The Rocky Mountain Chapter of The ESOP Association

Re-Leveraging and the Central States Manufacturing Case: Early Take-Aways and Best Practices for Fiduciaries and Boards of Directors

Rocky Mountain Chapter 2024 Spring Conference

April 4-5, 2024
Salt Lake City, Utah

Agenda

- The Complaint – Claims and Issues Raised
- Takeaways - Releveraging Considerations
- Takeaways – Best Practices/Protective Processes

The Complaint – The Parties

- Named plaintiffs – two former employees with undistributed shares in their accounts prior to the redemption; one former employee who left after the releveraging transaction.
- Class plaintiffs – all participants in the ESOP
- Defendants – the Company, members of the Board of Directors, the CEO, the CFO (also a board member), the ESOP trustee (GreatBanc)

The Complaint – The Facts

- Central States Manufacturing has been 100% ESOP owned since 1991
- The ESOP has roughly 700 participants
- By 2020, almost all shares in the ESOP had been allocated
- In August 2020, the Company purchased 2,222,222.22 shares from inactive participants' accounts (redemption)
- In December 2020, the Company sold those shares to the ESOP for $40MM in exchange for a 30 year loan (releverage)

The Complaint – Legal Claims

- In approving and executing the releveraging transaction, the Company, the executives, the Board of Directors, the individual directors and the ESOP trustee acted in a fiduciary capacity because they exercised discretionary authority over plan assets, the management of the ESOP, and the administration of the ESOP.

The Complaint – Legal Claims

- The Company, the Board, the Directors and the Executives breached their fiduciary duties by:
  – Failing to consider the impact of the releveraging transaction on share price
  – Failing to consider other alternatives to releveraging
  – Acting to reduce future repurchase liability which placed the Company's interests over the Participants'
  – Approving the transaction despite the "dilutive" effect on share value

The Complaint – Legal Claims

- The Board of Directors and the individual Directors breached their fiduciary duties by:
  - Failing to monitor the ESOP Trustee
  - Failing to remove and replace the ESOP Trustee

The Complaint – Legal Claims

- The ESOP Trustee breached its fiduciary duties by:
  - Failing to consider the impact of the releveraging transaction on the value of stock allocated to participants' accounts
  - Failing to consider alternatives to releveraging
  - Placing the Company's fiscal interests over the interests of participants and beneficiaries
  - By approving the transaction despite the "dilutive" effect on the Company's shares held by the ESOP and allocated to participants' accounts

The Complaint – Legal Claims

- The Company, the Board of Directors, the individual directors and the executives engaged in a prohibited transaction because they acted in the interests of the Company and adversely to the interest of ESOP participants and beneficiaries

Legal Framework

- ERISA 404 requires a fiduciary to act “solely in the interest of the participants and beneficiaries”
- It requires a fiduciary to act “for the exclusive purpose” of “providing benefits” (note: not “maximizing” benefits)
- “Participant” is defined as employees who might be eligible for benefits, not only those who currently are eligible
- Trust law principles support that a trustee owes duties to future beneficiaries, not just current

Legal Framework

- Participants have a right to shares that they have been allocated
- Participants generally have no right to a particular *value*, absent some event
- ERISA fiduciary obligation arguably extends to decisions that affect the Plan's ownership stake
- Corporate personnel generally do not act as ESOP fiduciaries when making decisions about corporate assets

Issues Raised

- Is the decision to releverage and the execution of the releveraging transaction a settlor function or a fiduciary function?
- Do the ESOP trustee's fiduciary duties run to participants as a whole (current and future) or to particular groups of participants?
  - What if a proposed transaction affects different participant groups differently?
  - Can an ESOP trustee consider the impact of repurchase obligations on the Company's financial health?
- What is the ESOP trustee's duty with respect to a releveraging transaction?
- Does the value of shares at a time other than at the annual valuation or time of a transaction have any relevance under ERISA?

Initial Take-Aways – Releveraging Considerations

- Analyze Company's current and future repurchase obligations
  - Sustainability study
- Evaluate all options for addressing repurchase obligations
  - Impact on equity value (ESOP assets)
  - Impact on per share value
  - Impact on share value growth compared to equity value growth
  - Impact on Company's ongoing ability to fund repurchase obligations, debt obligations, corporate operations and growth

Initial Take-Aways – Releveraging Considerations

- What would happen if a releveraging is not undertaken?
  - Impact on the Company
  - Impact on the sustainability of the ESOP
  - Impact on participants
- Evaluate potential disparate impact of releveraging on different groups of participants
  - Are protections or “sweeteners” needed to mitigate negative impact on any particular participant group?
  - What is the impact of such “sweeteners” on other participants?

Initial Take-Aways – Best Practices/Protective Processes

- Document, document, document
- Quantify and document “why?”
- Amend ESOP plan documents as needed
- Identify any participant groups that will be negatively impacted
  - Document costs and benefits to ESOP and other participants of “make whole” options
- [Other processes?]

Addendum 1: Valuation Basics

Valuation Basics

Value Derived From Multiple Approaches

Income Approach

The Company's projected future cash flows are discounted at the "weighted average cost of capital" or "WACC" to arrive at a value.

The WACC is determined based on multiple factors including market interest rates and company risk.

Market Approach

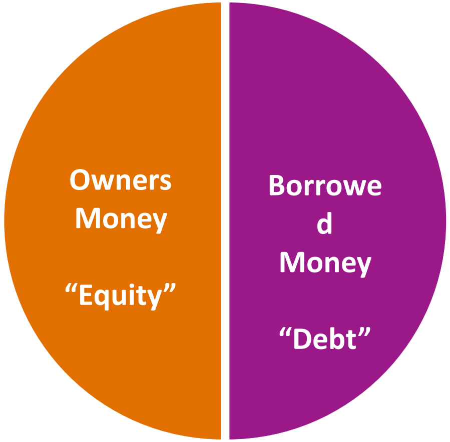
Company's value is determined by comparing it to similar public companies and to transactions involving companies in the same industry.

Valuation Multiples and Transaction Multiples are applied to the company's financial metrics.

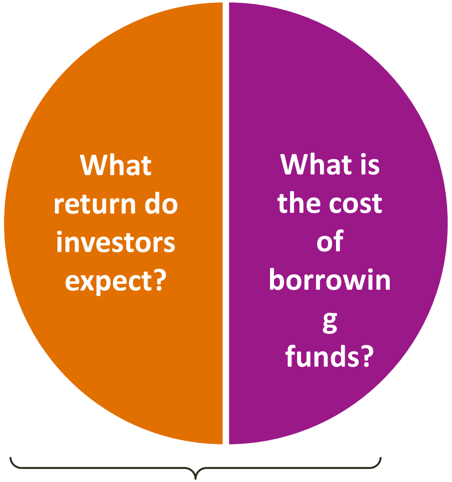
Income Approach – Calculating the WACC

- The weighted average cost of capital is a market-based rate that reflects the inherent risks associated with an investment in a company.

How is the company financed?



What is the cost financing?



Weighted Average Cost of Capital

What affects these costs?

- **Monetary policy**
- **Stock market**
- **Lending environment**
- **Company characteristics**
- **Economic environment**

Market Approach

Two Widely Accepted Methods

Guideline Public Comparables

The primary focus is to assess the subject company relative to a group of similar, publicly traded companies.

Valuation multiples derived from this public company group is applied to the subject company's financial metrics.

Guideline Transactions

The primary focus is to examine the terms, prices, and conditions found in sales of companies in the subject company's industry.

Transaction multiples are screened and then applied to the subject company's financial metrics.

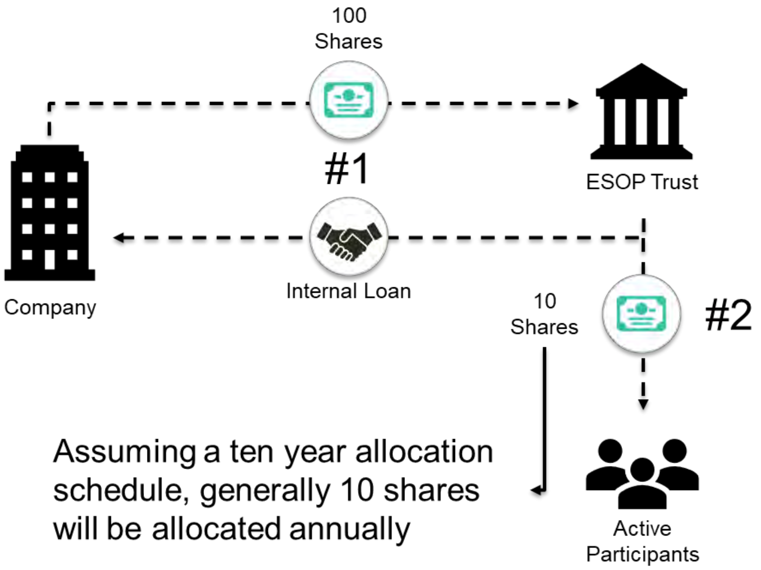
Addendum 2: Releveraging Basics

Releverage: Transaction

- A releverage transaction occurs between the Company and the ESOP Trust and is generally used to manage benefit levels

#1 The Company sells shares to the ESOP Trust in exchange for a note ("Internal Loan")

#2 Over the term of the loan, these share are allocated to active participants annually



Releverage: Implications

- To counter the dilutive impact of a releverage transaction, oftentimes a “price-protection” provision is implemented

Impact on Company Value

	Pre Transaction	Post Transaction
Equity Value	$100	$100
Releveraged Shares	0	10
Pre-Transaction Shares	100	100
Total Shares Outstanding	100	110
Price per Share	**$1.00**	**$0.91**

Impact on Participants’ Accounts

Company Per Share Value	# of Shares	Total Value of Shares

In December 2019, the IRS released a memorandum that outlined circumstances when distributions subject to a “Price Protection Agreement” could be taxable to a participant

Releverage: Summary

Advantages

- Reduces short-term and mid-term repurchase obligation
- Contributions to pay internal loan are tax deductible
- May reduce 409(p) concerns when compared to redemption strategy
- Future allocations of shares for new participants (can assist with have and have not issue)

Disadvantages

- Immediate dilution as cash/debt is used to fund the purchase.
- Impacts ESOP and non-ESOP shareholders (also SARs/Warrants)
- Increased fiduciary risk since ESOP is purchasing shares
- Transaction costs (valuation / opinion)
- Administrative complexity if re-leveraging strategy is used consistently

Addendum 3: Legal Resources

- Gamache v. Hogue (TAG)
- Field Assistance Bulletin No. 2002-01

Gamache v. Hogue (TAG)

- 2006 ESOP, $16 million in seller notes
- 2011, TAG refinanced the ESOP’s debt
  - Borrowed $8 million from lender
  - Paid off the seller notes
  - ESOP internal note for $7.5 million
  - Issued new shares to former shareholders for 40% ownership

Gamache v. Hogue (TAG)

- Trustee received FO, but FO did not consider potential dilutive effect
- Plaintiff sued for diluting ESOP ownership.
- MTD:
  - The refinancing “involved plan assets” because it involved unallocated ESOP stock that was pledged to secure loan
- MSJ:
  - Fact issues about: (1) **whether defendants acted as fiduciaries**; (2) whether transaction was intended to benefit participants.
  - Case will proceed to trial.

FAB No. 2002-01

- Issue: Obligations of an ESOP fiduciary under Sections 404(a) and 408(b)(3) in connection with refinancing an exempt ESOP loan
- Fiduciary must:
  - Assess costs and benefits to ESOP and likely consequence of failure to refinance
  - Ensure that refinancing primarily in the interest of participants and beneficiaries (primary benefit test)
    - Must conclude after carefully assessing benefits and costs that refinancing is advantageous to participants and beneficiaries, and terms at least as favorable as would be between independent parties
    - Inducements offered by Company to participants (like event protection, dividend make whole, increased diversification rights, increase in 401(k) match) may be considered
  - Duty of impartiality to all participants and beneficiaries, so can balance the interests of different classes of participants
  - Assess extent to which consistent with plan and governing documents

Questions?

Elizabeth Di Cola

Senior Vice President, Employee Benefits Group
TI-Trust
Elizabeth.dicola@ti-trust.com
Direct: (630) 986-0901
Mobile (312)933-4689

Elizabeth Di Cola is a member of the ESOP fiduciary team at TI-TRUST, which oversees decision making on behalf of the plans and plan participants served by TI-TRUST. Beth brings knowledge gained over three decades as an attorney, corporate finance professional and banker. She served ESOP-owned companies for fifteen years as a commercial banker and leader of ESOP finance teams for two regional banks. She practiced law in the areas of ERISA litigation and employee benefits. She belongs to the NCEO and The ESOP Association. She earned a B.S. in Finance from University of Illinois and a J.D. from UC Berkeley.

Rocky Fiore

Managing Director and COO
Prairie Capital Advisors
630.413.5575
rfiore@prairiecap.com

Rocky Fiore joined Prairie Capital Advisors in 2000 and serves as a member of the company's Board of Directors, Fairness Committee, Operating Committee and Business Development Committee. He is also a shareholder in the firm. As a Managing Director, Rocky oversees client engagements related to employee stock ownership plan (ESOP) feasibility and structuring, valuation, fairness opinions, mergers and acquisitions ("M&A"), estate planning, capital structuring and more for clients across the country. Rocky has extensive experience in leveraged ESOP and M&A transactions as well as other forms of leveraged buyouts. He also has a diverse background working with companies in many different types of industries. As Chief Operating Officer, Rocky manages all production teams, ensuring the exceptional delivery of services and the ongoing development of Prairie professionals. In addition, Rocky oversees business development across the entire organization.

Rick Pearl

Partner
Faegre Drinker Biddle & Reath LLP
312 569 1907
rick.pearl@faegredrinker.com

Rick Pearl is a partner at Faegre Drinker Biddle & Reath, LLP representing clients in ERISA litigation and non-litigation matters involving risk-mitigation issues. His focus is on ESOPs and ESOP stock transactions. Rick has developed successful novel approaches to complex ERISA and valuation issues. He has extensive knowledge of ERISA legislative history, particularly related to ESOPs and indemnification. He is proficient at cross-examining expert and lay witnesses on valuation principles, damages models and trustee and fiduciary prudence standards. He earned a B.S. in Psychology and Philosophy from Northern Illinois University and a J.D. from Loyola University Chicago School of Law.

Session Evaluation

- Please fill out a session evaluation form and drop it off at the table outside of this room
- Your feedback on topics and presenters is important and will be used to develop subsequent TEA programs
- Scan the QR code in the back of your program or scan it here to access the surveys