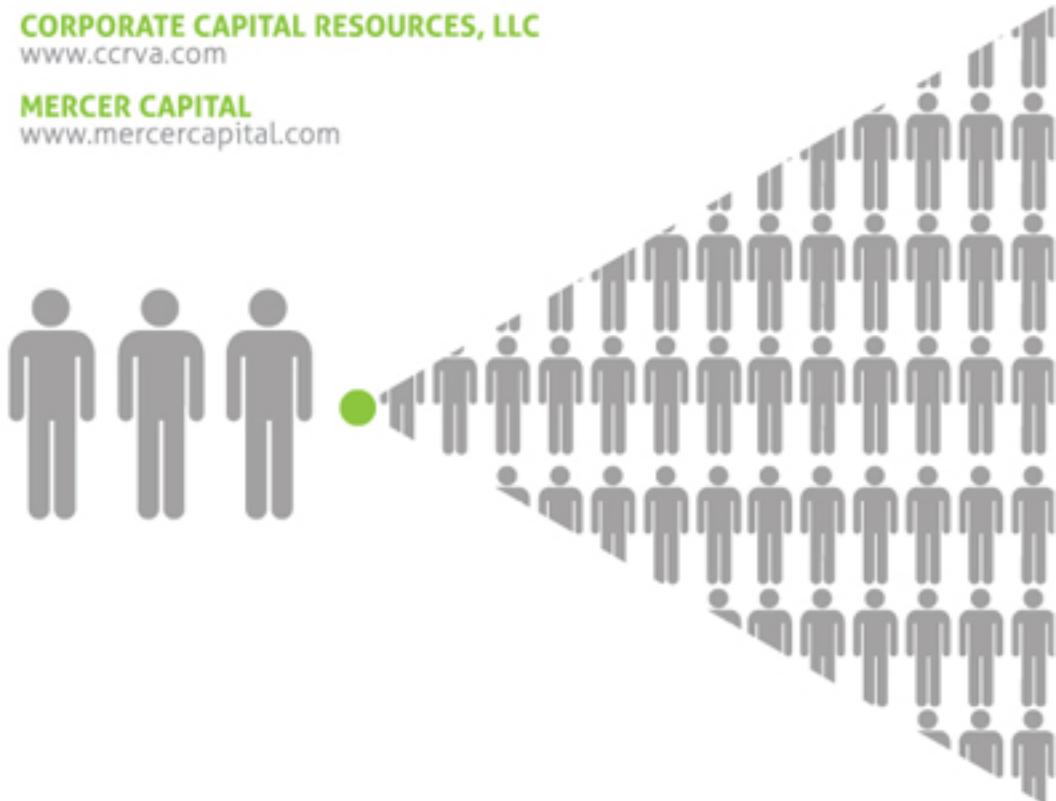


THE **ESOP** **HANDBOOK** FOR BANKS

Exploring an Alternative for Liquidity and
Capital While Maintaining Independence

CORPORATE CAPITAL RESOURCES, LLC
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About Corporate Capital Resources, LLC

About Mercer Capital

Introduction

The purpose of this handbook is to address an important omission in the current financial environment: the lack of a broader, strategic understanding of the possible roles of Employee Stock Ownership Plans, or ESOPs, as a tool for managing a variety of issues facing banks. Banks proportionately make more use of ESOPs than any other industrial classification in the U.S., often without understanding the extent of their potential applications. While an ESOP is not suitable in all circumstances, an ESOP may provide assistance in resolving the following issues, either by itself or in conjunction with other elements of a well-rounded strategic plan:

- + Augmenting capital, particularly for profitable institutions facing limited access to external capital. Though an ESOP strategy generally builds capital more slowly than a private placement alternative or a public offering, it provides certain tax advantages and may result in less dilution to existing shareholders;
- + Facilitating stock purchases by creating an “internal” stock market. The ESOP offers the further advantage of providing a vehicle to own shares that is “friendly” to the existing board of directors; and,
- + Providing employee benefits. ESOPs provide a beneficial tool in rewarding employees that add to the institution’s long-term value.

ESOPs are subject to both tax and benefit (qualified plan) law provisions, which were first spelled out formally for ESOPs in the Employee Retirement Income Security Act of 1974 (ERISA).

The best decision tree will have a competent feasibility study performed to reduce the complexity to manageable proportions. ESOP implementation can be a complex process when viewed from a technical perspective. It need

not be so complex when understood as part of a *coordinated* capitalization or market-making strategy. An ESOP alone is never *the* answer to a bank's strategy decisions, and ESOPs should not be installed without due appreciation of the need to coordinate the plan with key executive compensation, selling shareholders' desires, and a host of other concerns.

The need for strategic clarity may be illustrated by an anecdote based on our many years of working with ESOPs. In this example, an ESOP was rejected, though it could have been part of a good solution to the bank's needs.

An officer of the bank holding company (for a non-TARP bank) was interested in making a tax-efficient market for a class of preferred stock other than the existing common stock and was told by a tax attorney that the ESOP could only purchase the highest and best class of shares with respect to voting rights, dividend preferences, and other features.

While the "highest and best class" rule was correct and required, the counsel failed to suggest a broader strategy. The holding company could sell newly-issued common shares to the ESOP (which would be dilutive to per share value), gain a tax deduction for the purchase by the ESOP, and then use untaxed proceeds from the common stock sale to redeem some preferred shares (offsetting the dilution caused by the sale of stock to the ESOP). This process is at times referred to as "going public internally." In this case, the process could have been executed with minimal dilution.

This strategy for the closely held holding company would have required an independent valuation of the common stock and a coordinated plan, but would have provided the desired result: the redemption of preferred stock with pre-tax dollars using the ESOP as a single, tax-exempt shareholder.

This handbook describes the function of ESOPs in the real world of banks and bank holding companies. While it can correct misunderstandings and offer sound guidance, it cannot exhaustively detail the many interactions of Employee Stock Ownership Plans with current federal and state banking regulations and the extensive laws and regulations governing employee benefits and taxation. Bank directors and managers can use the information in this handbook to make solid, initial decisions regarding the potential merits of an ESOP.

Those directors and managers who make decisions affecting bank profitability, ownership, and capitalization should be aware of the potential advantages of an ESOP in offering a tax-advantaged vehicle that supports local control, while building shareholder value. This approach may prove beneficial compared with alternative structures that bring outside capital to the table for a price exacted in terms of greater dilution, dollars, and at times, control. Both approaches must be considered by any Board of Directors.

Before embarking on a particular strategy to deal with the various challenges facing small- to mid-size banks, the decision makers in profitable institutions may wish to consider how an ESOP can assist in addressing issues such as shareholder liquidity, employee ownership and compensation, and capital management.

CHAPTER 1

ESOPs AND THEIR BENEFITS FOR BANKS

An ESOP is a written, defined-contribution retirement plan—much like a more typical profit-sharing plan—designed to qualify for tax-favored treatment under IRC §401.¹ The assets in the plan (bank stock and other investments) are held in a tax-exempt trust. Participants ultimately pay ordinary income taxes on the value received when a vested account balance is paid to them.

A defined-contribution plan, such as an ESOP, does not guarantee what participants or beneficiaries will receive when a distribution is made to them. Further, the sponsor can define the amount of the contribution depending on its desire and ability to fund the plan each fiscal year in the context of the plan's liquidity needs.

The fundamental difference between an ESOP and a profit-sharing plan is that the ESOP must be “primarily invested in employer securities” as outlined in IRC §4975(e)(7); in short, it must own stock in the sponsoring company. How much stock an ESOP owns and when the stock is purchased are questions we will explore in subsequent sections of this handbook.

Why Do Banks Make More Use of ESOPs than Companies in Any Other Industrial Classification?

Closely held banks often need a mechanism to acquire shares efficiently. An ESOP permits containment of the number of stockholders through an untaxed mechanism ultimately under the governance of the board. Most bank ESOPs hold a minority interest in the employer's common stock. Banks which cannot buy back their shares directly can sponsor an ESOP to effect share purchases.

Who Can Sponsor an ESOP?

Since ESOPs must own shares in the sponsoring company, only C or S corporations (stock companies) can sponsor them. The laws permitting an ESOP to be an eligible shareholder in an S corporation have only come into being and been refined over the last decade. An S corporation ESOP behaves much differently than a C corporation plan.

How Does an ESOP Work?

The sponsoring bank or bank holding company makes contributions to an ESOP, either in stock or cash, subject to certain limits. These contributions are allocated among participants in proportion to compensation, or compensation plus length of service. The contributions to the plan and the assets in the plan must be allocated to the participants on a non-discriminatory basis. When an employee exits the plan, the ESOP may use its cash to purchase shares from the participant, often paid out over time, and those shares then are reallocated among the remaining participants. The ESOP is treated as a single, tax-exempt shareholder, which is beneficial for banks with shareholder counts approaching the number of shareholders that would trigger SEC registration.

How Does an ESOP Acquire Shares?

An ESOP may acquire shares using employer cash contributions, dividends or distributions on existing shares held in the plan, or by borrowing money to purchase stock of the sponsoring S or C corporation. The shares so acquired may be newly issued shares or purchased from existing shareholders or participants exiting the Plan. The employer may also issue shares to the plan in lieu of a cash contribution.

As an example, if a profitable bank contributes \$100 to the ESOP, the ESOP can purchase \$100 of newly issued shares at an after-tax cost to the bank of \$60. Because contributions are tax-deductible, purchasing newly issued shares is accretive to total equity, although the transaction would dilute the ownership interest of non-ESOP shareholders. While an ESOP would be dilutive to

non-ESOP shareholders in this example, it may be less dilutive than other alternatives (e.g., a private placement of common stock) that have less favorable tax or governance consequences for the bank.

When Does an ESOP Purchase the Sponsor's Stock?

The issue of when the sponsoring corporation's shares must be in the plan is not a bright line test. Many plans are operated as a "cash accumulator" for a year or two, using the tax-deductible contributions to build liquidity for a stock transaction. During this accumulation phase, there is no stock in the plan. In fact, since Limited Liability Corporations can sponsor qualified plans, it is possible for an LLC to sponsor a cash-only ESOP and become an S or C corporation in the following year or so to make stock available to the plan.

Any contributed accumulation of cash in an ESOP should be used within about three years to purchase shares of the sponsor (from whatever source) in order to meet the "primarily invested in employer securities" rule. A business plan for the ESOP should describe how the ESOP intends to acquire shares using the accumulated cash at no more than fair market value.

What Happens When an ESOP Borrows Funds to Purchase Stock?

Often, the transaction is structured with a "mirror" loan. In this case, the bank holding company would borrow funds from a third-party correspondent bank. The proceeds from this loan would be lent to the ESOP to purchase newly issued shares from the bank holding company or existing shares from outside shareholders. The ESOP then services its loan to the holding company using cash flow from contributions, dividends, or distributions, thereby providing funds to the holding company to service the correspondent loan. When an ESOP uses borrowed funds to acquire shares, the principal payments on the acquisition loan in essence are tax-deductible.

In a leveraged ESOP transaction, accounting rules generally require the bank holding company to record a "contra-equity" account in a like amount to the ESOP loan. This contra-equity account declines as the ESOP loan is amortized.

Thus, a leveraged ESOP transaction may be dilutive to the bank holding company's total equity.

How Does an S Corporation ESOP Differ from a C Corporation ESOP?

Among other distinctions, S corporation ESOPs do not face the tax liability that otherwise would "pass through" to taxable shareholders. For example, assume that an S corporation bank holding company reports taxable earnings of \$100 and declares shareholder distributions of \$40. In this scenario, a non-ESOP shareholder's tax liability is offset by his or her pro rata share of the holding company's distribution, leaving the shareholder with no "economic" dividend. However, the ESOP is tax-exempt. It would, therefore, retain its pro rata share of the company's distributions, which would be available to service debt, redeem shares from participants, or acquire additional shares.

What Is the Impact of TARP Executive Compensation Restrictions on ESOPs?

While Troubled Asset Relief Program ("TARP") requirements preclude key executives from non-qualified and discriminatory plans, these requirements do not apply to ESOPs.

What Benefits Do They Have for Participants?

Participants receive a retirement benefit as an equity interest in the sponsor at no cost to themselves. ESOPs typically reward loyal, long-term employees through vesting schedules, eligibility rules, and the like, which cause the bulk of the plan assets to accumulate in their accounts.

In What Instances Would an ESOP Not Be Appropriate?

ESOPs require a profitable sponsor possessing the ability to create value over time. Since they have an existing market for their shares, widely traded public corporations do not often use ESOPs. Highly leveraged ESOPs often are

inadvisable. As a capital planning tool, ESOPs are less beneficial in situations where a bank or bank holding company faces the need to raise a significant amount of capital within a short time period. ESOPs provide significant benefits, but those benefits require patience to realize over time.

Who Controls the Stock?

For private corporations, the trustees are the legal owners who vote the stock, except in the case of major transactions, such as a sale of the bank or bank holding company. Participants in public company ESOPs vote all shares allocated to their accounts.

Who Should Be ESOP Trustees and What Are Some of Their Duties?

Anyone serving as a Trustee should have sufficient business experience and/or training in corporate finance and ESOP/ERISA requirements to make prudent decisions relative to the disposition of plan assets. The Trustees are the legal owners of the shares (not the employee participants) and vote the shares in closely held ESOPs in nearly all cases.

It is frequently the case in small ESOPs with a few hundred or less participants that a Trustee is also a Board member and/or a shareholder. This can create a conflict of interest if a shareholding Trustee wants to sell some stock to the ESOP. In such cases, the seller should abstain from all decisions related to the approval of a transaction at both the Board and Trustee levels, and the Board (which appoints Trustees) should also consider the appointment of a special independent Trustee to act as a consulting fiduciary relative to the stock purchase.

As a general rule, it is always wise for the board to consider bringing in an outside, independent Trustee for one-time transactions or longer roles when needed to provide independence and oversight, demonstrate regulatory compliance, and protect the existing fiduciaries. The latter can resume their roles following their abstention and the final decision. Such actions and the thorough documentation of them go a very long way towards protecting all parties in an ESOP transaction.

How Is Value Established?

The trustee establishes value. For privately held banks, the trustee engages an independent appraiser to value the stock, and the ESOP can pay no more than “fair market value” in transactions involving the plan. Valuing banks in the current regulatory and economic environment is challenging; banking industry and ESOP expertise should be key considerations for the trustee in appraiser selection. Appraisers consider numerous factors and apply specific valuation methods considered most appropriate. Draft regulations from the U.S. Department of Labor provide guidance specific to shares held by ESOPs.

What Are the Characteristics of a Successful Bank ESOP?

While every case is unique with respect to specific combinations of corporate objectives, employee benefit goals, tax concerns, and the like, the following considerations can help bank officers analyze the potential implementation of an ESOP:

- + A bank or a bank holding company that is a C or an S corporation can sponsor an ESOP, but it must be sufficiently profitable to take advantage of the tax benefits derived from contributions of stock or cash to the plan; corporations with less than \$500,000 of pre-tax, pre-benefit plan earnings are questionable candidates.
- + The company must have sufficient employees to meet the various contribution limit and other tests required for compliance with IRS rules. ESOPs have been implemented in companies with fewer than 20 to 30 employees, but this is not recommended. An eligible payroll for qualified plan purposes of over \$1 million is generally the threshold.
- + Both publicly traded and private corporations can sponsor ESOPs, but actively traded institutions typically do not need the market generated by an ESOP. Private and thinly traded companies often need the market for shares and make the

greatest use of these plans. The suitable strategies and applicable rules governing ESOP operation differ considerably for private and public institutions.

- + Stock must be available within a few years of plan installation for either contribution to the ESOP or for purchase by the ESOP. The ESOP is indifferent to the source of the shares—newly issued shares or stock from outside shareholders—but it is an economic buyer and may purchase the shares at no more than fair market value. This stock value must be determined by an independent appraisal firm when closely held and thinly traded banks and bank holding companies are plan sponsors.
- + The financial strength of the bank should be sufficient over time to support shareholder value. Contra-indications of a strong ESOP candidate include: erratic or low earnings, inadequate capital ratios relative to regulatory expectations, poor CAMELS ratings,² and other negative factors known to management (e.g., pending detrimental litigation). It is important to remember that ESOPs are long-term retirement plans with an interest in the long-term economic viability of the sponsor.
- + A psychological factor is also important for management to consider. Bank management must be willing to engage in the process of managing not just cash flows, capital ratios, regulatory requirements, and the like, but also the interaction and effect of stock flows between the corporation, shareholders, and the ESOP. Such complexity can accomplish corporate objectives, but nonetheless requires effort and a clear understanding of the strategies involved.
- + A corollary of this ESOP “psychology” is the establishment of an ownership culture among the bank’s employee base. Employees should be educated as to their influence on the

value being created in the plan's stockholdings, and greater financial transparency may be necessary. It is important to note again that the ESOP participants have an economic interest in the value created but are not the legal owners or shareholders. The legal owners of the shares are the trustees of the plan, who are appointed by the Board of Directors.

ENDNOTES

- 1 Section 401(a) governs the qualification of all deferred compensation plans. The IRS has published a "A Guide to Common Qualified Plan Requirements at <http://mer.cr/p1Q483>.
- 2 Rating given by The Federal Deposit Insurance Corporation ("FDIC") and other bank supervisors to monitor the health of individual banks based on financials and on-site examinations. The acronym stands for: C - capital adequacy; A - asset quality; M - management quality; E - earnings; L - liquidity; S - sensitivity to market risk.

CHAPTER 2

USING AN ESOP TO ENHANCE CAPITAL

One of the benefits of an ESOP is the ability to raise additional capital by making tax-deductible contributions to the plan, which the ESOP can then use to purchase shares of stock from the sponsoring company. For example, a bank could contribute \$100 to an ESOP, which because of the tax deductibility of the contribution, results in an after-tax expense of only \$65 (assuming a 35% tax rate). Shortly thereafter, the ESOP can purchase \$100 of newly issued common shares, thereby increasing the bank's common equity by \$100 at an after-tax cost of \$65.

Using this approach, over time the bank or bank holding company can enhance its capital. Taken a step further, the bank or bank holding company can use an ESOP as part of a strategy to redeem the TARP Capital Purchase Program (“CPP”) preferred stock using pre-tax funds. This is not a direct purchase of the CPP preferred stock by the ESOP, but a redemption using holding company liquidity increased through the sale or contribution of common stock to the ESOP. We note, however, that an ESOP does not necessarily need to be used in isolation; instead, an ESOP can complement other strategies to enhance capital and redeem TARP or Small Business Lending Fund (“SBLF”) preferred stock.

While an ESOP has benefits as part of a capital strategy, limitations exist on the strategy.

- + The benefits provided by the ESOP structure are realized gradually. If the bank or bank holding company requires an immediate capital infusion, the ESOP likely is not the best solution, although it can be used in conjunction with other capital raising strategies;

- + Quantitative limits exist on the amount the employer may contribute to the plan, thereby capping the capital enhancement and tax benefits derived from ESOP contributions;
- + The strategy requires the bank or bank holding company to be profitable (or at least to record a book tax benefit, if it reports a book loss) to realize the tax benefits; and,
- + The shares purchased by the ESOP must one day be repurchased from the plan's participants. As described in Chapter 5, these repurchase obligations can become significant issues in plans holding a more substantial share of the employer's outstanding common stock and should be managed carefully.

ESOPs and TARP/SBLF Obligations

The intersection of ESOPs, TARP, and SBLF provide an intriguing set of capitalization possibilities. Banks that accessed TARP, or that issued SBLF preferred stock to improve capital ratios or redeem the TARP preferred stock, may make use of an ESOP to assist in the retirement of these obligations. The key to using ESOPs as part of a capitalization strategy is to have a profitable banking institution with a CAMELS rating preferably of 1 or 2, but no worse than 3. Such banks can use tax-deductible ESOP contributions to build capital and do not have such significant capital limitations that an ESOP is inadvisable.

Since both the TARP and SBLF programs require after-tax dividends that eventually scale up to 9% annually, there is a significant need for after-tax dollars to service the required dividend payments, notwithstanding the need to redeem the securities. For example, a \$10 million TARP preferred stock issuance currently requiring a 5% dividend means that the \$500,000 after-tax annual distribution would require pre-tax income of \$770,000 (assuming a 35% corporate tax rate) just to satisfy the current dividend obligation. The impending increase to a 9% dividend for our hypothetical bank with \$10 million of TARP funds would then require \$1.38 million of pre-tax earnings.

This rising dividend rate necessitates an ongoing assessment of alternatives to redeem the TARP preferred stock. Community banks with strong earnings should consider an ESOP within a capital planning framework and may find it advantageous relative to external capital markets that may provide capital on less-favorable terms.

SBLF Preferred Stock Redemption Using an ESOP

Assuming that a bank holding company converts its TARP preferred stock into SBLF preferred stock, the dividend “step-up” date would be extended by four and one-half years and, depending on the bank’s loan growth, the dividend rate may be reduced below TARP’s 5% dividend rate. The bank holding company can use the period prior to the SBLF’s dividend rate increase to accumulate cash inside the ESOP. This requires tax-deductible contributions to the ESOP, building an off-balance sheet pool of liquid assets that we refer to as a “cash warehouse.”

For example, if the bank has the capacity to make pre-tax contributions of \$1 million annually for three years (while the SBLF is in place) without impairing capital ratios, at the end of the three years the bank holding company could sell newly issued shares to the ESOP and recover the \$3 million. The \$3 million of capital obtained through the ESOP transaction could then be used to reduce the SBLF preferred stock.

After purchasing stock from the bank holding company, the ESOP’s liquidity could be replenished with both dividend income and future contributions from the sponsoring bank to repeat the process. The elimination of the dividends on the repurchased SBLF preferred stock will also improve the bank holding company’s cash flow. The process would take some time, but the ESOP would benefit employees and would comprise a single, locally controlled shareholder, instead of the multitude of dispersed shareholders that may result from a private placement.

To achieve the same result with after-tax earnings, assuming a 35% state and federal tax rate, the holding company would need to allocate \$4.6 million of pre-tax earnings. The tax arbitrage resulting from using an ESOP yields a \$1.6 million improvement relative to a strategy using after-tax earnings to

redeem the preferred stock. Stated somewhat differently, the holding company would have an additional \$1.1 million of capital at the end of the three-year ESOP implementation period than if it simply redeemed the SBLF preferred stock using after-tax earnings (\$3,000,000 contribution multiplied by the 35% tax rate).

Is this financial benefit sufficient to warrant the costs of plan implementation and dilution to existing shareholders? If the bank desires to keep governance a local matter and use the ESOP to augment, not entirely replace, other strategies the answer is often “yes.” In some cases, the issue of whether to implement an ESOP requires an analysis of the relative valuations of stock issued to an ESOP or through a private placement and the dilution expected under both scenarios.

Example of an ESOP Transaction

To illustrate the benefits of using an ESOP as a capital-raising tool, we present a simple example of a bank that installs an ESOP with the goal of using tax-deductible contributions to the plan eventually to redeem its TARP CPP preferred stock. While we present specific numbers below, we emphasize the general impact on bank and company capital ratios, cash flows, stock value, and ownership transition.

XYZ Bancorp

For this example, we consider a healthy financial institution, XYZ Bancorp, with TARP preferred stock totaling approximately 1% of its assets, or \$5 million. The holding company’s primary asset is its investment in XYZ Bank, and it incurs minimal operating expenses. At December 31, 2011, both the bank and the holding company are well-capitalized, but management of XYZ Bancorp has set a goal to redeem the TARP preferred stock by December 31, 2014, before the dividend rate increases from 5% to 9%.

Additionally, XYZ Bank has a management team that is nearing retirement age and that owns a meaningful percentage of the company’s closely held shares. After evaluating a number of options, the management team determines that installing an ESOP is the most effective way to accumulate cash with which to redeem the TARP preferred stock and also to transition ownership to the next

generation of management while facilitating the repurchase of shares held by the existing management team.

ESOP Transaction

The ESOP is installed effective January 1, 2012, and the bank makes tax-deductible ESOP contributions of \$1,666,000 in 2012, 2013, and 2014. The ESOP, in turn, accumulates these cash contributions until 2014, when it purchases \$5 million of newly issued common shares in XYZ Bancorp. As the last step in this transaction, XYZ Bancorp redeems the TARP CPP preferred stock investment with the funds provided by the ESOP's purchase of newly issued common shares.

The contribution, which is significant at approximately 25% of covered compensation, causes XYZ Bank's return on assets to decline by about 20% during the 2012 to 2014 period, versus a scenario where no ESOP is implemented assuming the bank makes no offsetting adjustments to any existing benefit plans. From a capital standpoint, we compared XYZ Bank's equity/asset ratio in 2014, assuming ESOP implementation occurs, to an alternative scenario that does not establish an ESOP but assumes a \$5 million dividend from the bank to the holding company. In this comparison, XYZ Bank's 2014 equity/asset ratio is about 3% higher if the Bank uses an ESOP.

In 2014, the ESOP purchases shares of the company's common stock at the fair market value of the stock as determined by an independent appraiser. The shares purchased by the ESOP in 2014 are newly issued by the company, raising the additional capital necessary for management in turn to redeem the TARP preferred stock. An important issue for the ESOP's independent appraiser to consider is the extent to which XYZ Bank's contributions leading up to the ESOP's share purchase are indicative of its ongoing contribution levels. The example assumes that, following the ESOP transaction, ESOP contributions normalize from 25% to 10% of compensation. Based on this assumption, the total number of shares outstanding increases by approximately 9% in our example, and the ESOP now holds around an 8% stake in the company, but the TARP Capital Purchase Program preferred stock has been redeemed and the dividend payment obligation extinguished without raising external capital.

Why would management and the Board of Directors determine that such dilution to earnings, capital ratios, and ownership is an acceptable result? In short, it would reach this conclusion if these outcomes compare favorably relative to the alternatives available:

- + Relative to a scenario where no ESOP is installed, but XYZ Bank provides a dividend of \$5 million to enable XYZ Bancorp to redeem the TARP CPP preferred stock, the ESOP scenario results in greater capital at the bank and holding company. This additional capital approximates the tax benefit of the ESOP contributions.
- + Investor groups unaffiliated with the holding company may require substantial concessions to encourage their investment, which may be dilutive to remaining shareholders (e.g., warrants in addition to the shares purchased). While an ESOP can pay no more than fair market value for the shares, it may be viewed as a more friendly vehicle to acquire shares than a private investor group.

Alternative to an ESOP

As an alternative to installing an ESOP, XYZ Bancorp management may raise additional capital in a 2014 private placement transaction. Assuming no other changes to financial performance, management may expect the private placement to result in greater dilution of the common stock. For example, existing shareholders and directors may not have the financial means or desire to make substantial additional capital injections. In this case, the bank holding company may turn to an investor group to raise the necessary capital; however, smaller banks often attract less interest from these groups, who often look for attractive public offering or acquisition candidates. With a less persuasive exit strategy, the investor group may demand greater concessions on price, transaction enhancements such as warrants, and other non-financial perquisites such as board of directors' seats. Based on these requirements from investor groups, management may reasonably expect that the number of shares the ESOP would need to purchase in order to raise enough capital to redeem the

TARP would be smaller than the number of shares that would need to be sold in a private placement.

In the example, we assumed that XYZ Bancorp issues stock in a private placement at an approximate 15% discount to the shares' fair market value, as would be used in an ESOP transaction. If this occurs, then the bank holding company would issue more shares to the investors in the private placement than it would have issued to an ESOP, creating greater dilution for all the shareholders. Depending on the ongoing ESOP contribution, by implementing an ESOP, the bank holding company could have a higher earnings per share than if it undertook a private placement and provide its employees with an additional retirement benefit.

Scenario Comparison

The following tables summarize certain key metrics for XYZ Bank under the four scenarios described above. All scenarios assume the same growth and profitability expectations.

Do Nothing	2011	2012	2013	2014
Earnings				
ROAA - Company	0.97%	1.00%	1.00%	1.00%
ROAE - Company	9.92%	9.91%	9.46%	9.08%
Net Income - Consolidated	\$5,525	\$5,801	\$6,091	\$6,396
Performance Metrics				
Earnings per Share	\$100	\$105	\$110	\$116
Book Value per Share	\$931	\$1,026	\$1,125	\$1,229
Shares Outstanding	55,250	55,250	55,250	55,250

Bank Dividend	2011	2012	2013	2014
Earnings				
ROAA - Company	0.97%	1.00%	1.00%	1.00%
ROAE - Company	9.92%	9.91%	9.46%	9.44%
Net Income - Consolidated	\$5,525	\$5,801	\$6,091	\$6,396
Performance Metrics				
Earnings per Share	\$100	\$105	\$110	\$116
Book Value per Share	\$931	\$1,026	\$1,125	\$1,139
Shares Outstanding	55,250	55,250	55,250	55,250

ESOP	2011	2012	2013	2014
Earnings				
ROAA - Company	0.97%	0.79%	0.80%	0.81%
ROAE - Company	9.92%	7.98%	7.86%	7.74%
Net Income - Consolidated	\$5,525	\$4,718	\$5,008	\$5,313
Performance Metrics				
Earnings per Share	\$100	\$85	\$91	\$92
Book Value per Share	\$931	\$1,007	\$1,086	\$1,072
Shares Outstanding	55,250	55,250	55,250	60,342

Private Placement	2011	2012	2013	2014
Earnings				
ROAA - Company	0.97%	1.00%	1.00%	0.94%
ROAE - Company	9.92%	9.91%	9.46%	8.60%
Net Income - Consolidated	\$5,525	\$5,801	\$6,091	\$6,396
Performance Metrics				
Earnings per Share	\$100	\$105	\$110	\$110
Book Value per Share	\$931	\$1,026	\$1,125	\$1,108
Shares Outstanding	55,250	55,250	55,250	61,017

The tables indicate the following:

- + The “do nothing” strategy generates the most favorable financial metrics, but it also does nothing to eliminate the TARP or SBLF preferred stock and the dividend step-up that would occur and absorb a greater proportion of the bank holding company’s earning power;
- + The private placement strategy generates the highest pro forma capital ratios, but at a cost of greater dilution to existing shareholders and, potentially, a loss of control; and,
- + The ESOP strategy generates better capital ratios relative to a strategy whereby the bank holding company uses the bank’s existing equity to redeem the TARP or SBLF preferred stock. Further, when ESOP contributions normalize from their initial rate of 25% of compensation, the ESOP transaction generates better or comparable EPS to a private placement,

but has the salutary benefit of providing additional compensation to the employees.

The ESOP Going Forward

Once the bank has used the cash held by the ESOP to raise capital with which to redeem the TARP CPP preferred stock, the ESOP can be used to buy out existing shareholders desiring liquidity. XYZ Bancorp pays annual dividends on its common stock, which results in dividends paid to the ESOP. Additionally, management can continue to make contributions to the ESOP. The dividends and the ongoing contributions result in cash inflows for the ESOP, which coupled with any cash remaining after the TARP redemption, leaves the ESOP with cash available to purchase additional shares in later years, increasing the ownership percentage. Keep in mind that the shares purchased after 2014 are obtained from existing shareholders, and the only dilution occurs in 2014 with the issuance of new stock to redeem TARP.

This can continue indefinitely (or at least until the ESOP owns 100% of the company), with the company varying the amount of contributions and dividends depending upon the amount of shares the ESOP wishes to purchase, the financial performance of the bank, and the liquidity needs of other shareholders. The contributions are deductible for tax purposes, while the dividends are not. Shareholders who are not participants in the ESOP are not able to participate in the contributions, only the dividends, and management must take into consideration the need to balance the return to all ownership classes of the company. Additionally, all else equal, the contributions do result in a decline in earnings in the years in which they are made, and the reduced earnings must be balanced with the benefits of creating liquidity for shareholders and increasing the ESOP's ownership interest.

Additional Considerations

The example above involving XYZ Bancorp made a number of simplifying assumptions for illustrative purposes. In reality, additional complexities enter into any analysis as to whether an ESOP satisfies a company's objectives. Some of these additional considerations include:

- + If net income is depressed leading up to the ESOP transaction as the company builds a "cash warehouse" by making periodic ESOP contributions, the stock value at the time of the transaction may be reduced, reflecting the depressed earnings. However, depending on the specific facts and circumstances, an appraiser may not consider the amount of such contributions to be reflective of the company's actual expense structure and may factor this consideration into the determination of the company's stock value at the time of the transaction. Some add-back of plan contributions in excess of peer-group retirement plan contributions is common when arriving at a representative earnings base for a valuation.
- + The example shown here pertaining to XYZ Bancorp shows a decline in earnings in the years in which the ESOP contributions occur, reflecting an increase in personnel expenses in the amount of the contributions. In some situations, the increase in expenses may not be as significant. Because ESOP contributions represent an employee benefit, banks with ESOPs may consider reducing contributions to other retirement plans or may otherwise reduce certain personnel expenses as an offset to the ESOP contribution. The extent to which ESOP contributions increase total expenses depends on the sponsoring bank's overall strategy for balancing the various needs and objectives of the bank.

- + In the preceding example, we assumed that balance sheet growth would be identical under all scenarios. However, because the ESOP may provide a greater amount of capital over time, the sponsoring bank may be able to realize greater balance sheet growth in the long term, thus enhancing shareholder value. For example, by using the ESOP to provide shareholder liquidity, more shares remain outstanding, relative to an alternative of repurchasing shares into treasury and thereby reducing common equity.

CHAPTER 3

TAX CONSIDERATIONS

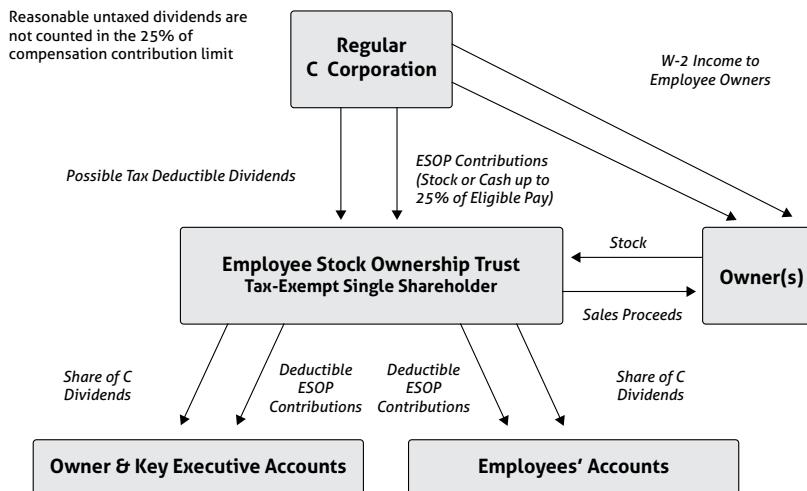
Tax-qualification is an attribute bestowed on an employee benefit plan by the IRS. This status allows the plan sponsor to make contributions to the plan using pre-tax dollars, within certain limits, and also allows the income tax on the participants' benefits to be deferred until the benefits are actually received by the participant or the beneficiary.

For an ESOP to retain its tax-qualification, the plan must be designed and operated in compliance with IRS and ERISA (Department of Labor) regulations.¹ These rules were written, for the most part, to ensure that plans do not discriminate in favor of highly compensated employees, and that plans are administered to protect the rights and benefits of plan participants. Employers must utilize experienced professionals to assist with plan operations and compliance in light of the complex body of interrelated IRS and DOL regulations.

C Corporation ESOPs

The following schematic shows the relationship between a C corporation bank holding company, the ESOP trust, the employees, and other shareholders. This example depicts the ESOP's purchase of stock from existing shareholders.

THE C CORPORATION ESOP



This simple arrangement depicted above of a direct sale of stock from an existing shareholder to the ESOP is common for small blocks of stock for which the purchase can be funded by cash accumulated in the plan.

ESOP transactions can become more complicated, however. For instance, to purchase shares beyond its existing liquidity resources, the ESOP may use debt in a so-called leveraged ESOP transaction. In one variation of this transaction, the bank holding company would borrow funds from another bank, and the bank holding company would then loan the funds to the ESOP via a mirror loan. The bank holding company and potentially the seller of the shares acquired by the ESOP would guarantee the third-party bank loan. The ESOP would then make debt service payments on the "mirror" loan to the bank holding company, which would then service the third-party bank debt.

C corporation banks and bank holding companies with a large number of shareholders will often have different strategies for stock purchases than S corporations, since more than one class of stock may exist.

A major advantage of private C corporation ESOPs that is not available for S corporation ESOPs is the ability of a shareholder who has held his or her shares for three years or more to take advantage of a tax-free sale of stock to the ESOP in an IRC §1042 tax-free (tax-deferred) rollover.

S Corporation ESOPs

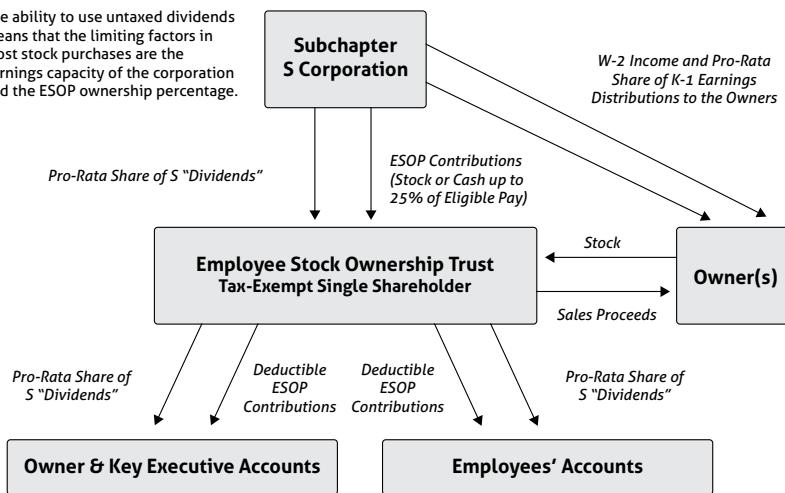
An S corporation is a “pass-through” entity, in which the individual shareholders are responsible for the income taxation attributable to their pro rata portion of the bank or bank holding company’s earnings. The ESOP, like any other S corporation shareholder, participates in the profits and losses of the sponsoring corporation. The ESOP receives its proportionate share of any earnings that are distributed at the direction of the Board, computed on a per-share, per-day rule in the tax year under consideration. Since an S corporation ESOP is treated as a single shareholder and pays no taxes, the earnings on S corporation shares are not taxable. They flow untaxed into the plan and can be used to purchase additional shares or pay down a stock acquisition loan.

This effectively means that the S corporation ESOP can be more tax-efficient than its C corporation counterpart. At the extreme end of the ownership spectrum, i.e., an ESOP owning 100% of the employer’s common stock, the only shareholder is the ESOP Trust, which pays no taxes. There is no need to distribute earnings on shares to taxable shareholders to cover their tax obligations, and the sponsoring S corporation is effectively tax-exempt. The number of such companies is increasing, although outside of the banking industry.

In the following diagram, we have shown a simple example in which the ESOP purchases stock directly from an existing shareholder using funds from the plan (either from cash accumulated in the plan or via a seller note making periodic principal and interest payments to the seller).

THE SUBCHAPTER S ESOP

The ability to use untaxed dividends means that the limiting factors in most stock purchases are the earnings capacity of the corporation and the ESOP ownership percentage.



If the company reports earnings of \$1 million and the ESOP owns 50% of the shares, the non-ESOP shareholders, who own the remaining 50% of the stock, would be responsible for the taxes on \$500,000 of the company's earnings. The ESOP would not be responsible for any taxes on earnings. A distribution of 35% of earnings to the taxable shareholders to satisfy their income tax obligations would require the same distribution to the ESOP of \$175,000. This is a much more efficient method of recovering tax dollars than a simple deductible contribution to an ESOP.

To achieve a recovery of tax dollars equal to \$175,000 with a pre-tax contribution of either stock or cash to an ESOP, the required contribution at an assumed 35% state and federal tax rate would be about \$270,000. In the case of our 50/50 ownership split between the ESOP and non-ESOP shareholders, the company still distributes cash in the amount of 35% of \$1 million, but in this case the ESOP share represents a complete recovery of dollars otherwise lost to taxation.

Despite the substantial benefits of using an ESOP with a large ownership interest to improve cash flow in S corporations, this strategy may be difficult to implement for several reasons. First, the other shareholders want to partake in the earnings. But, more importantly, it takes significant time (typically more than 10 years) for a company to buy in a significant proportion of its shares – even with a full tax shield for the ESOP purchase. Additionally, when an ESOP uses a loan to purchase shares, the debt may be treated as a reduction of shareholders' equity. In accounting terms, this contra-equity account arises because the accounting rules treat the leveraged transaction as if it were a repurchase of stock. While the contra-equity account declines over time as the debt is repaid, the transaction would dilute the holding company's capital ratios at the outset. Lastly, ESOPs owning large proportions of the employer's outstanding securities may generate another set of problematic issues, because of the materiality of the obligation to repurchase shares from participants exiting the plan.

There also are some concerns with partial S corporation ESOP ownership and high levels of corporate earnings. For example, if our example ESOP above only had 40% of the stock and the outside 60% owners wanted 70% of earnings distributed, the ESOP's share of the \$1 million of earnings would be 40% of \$700,000, or \$280,000. That could represent more cash than the ESOP needs for share purchases, loan payments, or repurchases of shares from departing, vested account balances.

Some S corporation banks with partial ESOPs have inadvertently “overfunded” their plans, making for some large participant accounts, when the distributions paid to outside shareholders have been quite high. This is not common, but represents one of many design considerations when implementing an ESOP.

Additionally, terminated participants may have vested account balances in the ESOP still held in the form of bank shares; the presence of stock in termininee accounts could benefit both from distributed earnings on their S corporation shares as well as price appreciation in the underlying shares. The effect of growing account balances for terminated participants is not difficult to deal with but needs to be understood both in the design and ongoing operation of an ESOP.

Very small S corporation ESOPs face an additional concern that C corporation ESOPs do not: the IRC §409(p) “anti-abuse” rules. After the passage of legislation in 1998 permitting ESOPs to be eligible shareholders in S corporations, the IRS belatedly recognized that there was a potential for abuse. The concern was that, the ESOP would not share ownership broadly on a non-discriminatory basis, yet would provide a full tax exemption to the shareholders/participants who may be the same individual(s).

Since any S corporation with all of its shares held in the tax-exempt trust is effectively an untaxed operation, a small company with few employees could hold its earnings on the untaxed balance sheet of the company with that wealth concentrated in a few hands. The IRS, concerned with such a massive tax shelter, wrote the anti-abuse rules to prevent such a concentration of ownership. Without adducing the technicalities of this law, a failure to meet this requirement effectively destroys the ESOP, through a 50% excise tax on the amounts held by “disqualified persons,” possible disqualification of the plan, or other negative effects.

Although there are ways of addressing the ownership concentration issue, S corporation companies with fewer than about 15 participants in an ESOP, or with a potential of declining to that level, should either be a C corporation or consider an alternative to the ESOP.

Limits on ESOP Contributions

For an ESOP, as for any other tax-qualified plan, the IRS imposes limits on the amount of tax-deductible contributions. For eligible participants, typically those working at least 1,000 hours per year and age 21 or older (though sponsors can be more generous), the contribution by the sponsor to all of the qualified plans cannot exceed 25% of “covered” compensation. For example, a bank with an eligible payroll of \$2 million, making employer 401(k) contributions of \$100,000, could contribute a maximum of \$400,000 to an ESOP on a tax-deductible basis. (Total allowable contribution of 25% of \$2 million = \$500,000. Netting out the 401(k) contribution of \$100,000 leaves \$400,000 for the ESOP.)

While historically other contribution limits have been subject to a cost of living adjustment, there have been no increases for the past two years.

The following caps apply for the 2011 and 2012 plan years:

	2011	2012
Compensation limit for computing all plan contributions <i>Source: Annual Compensation - IRC 401(a)(17)/404(l)</i>	\$245,000	\$250,000
Maximum 401(k) elective deferral <i>Source: Elective Deferrals - IRC 402(g)(1)</i>	\$16,500	\$17,000
Age 50 401(k) catch up contribution maximum <i>Source: Catch-up Contributions - IRC 414(v)(2)(B)(i)</i>	\$5,500	\$5,500
Annual addition limit without 401(k) catch up amount <i>Source: Defined Contribution Limits - IRC 415(c)(1)(A)</i>	\$49,000	\$50,000
Annual addition limit with 401(k) catch up above age 50	\$54,500	\$55,500

COLA increases for dollar limitations on benefits and contributions are updated annually and reported on the www.IRS.gov website each fall.

It must be noted that ESOPs have some exceptions to the above constraints. For example, the following additional monies flowing untaxed into an ESOP do not count in any of the above limits:

- + S corporation earnings on shares held by an ESOP (which can be used to purchase and repurchase shares or pay down an ESOP loan), and,
- + C corporation dividends that are characterized as reasonable by the IRS.²

The effect of these exceptions for ESOPs is that the contributions to ESOPs generally run well ahead of other profit-sharing plans. For example, the average employer contribution to a 401(k) is about 4% of compensation. We have seen ESOPs in some cases with total funds flowing into participant accounts averaging 35% or more of eligible pay in some years, though the national average is closer to 8%. The typically high level of plan contributions eventually results in substantial stock values accumulating in participant accounts, making the ESOP a great tool to build retirement savings.

Summary of Similarities and Differences Between S and C Corporation ESOPs

Feature	Private C Corporation ESOP	Subchapter S ESOP
ESOP 1042 Tax-Free Rollover	Yes, if ESOP = 30%	No
Tax-Deduction Limit for ESOP Loans	Includes only Principal in Most Cases. Must Pass "One-Third" Test for This. Otherwise, the Limit Includes Principal and Interest	Counts both Principal and Interest
Tax-Deductible Dividends	Yes, if "Reasonable" and Used to Retire ESOP Debt, Passed Through to Participants or Reinvested in Shares	No
Untaxed Earnings on ESOP Shares	No	Yes
Dividends Can Be Distributed to Participants	Yes	No
Retiring Participants Can Demand Stock Pursuant To Put Option	Yes, Unless Restricted by By-Laws & Charter Deeming Sponsor to be "Substantially Employee Owned"	No
Participants Vote Their Shares	No, Except in Very Major Issues: Liquidation, Sale, Sale of Substantially All of the Assets, Merger	No, Except in Very Major Issues: Liquidation, Sale, Sale of Substantially All of the Assets, Merger
Tax-Deduction Limit for Combined Qualified Plans	25% of Eligible Compensation, not Counting Dividends paid to ESOP	25% of Eligible Compensation, not Counting Earnings on ESOP Shares

CHAPTER 4

VALUATION CONSIDERATIONS

Why a Valuation Is Needed

The primary regulator of these types of employee benefit plans is the Department of Labor (“DOL”), which draws its authority from the Employee Retirement Income Security Act of 1974 (“ERISA”). ERISA requires that an independent third party appraise the stock in a privately held company owned by an ESOP. Secondarily, the Internal Revenue Service has authority to review the activities of the plan of the deductibility of contributions. The IRS requires a valuation to be performed annually if the plan is leveraged.

Publicly Traded vs. Non-Publicly Traded Companies

Whether or not the employer stock is publicly traded can impact the valuation of the sponsor’s stock. Often, banks whose stock is listed on an exchange do not obtain independent valuations as the trustee presumes that the value of the ESOP stock will approximate the market price. However, care should be taken by both the plan sponsor and the trustee to ensure that the use of the bank’s “market” price is appropriate.

Guidance on the regulatory definition of publicly traded was issued by the IRS on March 1, 2011 applying Section 401(a)(35) of the Internal Revenue Code to ESOPs. Section 401(a)(35) was issued in 2010 and defined a company as “publicly traded” if the employer stock is traded on either:

- + A national securities exchange that is registered under Section 6 of the Securities and Exchange Act of 1964 (e.g., NYSE or NASDAQ); or

- + A foreign national securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority and where the Security is deemed by the Securities and Exchange Commission as having a ready market (e.g., the FTSE Group All-World Index).

Stock not meeting the definition noted above, which includes stock traded on the over-the-counter bulletin board or the “pink sheets,” would not be considered publicly traded and would be required to satisfy the ESOP requirements that apply to non-publicly traded companies. Additionally, the market price of the stock of certain banks, including those meeting the publicly traded definition described above, may be deemed less meaningful after considering factors such as trading volume, free-float, volatility, and other specific factors.

The Appraiser’s Client

The trustee of the ESOP is the independent appraiser’s client, rather than the bank or bank holding company. Ultimately, the trustee must review and accept the appraiser’s opinion.

When a Valuation Is Needed

The ESOP’s need for an independent appraisal arises at several points over its life:

- + Initial valuation for the purchase of stock
 - For a new plan, the appraiser may be asked to prepare a preliminary valuation to assess the feasibility and attractiveness of a plan. If a decision is made to proceed, then the appraiser renders an appraisal upon which the transaction occurs.
- + Annual valuation for plan administration purposes
- + Periodic valuation for subsequent transactions

- If a significant transaction affecting the plan sponsor's stock is anticipated to occur, the ESOP trustee may desire assistance from the independent appraiser. The appraiser can analyze the proposed transaction from a financial point of view and may issue a fairness opinion to the ESOP trustee, which may assist the ESOP trustee in voting the shares held by the plan.
- + Upon termination of plan
- + As an informal rule of practice (unsupported by any formal rule), transactions occurring throughout the year occur at the price determined as of the plan's year-end. For example, transactions occurring in calendar year 2012 would occur at the appraised value as of December 31, 2011. However, if certain significant transactions occur in the interim, the ESOP trustee may desire an updated valuation of the stock.

Basic Valuation Concepts

Standards of Value

The *ASA Business Valuation Standards* define the standard of value as “the identification of the type of value being used in a specific engagement; e.g., fair market value, fair value, investment value.”¹ The selection of the standard of value drives the application of valuation methods. The most common standards of value include:

- + **Fair Market Value** is the applicable standard of value for ESOP appraisals and is discussed in more detail below;
- + **Statutory Fair Value** is generally defined by judicial interpretation of the relevant statute in a particular state; and,
- + **Fair Value for financial reporting purposes** is defined in Accounting Standards Codification Topic 820 as, “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”²

Fair Market Value

Fair market value is the most widely known standard of value and is applicable to almost all federal and state tax valuation matters. Additionally, ERISA defines adequate consideration as, "...in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by the trustee or named fiduciary..."³

Fair market value has been defined in numerous court cases, as well as in Internal Revenue Service Ruling 59-60. Fair market value is defined by the American Society of Appraisers as:

"The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."⁴

The definition of fair market value presumes the following:

- + **A Willing Seller and a Willing Buyer.** Both are hypothetical parties. Each is assumed to be well-informed about the subject interest and the market context in which it might be transacted.
- + **Arm's Length.** Fair market value assumes willing, financially capable, and informed buyers and sellers, none of whom is related or acting under any compulsion.
- + **Importance of Conditions in Existence at the Valuation Date.** Both internal conditions (financial health of subject bank, credit quality, etc.) and external conditions (state of stock markets, the relevant local, regional, or national economy, and industry conditions) must be determined by investigation and will influence the conclusion of value. From

the point of view of fair market value, these conditions and their future outlook should be assessed as of the specific valuation date.

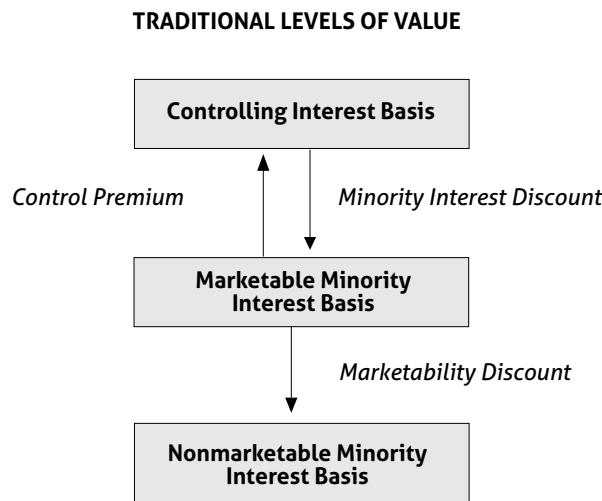
- + **Focus on the Critical Three - Common Sense, Informed Judgment, and Reasonableness.** Revenue Ruling 59-60 states: "A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."⁵

Levels of Value

Valuation theory suggests that there are three general levels of value applicable to a business or business ownership interest. Many writers parse these ideas more precisely. For purposes of perspective, we define the three traditional levels of value as:

- + **Controlling interest basis** refers to the value of the enterprise as a whole.
- + **Marketable minority interest basis** refers to the value of a minority interest, lacking control, but enjoying the benefit of liquidity as if it were freely tradable in an active market.
- + **Nonmarketable minority interest basis** refers to the value of a minority interest, lacking both control and market liquidity.

The traditional levels of value chart shown on the following page shows the relationship between the three levels of value and demonstrates how the indications of value are obtained at each level of value.



Controlling Interest Level of Value

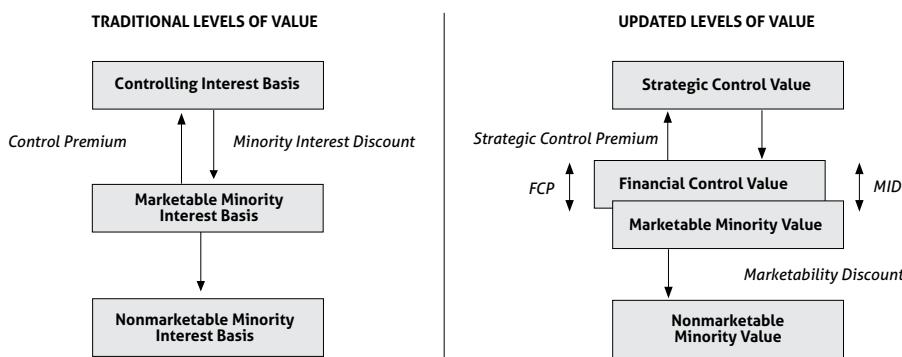
The highest level of value is called the controlling interest level of value. Controlling interest indications of value are commonly obtained directly by reference to actual change of control transactions using the guideline transactions method, which is described in the discussion of valuation approaches later in this chapter. Additionally, controlling interest indications of value can be obtained indirectly by reference to freely tradable values using a control premium.

The control premium is the difference between the value of a subject interest that exercises control over the company and the value of that same interest lacking control (but enjoying marketability). In practice, the control premium is generally expressed as a percentage of the marketable minority value. When the difference is expressed as a percentage of the controlling interest value, it is referred to as a minority interest discount. Both the concept of the control premium and that of the minority interest discount have been addressed in numerous studies by appraisal professionals and by the various courts.⁶

Many valuation experts further subdivide the controlling interest level of value into strategic control value and financial control value. We define strategic control and financial control as:

- + **Strategic controlling interest basis** refers to the value of the enterprise as a whole, incorporating the strategic intent that may motivate particular buyers and the expected synergies that may result from an acquisition.
- + **Financial controlling interest basis** refers to the value of the enterprise excluding any revenue and expense synergies that may accrue to a strategic buyer. This level of value is viewed from the perspective of a financial buyer, who may expect to benefit by improving the enterprise's cash flow and its capital structure but not through any operating synergies that may be available to a strategic buyer.

If adjusted, the levels of value chart looks like the following:



The “FCP” in the right chart is any applicable “financial control premium” over the marketable minority level. The corresponding “MID” is any applicable “minority interest discount.” It is widely acknowledged by appraisers that the typical public company pricing is analogous to the financial control level, such that financial control and marketable minority values are often indistinguishable.

Observing the differential between the financial controlling interest level of value and the strategic controlling interest level of value at a specific time in a particular industry can be difficult for a variety of reasons. Generally, a conclusion of value at the strategic controlling interest level of value results in a conclusion of value greater than a conclusion of value at the financial control level. However, a preponderance of financial buyers in a given industry can result in competitive bidding and the acceptance of lower returns by an individual financial buyer, which may increase prices paid by financial buyers to a level comparable to the prices offered and/or paid by strategic buyers.

Marketable Minority Interest Level of Value

The marketable minority interest level of value is typically the reference point for which the other levels are described. Indications of value on a marketable minority interest basis are often obtained by reference to valuation multiples of comparable publicly traded companies using the guideline public company method, which is described in the discussion of valuation approaches later in this chapter. Marketable minority interest indications of value can also be obtained directly by using a build-up methodology, which develops capitalization rates by estimating required rates of return in relation to public markets, or indirectly by reference to a control valuation via the application of a minority interest discount to reflect the lack of control.

Nonmarketable Minority Interest Level of Value

The nonmarketable minority interest value is typically derived by determining value at the marketable minority interest level of value and then applying a discount for lack of marketability. The American Society of Appraisers defines a discount for lack of marketability as “an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability.”⁷ Thus, a marketable minority interest would be worth more than a nonmarketable minority interest that is identical in all other respects, and the difference between the two (the marketability discount) is due to the inherent risk of holding an illiquid asset. For ESOP appraisals, discounts for lack of marketability generally may be lessened, as many ESOPs contain “put” provisions, requiring the employer or the ESOP itself to repurchase shares of stock from employees.

Valuation Approaches

The process of creating a valuation means consideration of various ways of measuring value. Since Mercer Capital adheres to the *American Society of Appraisers' Business Valuation Standards*, we use its terminology. The ASA recognizes three general approaches to valuation. Within each approach, the appraiser may apply various methods. The valuation methods used are considered by the appraiser to be those most appropriate to the valuation.

Asset Approach

The *ASA BV Standards* define the asset approach as “a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods based on the value of the assets net of liabilities.”⁸ Asset-based valuation methods include those methods that seek to write up (or down) or otherwise adjust the various tangible and/or intangible assets of an enterprise.

Within the asset approach, a potential method used for valuing a financial institution is the net asset value method. The net asset value method develops a valuation indication in the context of a going concern by adjusting the reported book values of a subject bank’s assets to their market values and subtracting its liabilities (adjusted to market value, if appropriate). This approach often is less meaningful than the income and market approaches.

Income Approach

The *ASA BV Standards* define the income approach as “a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods through which anticipated benefits are converted into value.”⁹ Valuation methods under the income approach include those methods that provide for the direct capitalization of earnings estimates, as well as valuation methods calling for the forecasting of future benefits (earnings or cash flows) and then discounting those benefits to the present at an appropriate discount rate. One of the most common methods used to value financial institutions within the income approach is the discounted future benefits method, which relies upon a

projection of a future stream of benefits, the present value of which represents the indication of value of the subject bank.

Market Approach

The *ASA BV Standards* define the market approach as “a general way of determining a value indication of a business, business ownership interest, security or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities or intangible assets that have been sold.”¹⁰

Within the market approach, the most common methods utilized are:

- + **The Transactions Method.** The transactions method develops an indication of value based upon consideration of actual transactions in the stock of a subject entity. Transactions are reviewed to determine if they have occurred at arm's length, with a reasonable degree of frequency, and within a reasonable period of time relative to the valuation date. Finally, the transactions should be of a similar level of value (i.e., a limited number of transactions involving a small number of shares would generally be inappropriate for a controlling interest valuation). Inferences about current value can sometimes be drawn, even if there is only a limited market for the shares and relatively few transactions occur.
- + **The Guideline Public Company Method.**¹¹ The guideline public company method develops an indication of value based upon pricing multiples of guideline companies. When valuing banks, guideline companies are most often publicly traded financial institutions that provide a reasonable basis for comparison to the investment characteristics of the subject bank. Sifting through the hundreds of publicly traded banks in the United States, appraisers evaluate comparability on the basis of several measures, most notably asset size, geographic location, asset quality, and profitability. The most commonly

used version develops a price/earnings (“P/E”) ratio or price/book value ratio (“P/B”) with which to capitalize net income or book value. If the public company group is sufficiently homogeneous with respect to the companies selected and their financial performance, analysts may begin the analysis by calculating an average or median P/E or P/B ratio as representative of the group or subdivide the group by other means. If the analyst determines that certain differences exist between the guideline companies and the subject bank, then the analyst may adjust the median or average multiples to account for these differences. Price/tangible book value ratios frequently are used in addition to or in place of price/reported book value ratios.

- + **The Guidelines Transactions Method.**¹² Also referred to as the merger and acquisition method, the guideline transactions method develops an indication of value based on change of control transactions involving target banks with investment characteristics comparable to the subject bank. Transactions are screened to include only those that occurred within a reasonable period of time proximate to the effective date of the valuation and involve target banks with comparable qualities, including asset size, asset quality, geographic location, and profitability. The most commonly used version develops a P/E or P/B ratio that is used to capitalize net income or book value. Other relevant valuation indicators for the banking industry may include the premium to core deposits.

Hot Topics in ESOP Valuation

Leveraged vs. Unleveraged Transaction

The use of leverage often creates complexity and misunderstanding in a variety of ways. First, if the ESOP's stock purchase is financed with debt, the transaction almost certainly will not create capital immediately, since *American Institute of Certified Public Accountants Statement of Position 93-6* generally does not permit it. This accounting pronouncement should be reviewed with the bank's auditors very carefully before implementing a leveraged plan to avoid any unwelcome adjustments to the holding company's equity. Second, the value of the stock may fall after the leveraged plan is implemented depending upon the treatment of the ESOP debt in the appraisal.

An ESOP can engage in a leveraged transaction involving a minority interest (less than 50% of the outstanding shares) or a controlling interest (more than 50%). When debt is involved, there is the expectation that it will be paid from contributions to the ESOP and possibly distributions (which are made to all shareholders). ESOP appraisers may treat the debt and contributions in a minority interest transaction as an increase in compensation. Hence, costs rise and value falls, with all other things being equal. Value will rise over time as the debt is paid; however, ongoing contributions to the ESOP will continue to reduce earnings. In a control transaction, appraisers may treat the debt as though it were similar to an externally financed stock acquisition. This is appropriate because the controlling shareholder can sell the company and pay the debt. On rare occasions, the debt can be paid from distributions, therefore no reduction in the stock value occurs.

Additionally, the use of leverage can create dilution, which lowers value. Dilution is a reduction in the fair market value per share, which occurs when there is an increase in the number of shares without an immediate, offsetting increase in value due to higher earnings or more capital. In the context of an ESOP, it occurs when: 1) shares are contributed to the plan and a tax deduction is taken for the fair market value of those shares; or, 2) newly issued shares are purchased by the plan and the purchase is financed with debt. Dilution is considered in the

determination of fair market value at the time of the appraisal and should not be confused with the decline in value, which sometimes occurs when existing shares are purchased with debt. Dilution is encountered most frequently when a bank is undertaking a new stock offering. The difficulty increases when the ESOP purchases its stock with debt.

Discount for Lack of Marketability

Appraisers often reduce the discount for lack of marketability if the ESOP plan document contains a “put” provision that is legally enforceable and financially viable. The put clause allows the participant to put the stock to the plan, to the employer, or both. An appraiser can apply a different discount for lack of marketability to stock inside an ESOP than to shares outside the plan.

One area of controversy involves the purchase of shares by an ESOP that would otherwise be subject to a larger marketability discount. If the ESOP pays the ESOP appraised value, which is based on a relatively low marketability discount, for shares subject to a larger marketability discount, some have argued that the ESOP would contravene the requirement that it pay no more than fair market value. That is, shareholders outside of the ESOP should not benefit from the put right accorded to ESOP participants.

Repurchase Liability

An emerging liability is the obligation of the plan or the employer to repurchase shares in the plan. The amount of the liability is a function of the value of the stock. Since repurchasing stock takes cash (or capital), the repurchase of shares in a mature ESOP is often in conflict with other financial needs of the business, such as funds needed for expansion. The emerging liability is rarely an issue in new plans and may not be an issue for many years. Appraisers differ as to the treatment of a repurchase liability in appraisals. From bank management’s perspective, though, the repurchase liability means that a greater portion of the bank’s earnings may be used to redeem shares from ESOP participants exiting the plan, rather than reinvested in the bank. The ESOP repurchase obligation should not be used to reduce unduly the value of the stock and solve the cash flow problem of a mature ESOP.

ENDNOTES

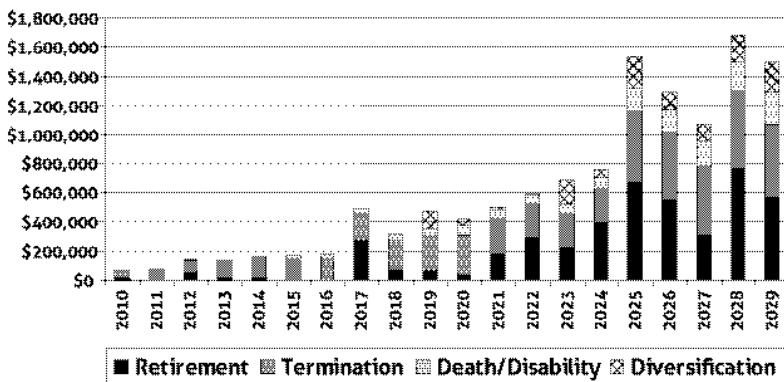
- 1 American Society of Appraisers, *ASA Business Valuation Standards* © (Revision published November 2009), "Definitions," p 31.
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- 3 ERISA §1002 (18)(b).
- 4 American Society of Appraisers, *ASA Business Valuation Standards* © (Revision published November 2009), "Definitions," p 27.
- 5 IRS Revenue Ruling 59-60.
- 6 American Society of Appraisers, *ASA Business Valuation Standards* © (Revision published November 2009), "Definitions," p 26.
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- 8 American Society of Appraisers, *ASA Business Valuation Standards* © (Revision published November 2009), "BVS-III Asset-Based Approach to Business Valuation," p 9.
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- 10 American Society of Appraisers, *ASA Business Valuation Standards* © (Revision published November 2009), "BVS-V Market Approach to Business Valuation," pp 12-13.
- 11 American Society of Appraisers, *ASA Business Valuation Standards* © (Revision published November 2009), "SBVS-1 Guideline Public Company Method," pp 33-34.
- 12 American Society of Appraisers, *ASA Business Valuation Standards* © (Revision published November 2009), "SBVS-2 Guideline Transactions Method," pp 35-36.

CHAPTER 5

THE ESOP STOCK REPURCHASE OBLIGATION

After implementing an ESOP, the sponsor has an obligation to cash out vested participants when they meet the plan distribution requirements, generally at retirement. Besides obligations due at retirement, there are payouts for death, disability, vested terminations, and the ESOP diversification election.

The chart below depicts an example of this long-term obligation for an ESOP started in 2008 that purchased \$8 million of company stock financed over 10 years. The vertical axis measures the annual repurchase obligation. The expected plan repurchases shown in the chart below assume 6% average annual share price appreciation and a positive effect on post-transaction value by the paydown of the ESOP debt.



Some of the issues arising for plan sponsors dealing with these long-term, emerging costs are:

- + The obligation is real, but is determined actuarially and is not reflected in the company financials under Generally Accepted Accounting Principles (“GAAP”). There is no requirement to report the obligation under GAAP, even when the repurchase costs are high.
- + Proper ESOP management requires that financial officers understand and manage not just cash flows, but stock flows as well, in light of the requirements of fiduciary prudence to operate the plan for the exclusive benefit of the participants. While there is no guarantee that stock value will rise over time, fiduciaries must show they have acted in the best interests of the participants.

Plan sponsors also must understand the interplay between the repurchase obligation and the major variables affecting the financial health of the plan and its sponsor, such as the following:

- + The independent ESOP stock valuation, which considers the sponsor’s earnings capacity that may itself be impacted by the repurchase liability;
- + The ways a bank holding company manages its excess capital (for instance, a possible “sinking fund” for ESOP stock buybacks), which affect value and the resulting buyback liability;
- + The direction of various stock flows, e.g., dilutive new share issues to the plan, repurchases of stock into the plan, or repurchases of stock back into treasury (which can be counter-dilutive to value); and,
- + The plan distribution rules and administrative policies governing the way payments are made to former participants.

A good ESOP repurchase study will help a plan sponsor analyze the many, and sometimes very creative, strategies that can coordinate these variables to keep a plan and its sponsor in the best financial position (and, incidentally, will also represent important documentation of prudence on the part of the fiduciaries). The ESOP repurchase study should not just measure the projected costs arising from the repurchase obligation, but should examine financial strategies for funding and cost containment.

A few central questions to be addressed by fiduciaries (Board of Directors and Trustees) responsible for an ESOP over the long term are:

- + Should the ESOP stock accounts subject the participants to the same risk in their retirement plan as the equity risk for outside stakeholders (as is the case when the ESOP relies entirely on current cash flows or has “buy-sell” funding roughly equivalent to that for other shareholders)?
- + If not, how should the risk be mitigated?
- + How does risk mitigation tie into repurchase funding and prudent fiduciary management of the plan? Reducing risk to ESOP participants implies some funding for the plan liabilities to reduce the risk of impaired payment ability. If there is cash beyond immediate liquidity needs in the plan or on the holding company’s balance sheet, then the risk of an account not being paid out is reduced.

Fiduciaries should assess the ESOP repurchase liability within a risk/reward framework. In making decisions on how to use capital, the sponsoring company must balance the competing goals of: 1) supporting the ESOP’s liquidity needs and 2) providing capital for the bank’s growth. At the extremes, the ESOP could either bear the same risk as non-ESOP shareholders and rely entirely on future cash flow to fund stock purchases, or all the available funds could be directed to supporting the plan, reducing the risk greatly but compromising the bank’s growth and capital flexibility.

Since the planning time horizons for ESOP repurchase obligations extend out over a decade and can grow to a relatively large sum, the bulk of the funding will come from current cash flows and the ability to leverage, if the costs grow very large or increase significantly in a given year. Given the long-term nature of the repurchase obligation, a pre-funding strategy can be structured to accumulate sufficient cash to meet short-term obligations. For example, sufficient liquidity can be set aside to cover the largest repurchase obligations expected in several years over the next decade or so.

The following are some basic recommendations for fiduciaries analyzing the repurchase obligation:

- + Fiduciary prudence requires the directors to take steps to measure, fund, and diversify some of the risk inherent in the long term buy-back obligations. Repurchase analyses run for a set of financial and benefit inputs can aid in understanding the sensitivity of the long-term payouts to factors the company can control.
- + To achieve some balance in the competing goals of the ESOP's security and the bank's growth and to demonstrate fiduciary prudence, the Trustees should have their independent appraiser provide some estimates of the effect of various pre-funded amounts for ESOP repurchases on the bank's stock value. No decisions should be made regarding the treatment of the obligation without knowing that approximate range.
- + Coordinate corporate projections with ESOP repurchase studies. Make the valuation firm aware of the anticipated repurchase costs.
- + Do not rely on single-solution financial product providers to address the problem of how to handle the repurchase obligation.
- + Start funding the obligation early in the plan's life, even with just a small amount. Whether the funds are held on the

holding company's balance sheet or in the plan depends on a number of factors such as corporate taxes and the age of the plan. Note that you can hold some money in key executive plans, which the executives can receive if the buy-backs are covered, or which can be used to pay the obligations if cash flows are light.

How to Fund the Obligations

The question of how to fund the repurchase obligation is the topic of entire booklets by professional ESOP associations, but we note a few points in this summary of the topic.

- + Contributions of cash to the plan are tax-deductible and generally are sufficient in the early years of an ESOP when attrition of the trust assets due to retirements and other payouts is small. In later years, excess cash in a plan can result in a bleeding ESOP, i.e., an ESOP in which some of the cash in participant accounts is paid out without ever buying a share of stock. To reduce the bleeding ESOP effect, companies with mature ESOPs are often better served by keeping the cash on the balance sheet under corporate control for a variety of reasons – even with the taxation triggered by retaining earnings. The bleeding effect can be exacerbated by IRC §409(p) anti-abuse rules for Subchapter S corporation ESOPs.
- + Cash-efficient, corporately owned life insurance can help with the obligation since payouts to beneficiaries in both of these cases must begin no later than the end of the year following the participant's separation from service. In the interest of ensuring that the policies will stay in force, it is helpful to have a permanent insurance product with cash accumulation that could be accessed to help with buy-back obligations or to pay premiums. Insurance should be owned outside the ESOP, as discussed in detail below.

- + ESOP fiduciaries need to look at planning timeframes extending well beyond a decade for a larger population of plan participants. Once they have taken the essential step of estimating the future liabilities, they have to consider the effect of mortality/morbidity on ESOP payouts – especially for the accounts of highly compensated participants.
- + If there is high anticipated growth in share value, rather than have higher buyback obligations consume more cash, consider setting some cash aside in the near-term for the liability. The cash set-aside could result in lower average annual share price appreciation in future years, especially if the pre-funding was coordinated with a key executive program.

As noted previously, if life insurance is used as a method of helping to fund the ESOP repurchase obligation, the insurance should be held by the sponsoring company rather than by the ESOP. An ESOP can own life insurance, so-called TOLI (Trust Owned Life Insurance). If the ESOP owns the policies, there would be an advantage in:

- + Improved cash flows for the company if the ESOP has the additional cash to invest in the insurance, because of the immediate deductibility of the premiums.
- + The repurchases related to large ESOP accounts are funded in event of death.

However, the drawbacks to ESOP ownership of insurance are quite significant:

- + Some fiduciary issues arise from ESOP ownership of life insurance; for example, ESOP-owned insurance with death benefits or cash for key employees or shareholders could create a possible prohibited transaction.

- + Insurance death benefits paid to the ESOP cannot be used to retire ESOP debt. Current law specifies ESOP loan repayments are to come from annual additions or dividends for that purpose. S corporation ESOPs can use K-1¹ distributions on unallocated shares to retire debt, but the purchase of insurance with them is a gray area.
- + A tax-free death benefit would be paid to a tax-exempt trust.
- + When permanent insurance products are used, there is possible tax-exempt deferred cash value building up in a tax-exempt trust.
- + A large cash infusion from a death benefit will generally repurchase stock for the trust or be paid out to departing participants, which increases the repurchase liability; it is probably better to have the flexibility of a death benefit coming to the balance sheet.
- + The limit for annual contributions to the ESOP must also support payment of the premium(s).
- + Plan fiduciaries must consider the implications of possibly canceling a policy when the death of an insured is a guaranteed benefit to the plan. Younger plan participants may claim fiduciary malfeasance in the elimination of this benefit that would more than likely accrue to them.

Corporately owned insurance contracts, on the other hand, can have numerous benefits:

- + The corporation can use any insurance proceeds or cash values to retire into the treasury as little or as much of the stock as desired, thereby adjusting the issued and outstanding shares, affecting both the size of the ESOP and the future repurchase obligation in light of the financial posture of the company, the plan, and shareholders.

- + The tax-free proceeds from the insurance policy to the company are more flexible than cash in the plan. They can be used to make tax-deductible contributions to the ESOP or loaned to the ESOP to the extent needed. In the case of an internal loan from an insurance benefit or cash values, the company can then make tax-deductible contributions to repay itself. However, the loan would be treated as a reduction in the holding company's equity, as AICPA Statement of Position 93-6 would require the holding company to record a contra-equity equal to the amount of the loan. This contra-equity account, resulting from even the internal loan between company and the ESOP, would decline over time to zero as the loan is repaid.
- + The premium(s) can be made tax-deductible if the company contributes newly issued shares to the plan, which can be adjusted as desired in light of the tax benefits needed and the minimum dilution incurred. If net operating loss carryforwards or other factors mitigate the need for a tax shelter, the company has control of the stock contribution and can choose to make no additional plan contribution.
- + The cash accumulations can be used to fund reasonable discriminatory key executive benefits outside the ESOP to retain critical employees for the benefit of the company and the ESOP participants. The vesting of such accumulated cash to key executives can be linked to the ability of these executives to retire ESOP debt or successfully fund ESOP stock repurchase obligations.

A potential drawback to the corporately owned insurance is:

- + A large tax-free death benefit paid to the corporation could increase the tax liability of the company through alternative minimum tax rules (the company should have its accountant review this possibility and its potential impact on stock valuation).

In short, the significant constraints on trust-owned insurance and the flexibility of a bank with insurance contracts on its balance sheet both argue strongly in favor of having Bank Owned Life Insurance rather than Trust Owned Life Insurance.

When Are ESOP Participants Paid for Their ESOP Accounts?

ESOP benefits are usually paid to participants after their employment with the company ends for any reason. The timing of ESOP benefit payments depends on whether a plan participant is retiring, has died, becomes disabled, or simply is leaving the company. The following IRS and DOL rules apply to the payment of ESOP benefits following a participant's departure from the company:

- + When an ESOP participant retires, becomes disabled, or dies, the ESOP must begin to distribute vested benefits during the plan year following the event. The maximum number of annual installment payments is five.
- + When an ESOP participant's employment terminates for reasons other than retirement, disability, or death, the distribution of his or her ESOP benefits can be delayed, but it must start no later than the sixth plan year after the plan year in which termination occurred (unless the participant is reemployed by the same company before then).
- + ESOP distributions may also be delayed if the ESOP is leveraged, in which case distributions of ESOP-held shares acquired through the loan generally may be delayed until the plan year after the plan year in which the ESOP loan is fully repaid. This does not apply, however, to certain ESOP distributions following the retirement or death of the participant.
- + Rules governing company stock acquired by an ESOP before 1987 differ slightly, and the value of those shares might not be distributed until the participant reaches retirement age.

- + The plan must generally begin distributing benefits to an ESOP participant who has reached age 70½ and has not requested an earlier distribution. Payments are made over the participant's life expectancy.²

In certain circumstances, participants may receive benefits from the ESOP while they are still employed:

- + Plan participants who are still working (and those who are not) may diversify their account balances if they are age 55 and have been participants for at least 10 years.³ They have the right during the following five years to diversify up to 25% of company stock that was acquired by the ESOP after December 31, 1986 and that has been allocated to their accounts. During the sixth year, they may diversify up to 50%, less any previously-diversified shares. To satisfy the diversification requirement, the ESOP must: 1) offer at least three alternative investments under either the ESOP or another plan such as a 401(k) plan or 2) distribute cash or company stock to the participants.
- + The employer may choose to pay dividends directly to ESOP participants on company stock allocated to their accounts (usually done by C corporations).
- + The plan must generally begin distributing benefits to an ESOP participant whose allocated shares represent 5% or greater ownership interest in the plan after the participant reaches age 70½, even if the participant is still employed.
- + There are certain other circumstances in which the ESOP plan may provide for in-service distributions, such as after a fixed number of years, upon attainment of a specified age, or upon "hardship."

How Are ESOP Participants Paid for Their ESOP Accounts?

ESOP distributions may be made in substantially equal payments (not less frequently than annually as set by policy) over a period no longer than five years (i.e., six payments over five years). However, this five-year period may be extended an additional year (up to a maximum of five additional years) for each \$195,000 or fraction thereof by which a participant's benefit exceeds \$985,000 (limits adjusted annually). Distributions are made in the form of cash or stock in a C corporation-sponsored ESOP and cash only in an S corporation-sponsored ESOP.

Please note that these are the most restrictive provisions mandated under current regulation. An employer may pay benefits earlier and must maintain a policy covering distribution guidelines. The policy may be changed prospectively, but all distributions will need to be paid consistently to plan participants and in accordance with regulations, the plan, and policies in place at the time of the distributable event and request for payment. It is not uncommon for these "Administrative Distribution Rules" (which are not part of the ESOP Plan & Trust document) to be adjusted every two or three years to match up with the ability of the sponsor to make the payments and support stock value over time.

ENDNOTES

- 1 A K-1 return is a tax document used to report the income, losses, and dividends of a business' partners or S corporation shareholders.
- 2 IRC Section 401(a)(9).
- 3 IRC Section 401(a)(28)(B).

CHAPTER 6

LEGAL CONSIDERATIONS

Plan Compliance, Record Keeping and Department of Labor Audits

After the implementation of an ESOP, upkeep is needed annually to continue the management of the plan and to keep the plan compliant with the law. For instance, companies that sponsor ESOPs need to perform record keeping each year to allocate shares of company stock to employees and to inform employees of the value of their holdings, based on an independent annual valuation.

For an ESOP, the ongoing compliance process presents unique complexities. Although an ESOP is a qualified, defined-contribution plan, there are significant differences from a 401(k) or profit-sharing plan. The employer and trustees must consider the following to ensure documentation and compliance obligations are met:

- + Plan document amendments as required
- + Summary Plan Description (SPD)
- + Investment policy and actual investment of cash balances
- + Participant education
- + Plan record keeping, including analysis of the census and financial data
- + Production of an allocation report that includes financial statements; summary of financial assumptions and transactions (including release of shares of employer stock) for the plan year; results of applicable compliance tests; participant detail including updated eligibility and vesting; allocation detail in total and per participant including contributions, forfeitures, distributions, dividends or S corporation distributions, investment gain or loss, and ending balances

- + Participant statements
- + Administrative distribution policy
- + Management of the distribution process including Qualified Domestic Relations Orders
- + Method for funding of plan distributions (stock repurchase obligations)
- + Annual IRS Form 5500 tax return series & all related 5500 schedules
- + Plan audit by a CPA for plans with over 100 participants
- + Summary Annual Report (SAR) for participants

Compliance and administration is complex and time consuming. Sponsoring companies should consider retaining professionals to serve as ERISA counsel to prepare document amendments and address other issues, professional record keepers to handle all of the participant details and testing, and a CPA to prepare the Form 5500 tax filing and perform the plan audit (if applicable).

The annual tax return is due by the end of the seventh month after plan year end and is filed with the Department of Labor's Employee Benefits Security Administration (EBSA) in conjunction with the IRS. The DOL uses the filings to determine who will be selected for plan audit by the service.

If an employer's ESOP plan is selected by the DOL for audit, it does not mean there is an anticipated violation. Records will be requested and reviewed over months and a report issued with any findings of error with mandated corrections. ERISA counsel should be contacted upon receiving notification that a plan will be audited. (See Appendix A for a copy of the DOL ESOP Audit Checklist). If there are errors, various remedies are available and will be disclosed by the DOL auditor and resolved.

If an employer is made aware of or discovers an error that is an operational defect and the plan is not being audited by the IRS or DOL, then steps must be taken to correct plan operations and make the plan "whole."

Under an IRS program known as Employee Plans Compliance Resolution System (“EPCRS”), plan sponsors and other plan professionals can correct certain errors in employee retirement plans, in some cases without even having to notify the IRS. Correcting plans in this way allows participants to continue receiving tax-favored retirement benefits and protects the retirement benefits of employees and retirees.

EPCRS includes three levels of correction programs:¹

- + **The Self-Correction Program (SCP)** permits a plan sponsor to correct “insignificant operational failures” in certain simple plans, such as 403(b) plans, Simplified Employee Pension Plans (“SEPs”), or SIMPLE IRA plans. These corrections can be made without having to notify the IRS and without paying any fee or sanction.
- + **The Voluntary Correction Program (VCP)** allows a plan sponsor, at any time before an audit, to pay a limited fee and receive the IRS’s approval for a correction of a qualified plan, a 403(b) plan, SEP, or SIMPLE IRA plan.
- + **The Correction on Audit Program (Audit CAP)** allows a sponsor to correct a failure or an error that has been identified on audit and pay a sanction based on the nature, extent, and severity of the failure being corrected.

The VCP and Audit CAP programs are available to ESOPs. It is recommended that a tax and/or legal professional be involved in the planning of all corrections and filings under the programs.

What Is a Fiduciary?

Generally a fiduciary is anyone who has control or direction over ESOP assets. The principal persons who have a fiduciary role in an ESOP are the members of the Board of Directors and the Trustees of the ESOP, who are appointed by the Board. These fiduciaries are personally liable for their roles in operating the plan for the “exclusive benefit of the participants” under section 404(a)(1) of ERISA.

ESOP Fiduciary Exposure and Fiduciary Liability Coverage

To protect the assets of an ESOP as a qualified plan, plan fiduciaries must be covered by an ERISA bond. The bond coverage amount must be at least 10% of plan assets up to a maximum amount of \$1,000,000. This bond protects against liability for potential fund mismanagement by trustees, administrators, and others associated with managing the plan. An ERISA bond is commonly and readily obtained from an insurance company. However, the ERISA bond is not fiduciary liability coverage, which must be more than just “ERISA liability” insurance. The best coverage will encompass any conceivable discretionary judgment action and will not provide for a claims retroactive date.

Fiduciary liability exposure and insurance are at times misunderstood as many employee benefit plan decision-makers expect that there is some insurance coverage within the corporate Commercial and General Liability (“CGL”) portfolio that will respond to this exposure. In reality, not only is there no other insurance coverage available, but unlike D&O liability insurance, which almost always carries a specific exclusion for liability arising out of the ERISA legislation, there is no provision for utilization of corporate bylaw indemnification provisions within the liability imposed by ERISA.

There is also confusion with the ERISA-mandated insurance for employee dishonesty, which is satisfied by “ERISA bonds,” or more simply an endorsement to existing employee dishonesty insurance coverage. Such coverage has no bearing on any allegations of liability for mismanagement of benefit plan assets, or the decision to utilize a third-party administrator, for example.

Additionally, until recently, large fiduciary liability claims were unheard of, and with the demands of employees relating to benefit plan options, enrollment periods, and continuous changes in individual coverage details, many human resources managers devoted their time to issues other than possible liability scenarios.

Many sellers of liability insurance products do not understand the nuances of ERISA and fiduciary liability insurance. As generalists, many otherwise well-qualified agents do not have the resources to devote to getting involved with

coverage details of fiduciary liability insurance. As a result, many organizations purchase and maintain relatively low limits, without detailed thought toward limits benchmarking or individual employer exposure.

For many employers fiduciary liability insurance remains much of a mystery, with respect to both exposure and appropriate insurance coverage. The complexities and impending changes of the ERISA legislation continue to compound the liability exposure of corporate executives, many of whom remain unaware of their exposures as well as the exposure of their personal assets in this liability.

The good news is that there are specialty insurers working in the area of ESOP fiduciary liability insurance in sufficient numbers to get competitive quotes for the required coverage. ESOP sponsors should take care to review the terms of their CGL coverage.

Some Basic Bank Regulatory Considerations

When considering the purchase of bank or bank holding company stock by an ESOP, attention must be given to the possible application bank regulatory provisions such as Regulation W of the Federal Reserve (“Reg. W”) and the change of control provisions of the 1956 Bank Holding Company Act (“BHCA”) in addition to the provisions of the Internal Revenue Code applicable to such plans.

In most instances, a bank holding company will serve as the sponsor of the ESOP with the bank subsidiary also serving as an adopting employer thereby covering the employees of the bank. To fund the Plan, the bank would “upstream” funds in the form of a dividend or make direct contributions to the ESOP based upon the compensation of its employees. These contributions would be utilized to purchase stock in the bank holding company.

In some cases, however, the bank may be the sponsor of the ESOP for state tax reasons or the absence of a bank holding company.

In general, Reg. W governs transactions between member banks and their affiliates such as a purchase of assets from an affiliate, extension of credit

to an affiliate, investment in securities offered by an affiliate, issuance of a guarantee on behalf of an affiliate and certain other transactions that expose a member bank to its affiliate's credit or investment risk. For purposes of applying the provisions of Reg. W, an ESOP may be considered to be an "affiliate" relative to the acquisition of stock of a bank. However, Reg. W would not apply to a bank holding company that carries out these transactions with the ESOP as its affiliate.

For purposes of applying the change of control rules, even a minority interest ESOP may need to demonstrate that it is not in "control" of the bank, as defined in the BHCA or the ESOP may be deemed to be a bank holding company itself.

To avoid what is deemed a "change of control" for a member bank or its holding company sponsoring an ESOP, the trustees of the ESOP will often agree that the plan will not acquire 25% or more of the voting stock or in any way gain control without prior approval from the Federal Reserve. The ESOP is required to play a passive role if the Plan is to own from 10% to less than 25% of the voting shares. The passivity commitments may include, among others, an agreement not to seek to exercise a controlling influence over management or policies of the bank, and an agreement not to seek or accept representation on the board of directors. An ESOP transaction can be structured to avoid the characterization of control.

Other required agreements pertaining to the ESOP's ability to acquire securities include:

- + The ESOP will not acquire any security prohibited to the holding company by the BHCA;
- + The ESOP will not take on debt that results in the combined debt of the holding company and the ESOP exceeding 30% of the holding company equity without Federal Reserve approval;
- + If the ESOP is to acquire greater than 25% of a holding company's shares or if counter-dilution could result in an increase in the ESOP's ownership interest to that level, prior approval must be obtained to be a registered bank holding company.

Although the passivity commitments were developed by the Federal Reserve in the context of bank holding company regulation, these principles are of general applicability to investments in nonmember banks and national banks presently regulated by the FDIC and the OCC, respectively, and eventually to be regulated by the FDIC in the case of state chartered savings institutions and by the OCC in the case of federally chartered savings institutions.

What Securities Can an ESOP Purchase?

The simplest and most general rule is that an ESOP must own the employer security with the highest and best voting rights and dividend preferences.²

The technical definition of “employer securities” means common stock issued by the employer (or by a corporation that is a member of the same controlled group) having a combination of voting power and dividend rights equal to or in excess of:

- + That class of common stock of the employer having the greatest voting power; and,
- + That class of common stock of the employer having the greatest dividend rights.

An ESOP sponsored by an S corporation must hold the single class of stock required of S corporations. This is the common voting stock, even though some S corporations have both voting and non-voting shares (which are not treated as two “classes” of stock), the ESOP cannot buy non-voting equity.

Many S corporations, in becoming an ESOP company, will recapitalize some or all of the non-voting shares with voting shares, which are then sold to the ESOP. This is occasionally the case when using an ESOP to consolidate a number of minority, non-voting equity interests into a single untaxed shareholder (the ESOP).

Closely held C corporations often have multiple classes of stock and hundreds of shareholders. This is an area where a good securities counsel with knowledge of ESOP law is essential. A discussion of the many alternatives of stock that

may be issued to the ESOP is beyond the scope of this handbook, but an example will illustrate a few possibilities.

A C corporation ESOP can own a convertible preferred stock with voting rights instead of common voting shares. This would mean that the preferred dividend could be paid only on the ESOP shares, and not on shares held outside the ESOP (if not required on the common voting stock, for example). Dividends characterized as reasonable by the IRS would be deductible to the C corporation sponsor if used to retire ESOP stock acquisition debt. Further, the conversion of the preferred stock to common stock at the full curtailment of the ESOP loan can result in the ESOP ownership decreasing as a percentage of the common equity and the non-ESOP ownership increasing by virtue of the indirect equity kicker.

Another factor to keep in mind is the ability of bank holding companies to both sponsor an ESOP and effect corporate redemptions of their shares. This opens up the option of providing a tax-shield for the purchase of classes of stock that the ESOP cannot purchase directly. The holding company redemption of shares ineligible for ESOP purchases is followed by the reissuance of new common voting shares to the plan in an amount sufficient to offset the tax consequences of the non-deductible stock redemption.

ENDNOTES

- 1 EPRC IRS Overview: <http://mer.cr/o8GF1h>.
- 2 IRC 409(l).

CHAPTER 7

ESOP INSTALLATION CONSIDERATIONS

Dos and Don'ts When Installing a Plan

Do:

- + Coordinate the ESOP design with all compensation, employee benefit, key executive plan, and capitalization requirements. This coordination can at times even include a major stockholder's estate plan.
- + Consider using an ESOP to assist in repaying TARP or SBLF obligations, potentially in conjunction with other capital raising alternatives.
- + Ensure that the bank has sufficient profitability to take advantage of the tax advantages of contributions to an ESOP.
- + Educate employees regarding their influence on the value being created in the ESOP's stockholdings.
- + Engage in the process of managing the interaction and effect of stock flows between the company, shareholders, and ESOP.
- + Consider the funding requirements for the ESOP's ongoing stock repurchase obligations and actively manage the balance between the emerging liability and the bank's financial needs.
- + Obtain independent appraisals of the fair market value of closely held or thinly traded stock for the implementation of the ESOP and for ongoing ESOP transactions.

Don't:

- + Implement an ESOP without discussing the complex issues around plan design with a team of experienced professionals.

Managing the Implementation Process

Implementing a new ESOP prompts many questions, and the plan's investment in employer securities creates a different level of complexity than that found in the typical 401(k) or IRA. As such, expert advice is often needed from a variety of parties to resolve a number of issues. We have detailed a few key steps as well as some key questions to consider for certain steps to assist with successfully managing the implementation of an ESOP.

- + Examine strategic alternatives for the bank and determine whether an ESOP is an attractive option.
 - What are the strategic goals of the bank? Will an ESOP assist and/or complement the bank's strategic objectives?
 - What are the primary goals and objectives for the ESOP? To attract, retain, award employees? To improve capitalization? To assist with repayment of TARP and/or SBLF obligations? To provide an exit strategy for a shareholder?
 - What are the potential drawbacks to an ESOP?
 - How does an ESOP compare to other strategic alternatives?
- + Gauge interest among stakeholders (senior managers, shareholders, board, and employees) for installing an ESOP.
- + Engage a financial advisor to conduct a feasibility study, which typically provides a baseline estimate of the bank's value for the Board and management to consider when determining the attractiveness of the plan.

- Does the financial advisor have the appropriate expertise, (credentials, banking industry expertise, ESOP experience, etc.)? Is the financial advisor independent?
- + Engage an ERISA attorney and plan administrator to discuss plan design.
 - Do these professionals have the appropriate expertise (credentials, banking industry expertise, ESOP experience, etc.)? Are they independent?
- + Decide whether or not to proceed with the transaction.
- + Determine the transaction structure.
 - How much stock will be transacted?
 - Whose stock will be purchased by the ESOP? Will the stock be newly issued and/or purchased from an existing shareholder?
- + Determine the funding mechanism.
 - Will the plan be leveraged, non-leveraged, or some combination?
 - Who will provide the loan if the plan is leveraged? What will the terms of the debt be?
 - How will the additional leverage impact the bank's value (both at implementation and going forward) and financial condition (earnings and balance sheet/capital ratio impact)?
- + Determine ESOP trustee or Administrative Committee.
 - Will these roles be filled internally (from an officer or group of employees within the company) or outside the company (attorney or corporate trustee)?

- + Determine the strategy, depth, and breadth of employee communications once implemented.
- + Engage a financial advisor to render an appraisal upon which the transaction can occur.
- + Discuss the treatment of emerging liability created by the ESOP's obligation to repurchase shares once the plan is implemented with your team of advisors.
- + Formalize ESOP documents and necessary filings.
- + Close the transaction.

Selection of the Advisory Team and Their Roles

Perhaps the most important aspect to successfully implementing an ESOP is to assemble a collegial and competent team. Banking industry and ESOP expertise should be an important consideration when selecting your advisors. Employee benefit plan design and administration is complex and requires the services of a number of professionals.

- + **Trustee** – The trustee acts as a fiduciary for the best interest of the plan participant and may be very active in an ESOP. In the context of an ESOP, the trustee is responsible for the purchase of employer securities and the proper maintenance and administration of the plan. When dealing with closely held securities, the trustee has a heightened level of responsibility. With respect to any plan which requires an appraisal, the trustee must select the appraiser and approve the conclusion of value for securities held by the plan.
- + **Administrator** – The administrator is responsible for record keeping and may also assist with tax filings and maintenance of plan documents. It is best not to handle the annual plan administration in-house. Engage a third party ESOP administrative specialty firm to prepare the annual

trust reconciliation and accounting, the participant account statements, and the filing of the Form 5500 tax return for the plan.

- + **Plan Sponsor** – The plan sponsor is typically the company.
- + **Administrative Committee** – Known by a variety of names, an administrative committee is often formed to assist the plan administrator and trustee with various duties associated with the routine administration of the plan.
- + **Attorney or Plan Designer** – The attorney works with the plan sponsor, administrative committee, and trustee to design the plan and create the documents necessary to implement it. Choose a design and implementation advisor who will work: a) with your CPA, corporate counsel, and other existing advisors, and b) under a capped fee arrangement – preferably in stages, with at least a cutoff point after a discovery phase.
- + **Financial Advisor** – The financial advisor may assist the trustee in determining the feasibility of a plan or the fairness of transactions engaged in by the plan from a financial point of view.
- + **Appraiser** – The appraiser provides the independent appraisals necessary to implement and administer the plan. (See Chapter 4, which discusses the scope of work by the appraiser. The use of the term “appraisal” is very specific in this context.)

Assure good communications between your corporate operations, the independent valuation firm, and the plan administrator. Be prepared to deal with complexity and be part of the process. This process has saved many shareholders and companies millions in taxes, made a controlled market for the stock, and rewarded the loyal, long term employees generously.

APPENDIX A

DEPARTMENT OF LABOR ESOP AUDIT CHECKLIST

1. The Plan's Annual Report (Form 5500), including the audited financial statements and the independent auditor's opinion thereon.
2. The current Plan document including any and all amendments.
3. The current trust agreement for the Plan.
4. The current Adoption agreement including any amendments.
5. The Summary Plan Description as distributed to participants in the Plan.
6. The most recent I.R.S. qualification letter for the Plan.
7. The Plan's Summary Annual Reports as distributed to participants for the last three consecutive years.
8. Financial statements, canceled checks, wire transfer statements, and other documents revealing the Company's contribution to the plan.
9. The Plan's current fidelity bond policy (which identifies the Plan as the named insured, the bond carries no deductible, the amount is sufficient to meet ERISA requirements, and that the general policy provisions include a one year discovery period).
10. The Trustees and Plan Administrator's fiduciary liability insurance policy(ies) (if applicable).

11. The Plan's written investment policies/guidelines (if applicable).
12. Information pertaining to the Plan's purchase of Company shares. Such information should include:
 - A. The characteristics of the Company shares (i.e. common stock, preferred stock, cumulative preferred stock, participating preferred stock, stock warrants, stock restrictions, voting, non-voting, etc.);
 - B. The date(s) that the Plan purchased the aforementioned shares;
 - C. The price paid by the Plan for the Company Stock;
 - D. The independent appraisals used by the Plan's fiduciaries to ascertain that the Plan was purchasing the party-in-interest investments at an arm's length price;
 - E. The price paid for the aforementioned independent appraisals;
 - F. The identification of those assets liquidated by the Plan in order to purchase this investment (if applicable);
 - G. The identity of the broker(s) transferring the company stock [if applicable];
 - H. Document any fees and/or commissions paid by the Plan in purchasing and transferring the stock to the Plan;
 - I. If debt was incurred to purchase the employer shares, and this debt remains outstanding, please provide the allocation formula and accompanying work product used by the Plan fiduciaries to release these encumbered shares to the Plan participants in accordance with D.O.L. Reg. §2550.408b-3(h). This

information should include the Plan's amortization schedule; a schedule of payments made to date; a schedule illustrating the appropriate release of encumbered shares to the Plan's trust account once payment was received; and, the allocation of the encumbered shares to the participants' individual accounts.

13. Information pertaining to the Plan's continued holding of Company stock. Such information should include:
 - A. The Plan's rate of return on this party-in-interest investment;
 - B. Dividends paid by the Company to the Plan;
 - C. Sales of the party-in-interest Company stock from the Plan; to include, but not be limited to, the following information:
 1. the date the shares were sold;
 2. the identification of the purchaser;
 3. the purchase price paid for the shares;
 4. the method used by the Plan's fiduciaries to determine the purchase price;
 5. the identification of any fees and/or commissions paid by the Plan in the selling of the shares; and
 6. the identification of those parties who received fees and/or commissions from the sales of these party-in-interest investments;
14. Provide a list of all Company employees; indicate current employees, also provide the date and reason former employees terminated such as retirement, disability, death or termination for some other reason.

15. For each terminated person identified in item #13, indicate whether that person received a distribution from the Plan, indicate whether the person elected to receive cash or Company stock, indicate the date the person was given a distribution, also provide the dollar (\$) amount of the distribution.
16. For each terminated person identified in item # 13, indicate whether that person exercised a put option, submit a copy of the put option exercised, the total value of the put option at the time it was exercised (# of shares and dollar per share), and the determination of the value of the security at the time it was exercised, payment terms and schedules.
17. Provide a list of all hardship distributions made from the Plan; provide a copy of the documentation submitted requesting the hardship distributions and the review and approval process, also indicate the amount and date of each hardship distribution.
18. Management letters written to the Plan's fiduciaries from the Plan's independent certified public accounting firm.
19. Management letters written to the Company's Board of Directors from the Company's independent certified public accounting firm.
20. Information pertaining to any private placement or private sale of Company stock for the past three years (if applicable).
21. The Company share certificates owned by the Plan and the percentage of outstanding Company shares held by the Plan.
22. A list of current Company shareholders and the number of shares that they own.

23. Company dividend policies on the stock held by the Plan.
24. A list of all Company mergers within the last three years that required shareholder vote.
25. A list of all Company consolidations within the last three years that required shareholder vote.
26. A list of all Company recapitalizations within the last three years that required shareholder vote
27. A list of all Company reclassifications within the last three years that required shareholder vote.
28. A list of all Company liquidations within the last three years that required shareholder vote.
29. A list of all Company dissolutions within the last three years that required shareholder vote.
30. A list of all sales of the Company or portions of the Company within the last three years that required shareholder vote.
31. A list of Company officers and Plan Trustees for Plan.

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Bill Gust has been assisting closely held corporations in developing and integrating business succession and estate plans for over 20 years. As part of the process, Bill works closely with allied professionals in banking, insurance and financial services industries. The development of a successful business succession strategy requires the integration of multiple disciplines to properly implement life insurance, deferred compensation, and estate planning strategies necessary for a tax-favored transition.

Bill serves as the President of Corporate Capital Resources, a wholly owned subsidiary of the Roanoke law firm Gentry Locke Rakes & Moore. In addition to his consulting role on behalf of Corporate Capital Resources, Bill is a Partner in Gentry Locke Rakes & Moore, where he specializes in Business, Tax, and Estate Planning.

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As a member of The National Center for Employee Ownership and the ESOP Association, Michael has published numerous articles on employee ownership issues, and has addressed many national forums on tax-advantaged business perpetuation.

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Andy provides valuation and corporate advisory services to financial institutions for purposes including ESOPs, mergers and acquisitions, profit sharing plans, estate and gift tax planning, compliance matters, and corporate planning.

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In addition, Andy directs projects related to the valuation of intangible assets under Accounting Standards Codification ("ASC") 805 and impairment testing under ASC 350.

Andy is the co-author of *The Bank Director's Valuation Handbook: What Every Director Must Know About Valuation*, with Jay D. Wilson, Jr., CFA, as well as *Acquiring a Failed Bank: A Guide to Understanding, Valuing, and Accounting for Transactions in a Distressed Environment*, published by Peabody Publishing, LP.

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About Corporate Capital Resources, LLC

Corporate Capital Resources works with clients involved in a variety of activities ranging from banking and service to manufacturing and sales. Our customers also range significantly in size, from a handful of employees at a closely held family company to companies with locations in several states.

Possibilities - How We Help Our Clients

- + **Banking & Lending** – Money is the lifeblood of a business. Helping companies secure capital needed for growth often requires extensive expertise in defining assets and demonstrating ability to repay. We have the ability to help companies present compelling cases for growth and the contacts with the banking industry to realize capital.
- + **Business Continuity** – How can you effectively plan to pass ownership to a new generation? The needs of both ownership and the company must be balanced to create an optimum environment for potential success. Corporate Capital Resources has effectively helped transition ownership to both individuals and employee owners. We help ensure the transition of your business with minimal adverse tax effects. The ultimate goal is best summarized in three concepts for private shareholders: control, flexibility, and financial efficiency.
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For more information, visit our website at www.ccrva.com, or contact Bill Gust or Michael Coffey at 540.345.4190.

About Mercer Capital

The Financial Institutions Group of Mercer Capital provides a broad range of specialized valuation and advisory services to the financial services industry. Though maintaining a particular emphasis among commercial banks, the Financial Institutions Group also assists insurance services, specialized finance companies, mortgage bankers, asset managers, broker/dealers, and merchant processors.

Mercer Capital has been assisting financial institutions with significant corporate valuation, transactions, and other strategic decisions for 30 years. We have provided hundreds of sound, well-documented financial analyses and valuation opinions for financial institutions large and small. In addition, we have a wealth of transaction experience helping clients with mergers, acquisitions, recapitalizations, and other substantial transactions.

Mercer Capital is a thought-leader among valuation firms in the financial institutions industry. In addition to scores of articles and three books - *Acquiring a Failed Bank* (2010), *The Bank Director's Valuation Handbook* (2009), and *Valuing Financial Institutions* (1991) - the Financial Institutions Group publishes *Bank Watch*, a free monthly e-mail newsletter covering five U.S. regions.

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- + Transaction Advisory Consulting
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THE ESOP HANDBOOK FOR BANKS

Exploring an Alternative for Liquidity and Capital While Maintaining Independence

This handbook addresses an important omission in the current financial environment: the lack of a broader, strategic understanding of the possible roles of Employee Stock Ownership Plans, or ESOPs, as a tool for managing a variety of issues facing banks.

Banks proportionately make more use of ESOPs than any other industrial classification in the U.S., often without understanding the extent of their potential applications. While an ESOP is not suitable in all circumstances, an ESOP may provide assistance in resolving the following issues, either by itself or in conjunction with other elements of a well-rounded strategic plan:

- + Augmenting capital, particularly for profitable institutions facing limited access to external capital.
- + Facilitating stock purchases by creating an "internal" stock market.
- + Providing employee benefits by rewarding employees that add to the institution's long-term value.

This handbook describes the function of ESOPs in the real world of banks and bank holding companies. Bank directors and managers can use the information in this handbook to make solid, initial decisions regarding the potential merits of an ESOP.

Before embarking on a particular strategy to deal with the various challenges facing small to mid-size banks, the decision makers in profitable institutions may wish to consider how an ESOP can assist in addressing issues such as shareholder liquidity, employee ownership and compensation, and capital management.

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