollars. On the other hand, ESOP debt often is considered "nonproductive" debt, in the sense that the loan proceeds go "out the door" to selling stockholders. In this situation, an ESOP loan results both in an increase in debt and a decrease in the borrower's equity. The lender may limit the leverage of an ESOP transaction. In order to complete the transaction, the selling shareholders may agree to sell their stock and receive a selling shareholder junior note that is subordinated to the outside loan.

G. Debt Structure and Capacity. If the level of debt needed to achieve the company's objectives is beyond the comfort level of an institutional lender, and reducing the size of the transaction or arranging for the transaction to be completed in stages is not acceptable to the company, it may be possible to obtain the desired amount of financing through credit-enhancement techniques. There are several possible approaches to credit enhancement of ESOP transactions (assuming the company has sufficient cash flow).⁶⁵

1. Pledge of Qualified Replacement Properties. If the ESOP Loan is designed to fund an ESOP 1042 Transaction, an additional source of collateral may be available to the lender to cover any collateral shortfall: the qualified replacement properties purchased by the sellers.

2. Seller Notes. The selling shareholders could provide partial financing for an ESOP stock purchase by accepting payment of a portion of the purchase price for their shares in the form of notes from the ESOP. These notes would be subordinated to the interests of the commercial lenders, but could bear attractive interest rates to the sellers and serve as an alternative (or be in addition to) to bringing mezzanine lenders or outside equity investors into the transaction. A complicating factor is that if the sellers desire to obtain tax-free treatment under Section 1042 of the Internal Revenue Code in connection with the sale, they will be required to buy qualified replacement properties within one year at a cost equal to the total

⁶⁴ I.R.C. § 409(p).

⁶⁵ See Josephs at 25-28.

purchase price for the stock sold to the ESOP, including the amount attributable to the seller notes. If the sellers have sufficient assets other than the stock of their company to finance the purchase of qualified replacement properties with a value equal to the amount of the seller notes, they still will be able to qualify the total sale for tax-free treatment. Otherwise, they may be able to borrow the needed funds by pledging the seller notes.

3. Management Investment. Another method for overcoming a collateral shortfall in connection with a proposed ESOP loan is to arrange for management to invest in the transaction. This is a very attractive means of credit enhancement from a lender's perspective because it serves to tie the management team into the business. In most cases, however, the members of the management team will not have sufficient net worth to provide a meaningful equity investment in the company.

4. Use of Funds from Other Benefit Plans. A company adopting an ESOP typically will have a pension, profit-sharing, or Section 401(k) plan in place. It may be possible to access some of the funds in these plans to provide supplemental financing for an ESOP transaction. The use of funds from other employee benefit plans to finance an ESOP stock purchase raises a number of issues under ERISA and under federal and state securities laws.

H. Mezzanine Debt and Private Equity Investment. Senior lenders will consider the financial sources needed to complete the transaction. If a mezzanine lender (or a private equity group) is used to complete the transaction, the lender will want to make sure its loan is fully collateralized and there is no cash flow leakage. Using mezzanine debt or private equity is another way by which a company could address a collateral shortfall would be to obtain subordinated debt or equity financing from third parties. Mezzanine and private equity investment will underwrite a loan on the basis of a company's cash flow and provide debt in excess of the loan value of the company's assets. To obtain this type of investment, the company must have strong and stable cash flows and be prepared to pay a significant rate of return to the mezzanine debt holders and private equity group.

I. Repurchase Obligations. The lender will take into account the impact of the ESOP repurchase liability on the company's cash flows (i.e., participants in an ESOP generally have the right to demand payment of their benefits in the form of shares of the company and require the company to repurchase such shares).⁶⁶

J. Accounting Considerations. Special rules have been developed to account for leveraged ESOP transactions. The company of a leveraged ESOP is required to record the ESOP Loan obligations as liabilities on its financial statements. The offsetting debit to this liability is a reduction in shareholders' equity accomplished by setting up a "contra equity" account. The recording of the liability and the creation of the contra equity account will result in a substantial reduction in the borrower's book value. The lender will need to make adjustments to certain loan

⁶⁶ If the stock is not publicly traded, the participants have the right to require that the sponsoring employer repurchase any shares distributed to them; and even if distributions by the ESOP to terminated participants will be made in cash, the source of the funds will be the company sponsor. In effect, the company will be required to repurchase the shares allocated to a terminated participant's account in order to provide the ESOP with the funds necessary to make a benefits distribution.

covenants relating to net worth. The liability recorded by the employer and the offsetting contra equity account both are reduced as the ESOP loan is paid down.⁶⁷

K. Trustee. A lender will or should consider whether the trustee is an insider or a professional outside trustee. Most lender will require an outside professional trustee to avoid any possible problems arising because the trustee was the selling shareholder or an employee. Even though this is not prohibited by ERISA, it generally is a better practice to appoint a professional ESOP trustee.⁶⁸ Often inside trustee are presented with difficult conflicts of interest. For example, inside ESOP trustees may be subject to pressure from the selling shareholders, to whom they may be beholden for their jobs, to accept a price that is higher than appropriate or to take on more debt than it is prudent for the company to bear. At a minimum, they will find it difficult to negotiate with their superiors regarding these matters. If as a result the price paid by the ESOP exceeds fair market value or the transaction otherwise is imprudent, the transaction will violate applicable laws and result in the imposition of large penalties upon the company. The lender group will not want to incur the risk of the company's projected cash flows being jeopardized by liabilities or penalties arising out of violations of the ESOP regulations and, more generally, should not fund a prohibited transaction.

⁶⁷ See, Miller, "Accounting for Employee Stock Ownership Plan Transactions," Employee Stock Ownership Plans, ch. 7 (Harcourt Professional Publishing 2000).

⁶⁸ For a thorough discussion of the fiduciary responsibilities of ESOP trustees, see Ackerman, "Questions and Answers Regarding the Duties of ESOP Fiduciaries," 13 J. of Employee Ownership L. and Fin. 3 (2001).