



The Big 5 Conference

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STORIES FROM THE FRONT LINES

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Background

ESOPs are like football games – steering clear of mistakes is important to a successful ESOP. But like mistakes in football, some are worse than others:

- ⦿ **5 yard penalty** – they seem pretty minor but could have an impact on the outcome of your ESOP game down the road.
- ⦿ **Missed block** – they can result in a more immediate problem or a missed opportunity that really hurts later on in the game.
- ⦿ **Red Zone Turnovers** – they have huge impact, major momentum shift.

We are going to discuss some things we've seen that fall into each and how they can impact your ESOP and your company's financing arrangements.

5 – Yard Penalty: Operation/Administration

- ◎ Story
 - Company doesn't coordinate ESOP with 401(k); breaches 415 limits
 - Safe harbor match applied to wrong plan
- ◎ Other Operational & Administration Errors
 - Record keeping, allocations, compliance testing, distributions & diversification
 - Coordination with other benefit plans, notably 401(k)
 - Failure to administer plan account to ESOP plan's provisions Make distribution payouts over longer period without amending plan or adopting written, formal distribution policy
 - Don't make diversification payouts within time frame set under ERISA
- ◎ Financial Consequences
 - DOL/IRS penalties
 - Litigation
 - If really egregious and represents pattern of abuse, could result in plan disqualification

The Missed Block: Repurchase Obligation

- ◎ Story
 - Plan changed to require lump sum payouts
 - Experienced large repayment obligation during period of workforce reduction
 - Resulted in large repurchase obligation over short period of time during difficult economic period
- ◎ Common mistakes
 - Lack of planning & analysis
 - When designing plan
 - Establishing strategy to manage repurchase obligation (e.g. recycle vs. redeem)
 - Failure to perform repurchase study and assess best way to handle RO – redeem, recycle or leverage?
 - Allow valuation to be inappropriately high
 - Projections reasonable?
 - Conclusion make sense?
- ◎ Financial consequences
 - Dollar cost of repurchase obligation grows to be too high and can't be sustained by Company's cash flows

Red Zone Turnover: Prohibited Transaction

- ◎ Story
 - Redeemed shares from ESOP without bring-down opinion from last valuation
 - Resulted in underpayment for shares
- ◎ Common mistakes
 - Existing ESOPs
 - Inside trustees and apparent conflicts of interest
 - ESOP receives less than “adequate consideration” for stock in a sale
 - New ESOPs or second stage transactions
 - Price above “adequate consideration” or valuation supporting price not current
 - Preferred dividends – too large
 - Seller warrants – too large
 - Internal loan as a PT
- ◎ Financial consequences of PTs
 - Rescission vs. price adjustment
 - 20% excise tax on recovery amount
 - Income tax implications – Plan disqualification = loss of S election

Red Zone Turnover: 409(p)

- ⦿ What is 409(p)? – Its about ownership concentration
- ⦿ Stories
 - Co. A failed to include deferred comp. as part of synthetic equity in 409(p) test
 - Came perilously close to tripping 409(p) violation just as it was executing significant transaction
 - Co. B's test was performed incorrectly, masking actual 409(p) violation
- ⦿ Common mistakes
 - Test performed incorrectly or fail to test altogether
 - Add synthetic equity or deferred compensation without consulting advisors
- ⦿ Financial consequences of 409(p) violation
 - 50% tax to the Company on the value of DQP's holdings in the ESOP.
 - Potential plan disqualification with resulting loss of Company's S election.
 - Levy C corporation income taxes to date of retroactive plan disqualification.
 - Limited experience in negotiating resolutions – community doesn't have good roadmap

Red Zone Turnover: S Election

- ◎ Stories
 - Co. A had previously converted to S, but retained two classes of stock
 - Had to resolve error with IRS prior to closing significant financing transaction
 - Co. B closing new ESOP with significant warrant package attached to seller financing
 - Obtained analytical support for strike price to protect S election
- ◎ Common mistakes
 - Second class of stock – An S corporation is not allowed to have two classes of stock.
 - Having two classes of stock – forget to eliminate second class had as a C.
 - Warrants – strike price too low or exercise period too long
 - Disproportionate distributions
 - Invalid S shareholder
 - Trust – qualified plan trust is ok; if plan disqualified, violates S election
- ◎ Financial Consequences of Loss of S Election
 - Company must pay corporate-level income taxes
 - May owe corporate income taxes back to date of event causing loss of S election

Financing Arrangements - Impact?

- ◎ Cost to borrower impacts credit worthiness
 - Big excise & income tax penalties can harm liquidity and capital position
 - Expose company to further private litigation brought by participants
- ◎ Tax position going forward
 - Loss of ESOP tax deductions or tax shield from combination of ESOP & S election will mean company will pay higher income taxes going forward
 - If transaction depended upon those tax savings, future company cash flow may not be sufficient to service and pay off debt
- ◎ Repurchase obligation
 - Could become too large to finance out of operating cash flow
 - Growth in annual cash claim relative to operating cash flow could cause covenant violation in credit agreement
 - Lender wants to understand how will deal with repurchase obligation going forward

How to Keep Offense Moving & Avoid Mistakes?

- ◎ Quality advisors – do your homework.
 - See if they are dedicated to ESOP practice or if it is part of ERISA/employee benefits practice (may not do that many ESOP deals a year or have experience dealing with DOL & IRS on compliance issues).
 - ERISA expertise is NOT the same as ESOP expertise and not enough.
 - Participation in the ESOP community is a plus as well.
- ◎ Learn, Learn and Learn some more – like watching game film.
 - More you know, the more likely you are to see issues before they are looming in front of you like a big middle linebacker in your passing lane.
 - Ask questions of your advisors and make sure you understand their answers.
- ◎ Prevention better than correction
 - Might be more expensive to use an outside trustee or plan administration firm.
 - Worth it because even minor compliance issues could be expensive to fix.
- ◎ Always try to do the right thing – it helps if the mistake is an honest one.

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Eric Zaiman is a Senior Vice President in the ESOP Advisory Group at JPMorgan Chase & Co.

Professional Experience:

A 23 year veteran of the finance industry, Eric is a senior vice president in the ESOP Advisory Group (EAG). Eric has a leadership role in managing ESOP financing transactions, including evaluation, structuring, underwriting and execution. Eric is actively involved in the EAG's portfolio management efforts as well. Like all members of the EAG, Eric is dedicated to helping bankers and their privately held clients evaluate the benefits of selling stock to an ESOP and provide liquidity in the transition.

Prior to joining JPMorgan Chase in 2009, Eric served for 11 years with financial advisory firm Duff & Phelps and a predecessor firm in its N.Y. office. Eric has structured and raised financing for ESOP transactions representing companies and sellers. In addition, Eric has represented ESOP trustees, issuing transaction and valuation opinions. Eric began his career in banking, served as a relationship manager and lender and in a credit/risk management role.

Memberships:

ESOP Association in Washington, D.C.

ESOP Association's Valuation Advisory Committee – Associate Member

Executive Board Member – ESOP Association's NY/NJ Chapter

National Center for Employee Ownership

Association for Corporate Growth

EDUCATION:

BA – Economics, Yeshiva University

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Jeffrey S. Kahn is a Shareholder in the Boca Raton office of the international law firm of Greenberg Traurig where he is a member of the firm's Global Benefits and Compensation Group and is the Co-Chair of the firm's ESOP Practice Group. His practice focuses on retirement plans, executive compensation, and the design, implementation and operation of Employee Stock Ownership Plans (ESOPs). A frequent lecturer and author, Jeff has published articles in numerous professional and trade magazines and has lectured frequently before professional, charitable, financial, and business audiences on ERISA, ESOPs, and other employee benefit subjects.

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