

EMPLOYEE STOCK OWNERSHIP PLANS

**AN EXTRAORDINARY FINANCIAL AND EMPLOYEE BENEFIT TOOL
FOR THE
CLOSELY-HELD COMPANY**



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INTRODUCTION

An employee stock ownership plan ("ESOP") is an extraordinary corporate financial and employee benefit tool for the closely held company. An ESOP is a tax-qualified retirement plan that is authorized by law and design to invest in the stock of the company sponsoring the ESOP ("Company"). The ESOP can pay shareholders fair market value for all or part of their Company shares, can raise capital by engaging in tax-favored Company share transactions, and can increase cash flow for the Company. At the same time, ESOPs permit participating employees to share in the Company's success. Both C corporations and S corporations may sponsor ESOPs, and the S corporation's "pass through" income is not taxable at the S corporation or ESOP level.

ESOPs offer unique tax-advantaged solutions for difficult corporate, financial, shareholder, and community issues, including:

- **Ownership Diversification** – ESOPs allow closely held business owners to take cash out of their business for diversified reinvestment on a tax-advantaged basis.
- **Raising Capital and Creating a Financial Partner** – ESOPs provide tax-advantaged financing for corporate rebuilding, expansion, acquisition, and management buyouts.
- **Owner and Management Succession Planning** – ESOPs provide the market and capital for the ownership transfer of a closely held business through successive generations of family or management.
- **Keeping Local Business Local** – ESOPs provide an important alternative to the sale of a business to outsiders, and help keep local businesses in the community.
- **Employee Benefits** – ESOPs provide cost effective employee benefits in the form of retirement benefits and wealth creation, and should thereby encourage teamwork and productivity.

This outline discusses potential benefits of an ESOP, the more important rules governing an ESOP (noting special S corporation rules), and the principal considerations for determining whether an ESOP may prove advantageous. **Attachment A** at the end of this outline illustrates a typical leveraged ESOP transaction.

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PART I

GENERAL DESCRIPTION OF AN ESOP

A. General Overview. An ESOP is a tax-qualified retirement plan under the Internal Revenue Code ("Code"), and is subject to a federal pension law entitled the Employee Retirement Income Security Act of 1974 ("ERISA"). ESOPs are designed to invest primarily in employer shares that are (i) common shares with dividend and voting rights as great as any other class of common shares of the employer (and any affiliates), or (ii) noncallable preferred shares that are convertible into such common shares at a reasonable conversion price determined as of the date acquired. Although an S corporation may have only one class of shares, voting rights may differ; therefore, an S corporation ESOP may acquire and hold only those shares with the greatest voting rights.

An ESOP may provide for mandatory or discretionary Company contributions that are allocated to participant accounts in the ESOP. The contributions may be in the form of cash, Company shares, or both. If the ESOP borrows money to acquire Company shares, the Company must make cash contributions sufficient for the ESOP to meet its loan obligations. In the typical ESOP loan transaction, however, the Company's cash contributions to the ESOP are repaid to the Company immediately because the Company is the ESOP's lender. (See Part II.D below and ATTACHMENT A.) Company shares acquired with borrowed funds are initially held by the ESOP in a suspense account, and generally serve as collateral for the loan. Shares are released from collateral, and allocated to the accounts of active participants in the ESOP, as the ESOP loan is repaid.

ESOPs are tax-qualified retirement plans. As a result, the Company generally can deduct its contributions currently. In turn, participants are not taxed on the ESOP benefits until paid to them. The tax-qualified status of ESOPs, however, subjects them to a number of requirements imposed by the Code and ERISA on all tax-qualified plans. Some of these requirements are discussed below. These requirements are principally intended to protect employees' anticipated retirement benefits, to prevent plans from discriminating in favor of highly compensated employees, and to prevent employers from abusing available tax incentives.

The Code and ERISA generally impose these retirement plan requirements taking into account all of the employees of all of the commonly owned or controlled trades or businesses including the employer directly sponsoring the ESOP. The term "Company" in this outline generally means all such commonly owned or controlled trades and businesses.

B. Vesting. A participant's account must fully vest pursuant to a vesting schedule set forth in the ESOP, which is subject to the Code's requirements. A vesting schedule commonly found in ESOPs is 0% vesting for less than 5 years of service, and 100% vesting for 5 or more years of service. Other vesting schedules may be adopted. For example, an ESOP might provide for 20% vesting per year starting with the second year of service. Generally, service before the ESOP is established does not count toward vesting. If a participant terminates employment before full vesting, the non-vested portion of the participant's account is forfeited. Amounts forfeited are generally allocated among the remaining active participants. The vested portion of

the participant's account is distributed after retirement, or other termination of employment. The actual timing of distributions is based on the ESOP's design (subject to the Code's requirements).

C. Participation and Coverage. The Code imposes minimum coverage requirements to assure that the ESOP does not unduly benefit highly compensated employees. Under these requirements, the percentage of non-highly compensated employees of the Company (and any commonly controlled affiliate) covered by the ESOP generally must be at least 70% of the percentage of the highly compensated employees covered by the ESOP. Generally, a "highly compensated employee" is any employee who earns more than \$95,000 in 2005 (\$100,000 in 2006) or owns at least 5% of the Company. In short, participation in the ESOP cannot be reserved to a few key employees.

D. Participant Benefits. An ESOP is a "defined contribution plan" with an individual bookkeeping account maintained for each participant. Each participant's account represents the participant's entire interest in the plan. Company contributions of shares or cash, to the extent not used to repay an ESOP loan, are allocated among the accounts of participants in a nondiscriminatory manner. Allocations are usually based on relative compensation. Cash contributions used to repay an ESOP loan result in the release of Company shares from collateral. These shares are then allocated to participant accounts in the same manner. The ESOP books are based on fair market values, and participant accounts are adjusted at least annually for earnings, losses, and changes in the value of Company shares.

On retirement or other termination of employment, participants generally have the option to receive their vested benefits in the form of Company shares or cash. Cash may be distributed in installments, or as a single lump sum. ESOPs sponsored by S corporations, and C corporations that restrict ownership to the ESOP and employees, may limit distributions to cash.

E. Share Repurchase and Cash-Flow Considerations. After participating for 10 years in the ESOP, and reaching age 55, a participant must have the right, over a 6-year period, to direct up to 50% of the participant's account out of Company shares and into diversified investments. This frequently requires the Company to purchase the employer shares. In addition, if a participant receives a distribution of Company shares from the ESOP (*e.g.*, at retirement), the participant must have a "put option" right that requires the Company to buy back the shares at fair market value. These diversification and buy-back rights of the ESOP participants have significant long-term cash flow implications for the Company that should be examined before establishing an ESOP.

F. Limitations on Contributions and Benefits. The maximum annual deductible contribution by the Company to an ESOP is based on the aggregate wages of the participants in the ESOP. The maximum annual allocation under the ESOP to a participant's account is based on the participant's individual annual wages from the Company. Generally, the Company may deduct contributions to an ESOP annually of up to 25% of the wages of participants in the ESOP for the year. The maximum annual allocation to a participant's account in an ESOP generally cannot exceed the lesser of \$44,000 or 100% of the participant's annual wages.

An ESOP and the Company must meet both of these deduction and allocation limits every year. Both limits are increased for a C corporation when an ESOP loan is involved. These

limits may be reduced by deductions and allocations under other qualified retirement plans sponsored by the Company.

G. Trust and Trustee. ESOP assets must be held in trust by a corporate or individual trustee. The trustee is held to strict fiduciary standards under the Code and ERISA to the extent of the trustee's duties (see Part III below). Generally, the ESOP trustee holds and votes the shares (but see Part IV below).

H. Part of an Employee Benefit and Incentive Program. An ESOP should be considered together with the Company's entire benefit package. Existing retirement plans are often modified or combined with the ESOP. Management typically should consider that (i) the ESOP retirement benefit depends on the value of the Company; (ii) the ESOP provides employees with ownership in the Company, and should motivate these new owners to increase the value of the Company for their retirement program; and (iii) the ESOP generates new cash demands on the Company.

I. Potential S Corporation ESOP Penalties. The Code includes significant potential penalties on an S corporation ESOP Company and "disqualified persons" where the disqualified persons own or are deemed to own 50% or more of the Company's shares. In addition to direct ownership, disqualified persons are deemed to own shares owned by "family" both inside and outside the ESOP, (ii) their indirect ownership through the ESOP, including a portion of any unallocated collateral shares under the ESOP (see Part II.D below), and additional "deemed" shares of "synthetic equity" (such as stock options), with "family" and "synthetic equity" broadly defined for these purposes. These tax penalties do not apply for C Corporation ESOPs, however, and generally should not apply for S Corporation ESOPs with significant, broad-based participation.

PART II

USE OF AN ESOP TO BUY SHARES

A. General Overview of ESOP Uses. An ESOP is a flexible financial tool for the adopting Company and its shareholders. The ESOP can borrow funds to buy shares on a tax-effective basis because the debt is repaid by the Company with pre-tax dollars. A Company also can contribute cash to the ESOP on a fully deductible basis over one or more years to reduce or eliminate the need for the ESOP to borrow funds. In addition, the Company can contribute shares and get a full, fair market value deduction that generates additional cash flow that may help pay for the resultant dilution to existing shareholders. This dilution often is a positive result actually furthering the business succession and estate planning goals of the Company's owners.

An ESOP can help the closely-held business owner diversify his or her assets by selling Company shares to the ESOP and investing the cash proceeds in other investments. The owner can diversify in this manner without sacrificing control of the Company. In addition, an ESOP can act as a financial partner to help management buy out current owners at a fair price. Such a buyout can occur in a single transaction, or through multiple transactions spread over a number of years. An ESOP also can help finance Company expansion. For example, the ESOP can

borrow funds, which are repaid on a pre-tax basis, to buy treasury shares from the Company. In turn, the Company may use the sale proceeds for acquisitions.

B. Advantages to Selling Shareholder. A shareholder in a C corporation who sells employer shares to an ESOP is not taxed on the gain if (i) the shareholder held the shares for at least 3 years before the date of the sale; (ii) the ESOP owns shares in the Company after the transaction that represent at least 30% of the voting rights and value of the Company; (iii) the selling shareholder timely buys "Qualified Replacement Property" (see Part II.C below); and (iv) the selling shareholder timely elects the tax-favored treatment. The shareholder's gain is taxed only when the Qualified Replacement Property is later sold, and then taxed only in proportion to the amount sold (*e.g.*, if 10% is sold, 10% of the gain is taxable). This is not available to shareholders of S corporations.

This tax-deferred treatment may prove particularly advantageous for estate planning purposes. No gain is recognized for transfers of Qualified Replacement Property by gift, or on account of the owner's death. On death, the heirs get a stepped-up tax basis equal to the fair market value of the Qualified Replacement Property at the date of death. In addition, the IRS has approved a number of transactions involving Qualified Replacement Property and charitable remainder trusts where the Company owner has a lifetime income interest.

C. Qualified Replacement Property. The C corporation shareholder must invest the sale proceeds in Qualified Replacement Property within the 15-month period beginning 3 months before and ending 12 months after the sale to the ESOP. "Qualified Replacement Property" is any "security" issued by a domestic "operating corporation" that did not have passive investment income (rents, royalties, interest, *etc.*) in excess of 25% of gross receipts for the taxable year preceding the year in which the security is purchased, *and* is not the same corporation (or member of the same group of controlled corporations) that issued the Company shares sold to the ESOP. The term "security" means (i) shares in a domestic operating corporation, (ii) a right to subscribe for, or receive, shares in a domestic operating corporation, or (iii) a bond, debenture, note, certificate, or other evidence of indebtedness, issued by a domestic operating corporation, with interest coupons or in registered form. An "operating corporation" is a corporation with more than 50% of its assets used in the active conduct of the trade or business at the time the security is issued, or before the end of the replacement period. Certain insurance companies and financial institutions are also considered operating corporations. Municipal bonds, other tax-exempt investments, and mutual funds do not qualify as Qualified Replacement Property.

D. General Structure of the Typical ESOP Transaction. Typically, before the actual ESOP transaction, an independent professional valuation of the Company shares involved is made, the Company designs and adopts the ESOP, the overall structure of the buy-sell and loan transaction is developed, and financing is arranged. The ESOP and Company typically enter into "back-to-back" loans where the Company borrows the needed cash from a commercial lender (the "outside" loan), and the ESOP in turn borrows the needed cash from the Company (the "inside" loan). The ESOP pays cash to the selling shareholder in exchange for the shares, and the ESOP holds the shares in a "suspense" account as collateral for the loan. SEE ATTACHMENT A.

The Company thereafter makes tax-deductible cash contributions to the ESOP sufficient to amortize the principal and interest due on the ESOP loan. Then, the ESOP repays the cash to the Company to pay down the ESOP loan. In turn, the Company pays the cash to the commercial lender that originally made the loan for the ESOP transaction. As the ESOP loan is repaid, shares are released from collateral and allocated to the accounts of active participants.

There is no requirement that the ESOP's acquisition of shares from the selling shareholder include debt. The Company may pre-fund the eventual purchase over time, with deductible cash contributions to the ESOP that can reduce or eliminate the need to borrow. In addition, a shareholder may provide "seller-financing" by taking back notes as part of the sale rather than looking for outside financing for all or part of the transaction. Such seller-financing notes also may receive favorable "installment sale" tax treat under the Code.

E. Tax Advantages to Company. Company contributions of cash or shares to an ESOP are deductible. Shares are deductible at their fair market value as of the date of contribution. Unlike a conventional loan, under which the Company cannot deduct the repayment of principal, all contributions to an ESOP generally are deductible, whether used by the ESOP to pay principal or interest (see the limits outlined below in Part II.G). Under the typical ESOP "back-to-back" loan transaction (see Part II.D, above and ATTACHMENT A), the amounts paid by the Company to the ESOP result in an equivalent deduction for the Company in paying down the principal on its loan from the commercial lender.

Contributions to pay interest on a C corporation ESOP loan generally are deductible without limitation. In addition, a C corporation generally also may deduct dividends paid on Company shares held by an ESOP if the dividends are paid in cash to participants or their beneficiaries, paid to the ESOP and distributed in cash to participants or their beneficiaries within 90 days after the close of the ESOP's plan year, or used to repay an ESOP loan used to acquire the shares. Dividends also are deductible if plan sponsors allow participants to reinvest the dividends in the ESOP or the Company's 401(k) plan on a pre-tax basis. These interest and dividend deduction rules do not apply to S corporation ESOPs.

F. Financial Disclosure. Generally accepted accounting principles require that an ESOP loan be recorded on the Company's balance sheet with an offsetting shareholder equity entry. These entries are reduced as the ESOP loan is repaid. These accounting requirements may have an impact on loan or other financial obligations, covenants, bonding, or reporting requirements of the Company, particularly if such requirements are tied to the Company's financial statements.

G. Limitations on the Acquisition of Shares. There are no direct limitations on the amount of Company shares that can be purchased by an ESOP. There often is a practicable limitation, however, based on the amount of debt the ESOP and Company can service. In addition, the Code limits the amount of annual deductible contributions and allocations to the accounts of participants (see Part I.F above), which indirectly limits the amount of financing the ESOP can service on a tax-effective basis.

H. Other Limitations and Potential Penalties. After a shareholder's tax-favored sale to an ESOP as described above (see Part II.B), two classes of participants must be excluded from

allocation of those shares under the ESOP: (i) the selling shareholder and "family", including spouse, siblings, lineal ancestors and descendants (although lineal descendants may receive up to 5% in the aggregate); and (ii) any person owning at least 25% of any class of Company shares during the 1-year period preceding the sale. If a prohibited allocation occurs, the Code imposes a penalty tax on the Company equal to 50% of the allocation.

In addition, the total number of shares held by the ESOP must not decrease at all, and the percentage of the Company held must not decrease to less than 30%, for 3 years after the sale. Exceptions are made for distributions following termination, a one-year break in service, or for reasons of death, disability, or retirement after age 59½. If a prohibited distribution occurs, the Code imposes a penalty tax on the Company equal to 10% of the amount realized.

PART III

FIDUCIARY RESPONSIBILITIES AND PROHIBITED TRANSACTIONS

A. General Rules of Conduct. Generally, the Company establishing the ESOP, its officers and directors, and the ESOP committee and trustee, are "fiduciaries" to the ESOP. Fiduciaries must discharge their duties to the ESOP solely in the interest of participants, for the exclusive purpose of providing benefits to participants, and for defraying reasonable plan expenses. Fiduciaries must perform their duties with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims (the "prudent expert" standard). Fiduciaries must also diversify the investments of the plan to minimize the risk of significant loss, unless not doing so is clearly prudent; however, ESOP fiduciaries are generally exempt from this duty. Finally, fiduciaries must discharge their duty in accordance with the ESOP's plan documents, to the extent consistent with ERISA. A fiduciary is personally liable for any loss to the ESOP resulting from the fiduciary's breach of duty. ESOP fiduciaries must know and follow ERISA's standards of conduct.

B. Prohibited Transactions. The Code and ERISA generally prohibit a fiduciary from causing the ESOP to engage in the acquisition or sale of any property, or the lending or guaranty of a loan, with a party in interest (*e.g.*, the Company, shareholders, officers, and directors). Violation of the prohibited transaction rules may result in personal liability for the fiduciary, as well as the imposition of significant penalties on parties in interest (*e.g.*, the selling shareholder). The acquisition of Company shares by an ESOP from a party in interest is exempt from the prohibited transaction rules *only if* the acquisition is for not more than fair market value. In such a transaction, an ESOP fiduciary must determine fair market value based on a written valuation by an independent appraiser, *and* no commission may be paid by the ESOP with respect to the acquisition. A loan to an ESOP made or guaranteed by a party in interest is exempt *only if* the loan is primarily for the benefit of participants, is at a reasonable rate of interest, and the only collateral given by the ESOP is shares acquired with the loan proceeds.

PART IV

VOTING OF COMPANY SHARES

ESOP participants do not have the right to vote shares allocated to their accounts on issues of day-to-day corporate governance, or on the election of the board of directors, unless the ESOP documents provide otherwise. Management's ability to operate the Company, therefore, generally is not affected by the employees' indirect ownership of shares through the ESOP. Typically, the ESOP trustee, or other named fiduciary, holds all of the voting rights to the ESOP shares, whether or not allocated to participant accounts. Although the trustee, or other named fiduciary, may be an officer or director of the Company, the act of voting shares is subject to ERISA's fiduciary duty standards discussed above (see Part III.A).

ESOP participants vote the shares allocated to their accounts if the Company merges, consolidates, recapitalizes, is reclassified, liquidates, dissolves, or sells substantially all of its assets. The participants do not vote the unallocated shares, unless the ESOP so provides. In any event, the ESOP will not control the Company if less than 50% of the Company's voting control is held by the ESOP.

PART V

GENERAL SUMMARY OF ADVANTAGES AND DISADVANTAGES

A. Potential Advantages of an ESOP. The ESOP creates a "fair value" market for closely-held Company shares without the need to sell the whole Company. Further, the ESOP often creates a financial "partner" for acquiring a Company. ESOPs, therefore, can be used in business succession and estate planning, management buyouts, and business acquisitions.

An ESOP can improve cash flow. The contribution of Company shares to an ESOP generates tax deductions equal to the fair market value of the shares. Company shares acquired through an ESOP loan transaction are purchased with pre-tax dollars, and both principal and interest payments generally are deductible by the Company. In addition, ESOP loan transactions may have advantages over non-ESOP loans because of the ESOP's tax advantages (*e.g.*, the lender should recognize the borrower's cash flow advantage in the pre-tax repayment of principal).

Individual shareholders who sell shares to a C corporation ESOP may defer or completely avoid any taxable gain on the sale of their shares. This presents significant planning opportunities and advantages in business succession and estate planning. In addition, an ESOP may increase the Company's overall productivity by providing employees with the incentive of Company ownership, as well as a retirement program.

For an S corporation ESOP, the Company's earnings pass to the ESOP "tax-free." The actual earnings may be retained by the Company to fund growth, pay more competitive salaries, or meet other business needs.

B. Potential Disadvantages of an ESOP. An ESOP loan transaction obligates the Company to make annual contributions to the ESOP. Typically, the Company also assumes a

direct loan obligation to a commercial lender. These obligations affect cash flow, and are a liability on the Company's financial statements. In addition, the Company has a contingent obligation to repurchase shares held by the ESOP at their future fair market value.

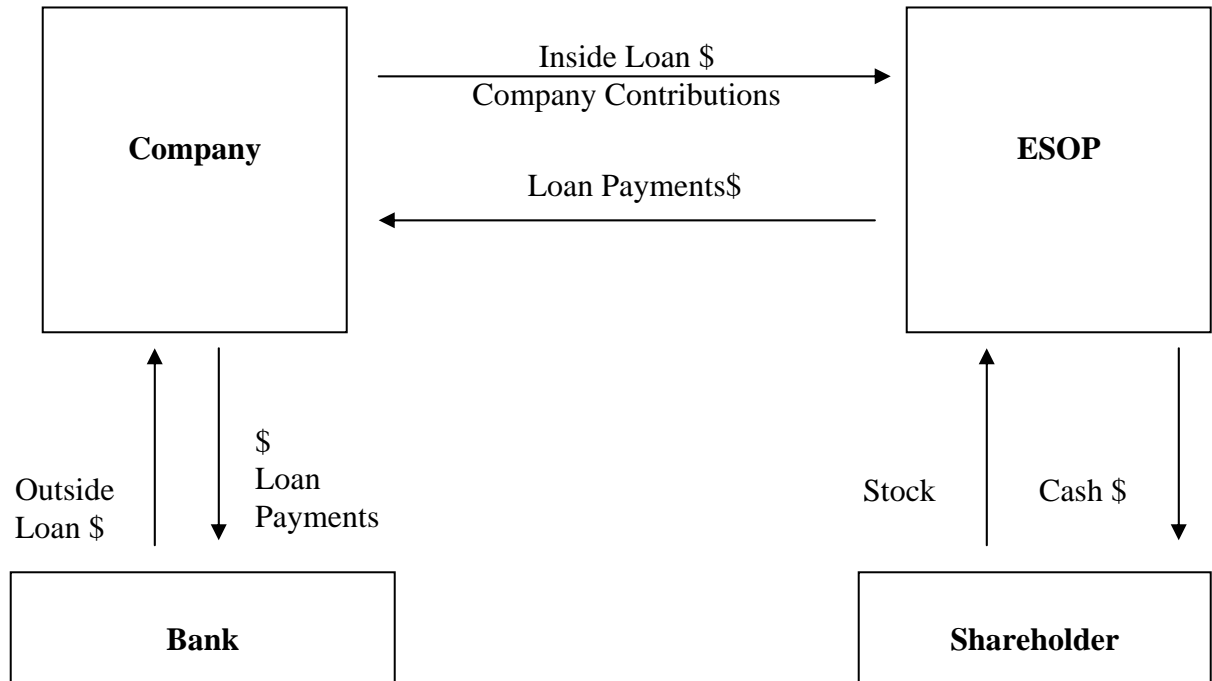
ESOPs are subject to complex legal requirements, and generally involve significant administrative costs, including fees for trustees, accountants, appraisers, and attorneys. Further, failure to comply with these legal requirements exposes ESOP fiduciaries, selling shareholders, and the Company to potentially substantial liabilities.

The ESOP also creates a new class of shareholders to whom the Company's officers and directors owe corporate fiduciary duties. These new shareholders also may dilute the voting rights and ownership of existing shareholders. Further, ESOPs are a more volatile and risky investment than normal retirement plans because they are invested primarily in Company shares.

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ATTACHMENT A

HOW A LEVERAGED ESOP TRANSACTION TYPICALLY WORKS



1. The Company adopts an ESOP and borrows money from the Bank (the outside loan), and then lends the money to the ESOP. The Loan proceeds borrowed by the ESOP from the Company (the inside loan) are then used by the ESOP to purchase stock from the Shareholders. The Company stock purchased by the ESOP is held as collateral for the inside loan.
2. The Company makes tax deductible contributions to the ESOP each year to permit the ESOP to pay its loan obligation back to the Company. The Company then repays the Bank with these pre-tax monies.
3. As the ESOP loan is repaid, Company stock is released proportionately from collateral and allocated to the individual employee accounts in the ESOP. Employees receive the value of their vested account at retirement or other termination.