Yet Another Risk About ESOP Transactions?

By Robert W. Wood • Wood & Porter • San Francisco

Readers of the M&A TAX REPORT who occasionally come across ESOP transactions know that their benefits can be truly extraordinary. Yet there are few rewards without risk, and ESOP transactions do have risks. [*See also Nixed ESOP Redemption Payments,* this issue.] In the classic ESOP buyout, a company (typically closely held) sells itself to an ESOP. There are myriad rules, not the least of which are fiduciary concerns and valuation issues.

These tend to make ESOP transactions fairly expensive. Still, if you are looking for an exit strategy, the idea of selling the company (or at least *part* of the company) can be quite attractive. Why are ESOP transactions attractive?

To begin with, provided that you meet certain rules, a seller who sells stock to an ESOP gets an enormous tax advantage. The seller is allowed to reinvest the sales proceeds in publicly traded securities without incurring a tax on the sale to the ESOP. There are many rules and requirements, including the threshold requirement that after the sale occurs, the ESOP must hold at least 30 percent of the corporation's stock. But if you do it properly, a tax-free rollover is pretty slick.

There are also advantages about ESOP loans that can make an ESOP an attractive party for an institution to make a loan. That's a good thing, because every ESOP deal needs a good loan. The loan will fund the purchase, with the seller ending up with the proceeds. The loan will usually be secured by the assets (and earning power) of the company. This is truly a leveraged transaction.

Finally, there can be estate planning advantages, including the ability to achieve a step-up in basis on death without paying tax on the gain from the sale. The founder who sells to an ESOP may roll all of his gain into public company securities in which he will take a historic low basis. If he is holding the public company stock on his death, he may pay estate tax, but he pays no income tax on the original gain, instead receiving a stepped-up basis in the public company securities on death.

There must be plenty of ESOP transactions out there, in both large and small companies. After all, as we've previously covered in the M&A TAX REPORT, there have been a number of cases dealing with ESOP redemptions and their tax consequences. [*See* Wood, *More on ESOP Redemption Deductions,* M&A TAX REP., May 2009, at 5.]

Downside?

Unfortunately, there are downsides to these transactions, notably costs and fiduciary concerns. Plus, a recent Ninth Circuit case adds potential trustee liability to the list. In *Johnson v. Couturier*, CA-9, 572 F3rd 1067 (2009), the court held that a trustee of an ESOP (who was also the company's president and on its board of directors) could be held liable for breach of fiduciary duty based on a decision to pay excessive executive compensation.

Not only was the CEO/trustee held liable to the ESOP for that fiduciary breach, but the Ninth Circuit even went on to rule that the indemnification agreement (which would have provided indemnity to the president/trustee) was pre-empted by ERISA. If you practice in this area or are considering doing (or advising about) an ESOP transaction, you should really read the Ninth Circuit's expose in *Johnson v. Couturier*. The court was probably right that this compensation was, well, let's just say less than austere: $26 million in cash, title to a Palm Desert home, a Bentley automobile, *etc.* You get the idea.

The court's holding about the indemnification agreement, though, may be more worthy of note. The ESOP holding company was obligated to advance defense costs. The ESOP participants sued for an injunction prohibiting the advancement of costs. When the district court issued a preliminary injunction, the defendants appealed to the Ninth Circuit. The defendants argued in the alternative the following:

- They were not ERISA fiduciaries.
- Setting executive compensation was a business decision not subject to ERISA.
- Whether the ESOP holding company was obligated to advance their defense costs was purely a matter of state contract law.

The Ninth Circuit rejected all of these arguments. Most notably, based on ERISA's broad preemption clause, the court said that ERISA generally supersedes any and all state laws that conflict with the provisions of ERISA or operate to frustrate its objects. There are only limited exceptions from this inclusive preemption.

The indemnification agreements at issue in this case provided complete indemnity as long as the challenged acts or omissions did not involve deliberately wrongful acts or gross negligence. That probably sounds reasonable. Yet ERISA §404(a)(1)(B) adopts a prudent-man standard, which is a considerably higher standard than that referred to in these indemnity agreements.

Plainly, the court found, the defendants would have been indemnified under the agreements even if they have violated ERISA's prudent man standard. As a result, the court held that the application of state law was pre-empted by ERISA.