External Limits on ESOPs: Special Considerations for Professional Corporations & Government Contractors

2013 ESOP Invitational at Pinehurst
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AREAS OF PRACTICE
• Employee Benefits
• Mergers & Acquisitions
• Taxation
• ESOPs

EDUCATION
University of Virginia School of Law
• Virginia Law Review

Hampden-Sydney College
B.A., Economics & Commerce; Greek & Latin
• James Madison Scholar
• Phi Beta Kappa

PROMINENT ASSIGNMENTS
Chris Horner is an Associate in the Washington, D.C. office. Mr. Horner’s practice includes a variety of matters with particular focus on employee stock ownership plans (“ESOPs”).

PROFESSIONAL INVOLVEMENT
• Member – National Center for Employee Ownership
• Member – The ESOP Association
• Associate Member – The ESOP Association Legislative and Regulatory Committee
• Member – Mid-Atlantic Chapter of the ESOP Association
Bill provides legal guidance in the design, implementation and administration of retirement and executive compensation plans, including incentive and deferred compensation arrangements, supplemental retirement plans, and equity based compensation arrangements. He has extensive experience with Ownership Succession Planning, including Employee Stock Ownership Plans (ESOPs), and the unique issues they raise. Bill has counseled tax-exempt organizations, including hospitals and health care providers, in employee benefits matters, particularly retirement planning and executive compensation issues in mergers, affiliations and divestitures.

Bill’s formal business training and experience enable him to understand and consider the practical business considerations commonly faced by business owners, which he brings to bear in advising both them and their outside consultants.
Ron Gilbert
President and Cofounder, ESOP Services, Inc.

Ronald J. Gilbert (“Ron”) is cofounder and President of ESOP Services, Inc., an international consulting firm specializing in all aspects of Employee Stock Ownership Plan (“ESOP”) applications.

He currently serves on the board of directors of The National Center for Employee Ownership, The ESOP Association’s Board of Governors and the Legislative and Regulatory Advisory Committee, and the board of directors of four ESOP companies.

Ron Gilbert is co-author and co-editor of *Employee Stock Ownership Plans: ESOP Planning, Financing, Implementation, Law and Taxation*, the most comprehensive work on the subject, published by the Beyster Institute.

Prior to cofounding ESOP Services, Inc., Ron was a Vice President of Kelso & Company in San Francisco, where he worked with Louis Kelso, the “father” of the ESOP.
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- Agenda
- Takeaways
- Leveraged ESOP Transaction
- Professional Corporations
- Survey of Select State Laws
- Alternative Leveraged ESOP Transaction
- Federal Government Contractor Considerations
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• **TAKEAWAYS**
  • Leveraged ESOP Transaction
  • Professional Corporations
  • Survey of Select State Laws
  • Alternative Legal Considerations
  • Practical Considerations
  • Leveraged ESOP Transactions Involving Professional Corporations
Takeaways

- Professional corporations can and do sponsor ESOPs.
- State law frequently restricts who is eligible to hold shares of a professional corporation.
- State laws governing professional corporations vary considerably and the characteristics of an ESOP-owned professional corporation will vary accordingly.
- Professional corporations seeking to sponsor an ESOP should retain competent legal and financial advisors to counsel them through the transaction.
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Leveraged ESOP Transaction

Step 1: Senior Lender loans funds to Corporation in exchange for a promissory note ("Outside Loan").

Step 2: Corporation loans these same funds to the Trust in exchange for a promissory note made by the Trust and payable to the order of the Corporation ("Inside Loan").

Step 3: Trust uses funds to purchase qualifying employer securities from Shareholder(s).
Leveraged ESOP Transaction

STEP 1

$ → SENIOR LENDER

STEP 2

CORPORATION → PROMISSORY NOTE → STEP 2

STEP 3

$ ← TRUST

SHAREHOLDERS

CAPITAL STOCK

PROMISSORY NOTE
Leveraged ESOP Transaction

- Prohibited Transaction Rules
  - ERISA §406
  - Code §4975(c)
- Exemptions From Prohibited Transaction Rules
  - ERISA §408(e); DOL Reg. §2550.408e
  - Code §4975(d)(13)
- “Qualifying Employer Security”
  - ERISA Sec. 407(d)(1); DOL Reg. 2550.407d-5
  - Code Sec. 409(l); Treas. Reg. 54.4975-12
Leveraged ESOP Transaction

[ERISA Sec. 407]

(d) DEFINITIONS.— For purposes of this section—

(5) the term “qualifying employer security” means any employer security which is –

(A) stock….
Leveraged ESOP Transaction

[DOL Reg. 2550.407d-5]

**DEFINITION OF THE TERM “QUALIFYING EMPLOYER SECURITY”**. (a) *In general.* For purposes of this section and section 407(d)(5) of the Employee Retirement Income Security Act of 1974 (the Act), the term “qualifying employer security” means an employer security which is:

1. **Stock**; or....
(l) **EMPLOYER SECURITIES DEFINED.** —For purposes of this section—

(1) **IN GENERAL.**—the term “employer securities” means common stock **issued by the employer** (or by a corporation which is a member of the same controlled group) which is readily tradable on an established securities market.

(2) **SPECIAL RULE WHERE THERE IS NO READILY TRADABLE COMMON STOCK.**— If there is no common stock which meets the requirements of paragraph (1), the term “employer securities” means **common stock issued by the employer** (or by a corporation which is a member of the same controlled group) having a combination of voting power and dividend rights equal to or in excess of—

(A) the class of common stock of the employer (or of any such corporation) having the greatest voting power, and

(B) the class of common stock of the employer (or any of such corporation) having the greatest dividend rights.
Leveraged ESOP Transaction

[Treas. Reg. 54.4975-12]

DEFINITION OF THE TERM “QUALIFYING EMPLOYER SECURITY”.— (a) In general. For purposes of section 4975(e)(8) and this section, the term “qualifying employer security” means an employer security which is:

(1) Stock or otherwise an equity security....
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Professional Corporations

• Definition

• Historical Overview
  • Introduced to regulate the use of the corporate form by licensed professionals such as attorneys, architects, engineers, public accountants, and physicians.

• Select Distinguishing Characteristics
  • Limited Liability to Members
  • Corporate Designation
  • Diversity Jurisdiction
  • Restrictions on Eligibility to be a Shareholder
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Survey of Select State Laws
Survey of Select State Laws

Commonwealth of Virginia

- Professional corporations organized to render services in the field of architecture, professional engineering, land surveying, or landscape architecture must issue at least two-thirds of their shares to licensees.
- Professional corporations organized to render services in the field of accountancy must issue at least fifty-one percent of its shares to licensees, including trustees of an employee stock ownership trust.
- Professional corporations organized to render services in a field not previously mentioned may not issue any of its shares to non-licensees.
Commonwealth of Virginia

- Professional corporations rendering professional services in the fields of accountancy, architecture, engineering, land surveying, and interior design are permitted to sponsor an ESOP. All other professional corporations not enumerated are not permitted to sponsor an ESOP.
- All trustees must be licensees, except for specific conflict of interest transactions.
- The plan document must restrict distribution of shares to licensees only. Shares may be distributed to non-licensees if the plan document provides that the shares will be immediately repurchased.
The ratio of shares allocated to non-licensee accounts and unallocated but allocable to non-licensee accounts shall not exceed one-half of the total shares of the professional corporation.

The ratio of shares allocated to non-licensee accounts and unallocated but allocable to non-licensee accounts shall not exceed one-third of the total shares of the professional corporation.
(a) Entities to whom stock may be issued. -- A professional corporation may issue stock, rights, and options to purchase stock to:

(1) An **individual who is authorized by law in this or another state to render a professional service** named in the corporation's articles of incorporation;

(2) A **general partnership** in which all the partners are qualified persons with respect to the professional corporation and in which at least one partner is authorized by law in this State to render a professional service named in the corporation's articles of incorporation; and

(3) A **professional corporation**, domestic or foreign, provided that the professional corporation receiving the stock is organized to perform the same professional service as the professional corporation issuing the stock.
(a) In general. -- A stockholder of a professional corporation may transfer or pledge stock, fractional stock, and rights or options to purchase stock of the corporation only to a qualified person.

(b) Void transfers. -- A transfer of stock made in violation of subsection (a) of this section, except a transfer made by operation of law or by court judgment, is void.
State of Maryland

[MD. CODE ANN. CORPS. & ASSOC’S. 5-101]

(a) In general. -- In this subtitle the following words have the meanings indicated.

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(h) Qualified person. -- "Qualified person" means an individual, professional corporation, or general partnership that is eligible under this Act to be issued stock by a professional corporation.
State of Maryland

[MD. CODE ANN. ECONOMIC DEVELOPMENT 14-101]

§ 14-101. Statement of policy
(a) In general. -- The State:
   (1) recognizes the declaration of the Joint Economic Committee of the Congress of the United States that broadening the ownership of capital and achieving full employment should be the twin pillars of economic policy; and
   (2) encourages the broadening of the base of capital ownership among greater numbers of the residents of the State through, as one means, the use of employee stock ownership plans.
State of Maryland

[MD. CODE ANN. ECONOMIC DEVELOPMENT 14-101]

§ 14-101. Statement of policy

*(b) Findings. -- The General Assembly finds that employee stock ownership plans, as defined in the Internal Revenue Code, make an important contribution toward the broadening of capital ownership, increase the income and financial security of the residents of the State, assure the residents of the State greater control of their economic futures, improve productivity and labor-management relations, contribute to the national effort to combat inflation, strengthen the free enterprise system, and put Maryland in the forefront of contemporary economic trends.*
Under G.S. 55B-6, may an architectural professional corporation establish an employee stock ownership plan (ESOP) wherein up to one third of the outstanding shares of the professional corporation are held in trust, by a trustee who is a licensed employee of the corporation, for the benefit of non-licensed employees of the corporation?
Survey of Select State Laws

State of North Carolina

[56 N.C.A.G 43 (1986)]

“[T]he participants under the plan would be equitable but not legal owners of the stock which constitutes the corpus of the trust. Since the participants are never given or promised any legal interest in the stock, they have no voting power and they are incapable of entering into an agreement to vest the voting power of the stock in another.”
"The policy behind G.S. 55B-6 presumably is that of keeping majority control of a professional corporation in the hands of licensed professionals who will manage the corporation consistent with the ethical standards of the profession. (See Official Comment to Model Professional Corporation Act § 22). The proposed ESOP would in no way contravene this policy, nor would it violate the statute. **All ESOP shares would be voted by the trustee, a licensed professional employee of the corporation. Moreover, the ESOP would absorb only so many shares as would allow the total number of shares owned by non-licensed employees (either equitably or legally) to be less than one third of the total amount of outstanding shares. This is consistent with G.S. 55B**"
§55B-6. Capital stock.

(a) Except as provided in subsections (a1) and (b) of this section, a professional corporation may issue shares of its capital stock only to a licensee as defined in G.S. 55B-2, and a shareholder may voluntarily transfer shares of stock issued to the shareholder only to another licensee. With respect to a professional corporation rendering services as defined in Chapters 83A [Architecture], 89A [Engineering and Land Survey], 89C [Landscape Architecture], and 89E [Geology] of the General Statutes, an employee retirement plan qualified under section 401 of the Internal Revenue Code of 1986, as amended (or any successor section), is deemed for purposes of this section to be a licensee if the trustee or trustees of the plan are licensees.
Survey of Select State Laws

(a) A professional corporation may issue shares, fractional shares, and rights or options to purchase shares only to:

   (1) **individuals** who are authorized by law in this or another state to render a professional service described in the corporation's articles of incorporation;

   (2) **general partnerships** in which all the partners are qualified persons with respect to the professional corporation and in which at least one partner is authorized by law in this state to render a professional service described in the corporation's articles of incorporation;

   (3) **professional corporations**, domestic or foreign, authorized by law in this State to render a professional service described in the corporation's articles of incorporation.

(b) If a licensing authority with jurisdiction over a profession considers it necessary to prevent violation of the ethical standards of the profession, the authority by rule may restrict or condition, or revoke in part, the authority of professional corporations subject to its jurisdiction to issue shares. A rule promulgated under this section does not, of itself, make a shareholder of a professional corporation at the time the rule becomes effective a disqualified person.

(c) Shares issued in violation of this section or rules promulgated under this section are void.
Section 33-19-200. Share transfer restriction.

(a) A shareholder of a professional corporation may transfer or pledge shares, fractional shares, and rights or options to purchase shares of the corporation only to individuals, general partnerships, and professional corporations qualified under Section 33-19-200 to be issued shares.

(b) A transfer of shares made in violation of subsection (a), except one made by operation of law or court judgment, is void.
State of South Carolina

Section 33-19-221. Attempted share transfer in breach of prohibition.

(a) An attempt to transfer shares in a professional corporation in violation of a prohibition against transfer binding on the transferee is ineffective.

(b) An attempt to transfer shares in a professional corporation in violation of a prohibition against transfer that is not binding on the transferee, either because the notice required by Section 33-19-210 was not given or because the prohibition is held unenforceable by a court, gives the professional corporation an option to purchase the shares from the transferee for the same price and on the same terms that he purchased them. To exercise its option, the corporation must give the transferee written notice within thirty days after they are presented for registration in the transferee’s name. The professional corporation may enforce specifically the transferee’s sale obligation upon exercise of its purchase option.
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Alternative Leveraged ESOP Transaction

Step 1: Shareholder(s) incorporate(s) Management Corporation. Corporation and Management Corporation establish management contracts whereby Management Corporation provides management services to Corporation in exchange for management fees.

Step 2: Senior Lender loans funds to Management Corporation in exchange for a promissory note (“Outside Loan”).

Step 3: Management Corporation loans these same funds to the Trust in exchange for a promissory note made by the Trust and payable to the order of the Management Corporation (“Inside Loan”).

Step 4: Trust uses funds to purchase qualifying employer securities from Shareholder(s).
Alternative Leveraged ESOP Transaction

1. Corporation pays Mgmt. Fees to Management Corporation

2. Senior Lender provides Note to Management Corporation

3. Management Corporation pays Note to Senior Lender

4. Ownership transfer of Shares from Corp. to Trust

CATEGORIES OF PARTIES

CORPORATION

MANAGEMENT CORPORATION

SHAREHOLDERS

SENIOR LENDER

TRUST
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Federal Government Contractors Considerations

- Sequestrian update
- Ownership requirements
- State of the market
- DCAA
- Prevailing Wage Acts
Ownership Requirements

- 51%
  - 8A
  - Woman owned
  - Etc.

- Exception
  - VA-ignores ESOP – 38 CFR-74h
  - Five or fewer owners
  - 1% veteran-owned example
  - 100% ESOP?
State of the Market

- $10,000,000 - $50,000,000 Flat Market
- Change of control can cause contract cancellation
- IRC 1042 “tax-free” rollover
## “Tax-Free” Rollover Example

<table>
<thead>
<tr>
<th>Transaction Amount</th>
<th>Federal Capital Gains Rate</th>
<th>State Tax Rate (rates vary from 0% – 13%)</th>
<th>Total Tax on Sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000,000</td>
<td>23.8%</td>
<td>6.2%</td>
<td>30%</td>
</tr>
<tr>
<td>Non-ESOP sale Taxes due</td>
<td>$2,380,000</td>
<td>$620,000</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>ESOP-IRC 1042 sale Taxes due</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
</tr>
</tbody>
</table>
DCAA

Audits

- Confrontational
- 1099 issue
- Not closed for one year or more
- 15% holdbacks
Recipients of federal government contracts, grants, or financial aid are subject to wage, hour, benefits, and safety and health standards:

**Davis-Bacon Act** - requires payment of prevailing wages and benefits to employees of contractors engaged in construction projects

**McNamara-O'Hara Service Contract Act** - sets wage rates and other labor standards for employees of contractors furnishing services

**Walsh-Healey Public Contracts Act** - requires payment of minimum wages and other labor standards by contractors providing materials and supplies
Generally…

An ESOP can provide required benefits
• Immediate eligibility and 100% vesting
• Receives at least quarterly contributions
• Does not require employment on last day of year

Contributions are subject to coverage and non-discrimination testing
Leverage creates challenges

- In the early years contributions are generally greater than value of shares released. In later years, contribution can be less than the value of the shares release. Which value applies to testing criteria?
- Can be non-leveraged

Payouts are typically delayed

- Employees tend to think of “fringe benefits” as cash payments when terminated. ESOP payouts are not typically immediate
Questions or Comments?

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