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CORPORATE and SECURITIES LAW UPDATE

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Business Succession Planning with an ESOP

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In these challenging times, preparing for the successful sale of your closely-held business is important. You may have already considered transferring ownership of your business to the next generation of your family. You may have also considered selling your business to others in a traditional asset purchase or stock purchase transaction. Most likely, you have not considered the potential benefits of selling your business through an Employee Stock Ownership Plan (ESOP). This article provides a brief introduction to the sale of the stock of a business through the use of an ESOP.

An ESOP can be used to buy all or some of the stock of the business from existing shareholders. An ESOP is a type of tax-qualified defined contribution benefit plan, which buys and holds the stock of a corporation in trust for employees of the corporation. The employees of the corporation are eligible to participate in the ESOP according to its terms.

Here are some of the key features and benefits of an ESOP:

- An ESOP is a method of rewarding employees for their service to the corporation.

- An ESOP helps the corporation preserve its legacy, reducing the risks commonly associated with the transfer of control of the corporation from one family generation to the next.

- If the corporation is a C corporation, the selling shareholders in an ESOP stock purchase transaction are eligible to defer gain on the sale of their stock under Internal Revenue Code Section 1042. To take advantage of this provision, the selling shareholders must reinvest the proceeds of the sale in qualified replacement property, such as publicly-traded securities. The selling shareholders must then hold the qualified replacement property for a period of three years. The ESOP must purchase at least 30% of the outstanding stock of the corporation in order for the selling shareholders to qualify for a Section 1042 deferral.

- The selling shareholders and/or a lending institution loan(s) funds to the ESOP, which the ESOP then uses to purchase the stock of the selling shareholders at appraised value.

- The stock is released annually in proportion to the repayment of the ESOP loan.

- The stock is held by the ESOP in trust for the employee participants.

- In the case of a C corporation, the principal payments on the ESOP loan are tax deductible.

- An ESOP works best for companies with stable cash flow and at least 20 employees.

- To succeed, the management of the corporation must be in favor of the formation and operation of an ESOP.

- An ESOP can also be used in an S corporation. In such an event, the selling shareholders are not eligible to defer gain on the sale of their stock under Section 1042, as described above. Any income earned by the ESOP in an S Corporation, however, is tax exempt, which is a powerful economic incentive.

There are a number of strategic considerations when planning for the sale of any closely-held business. An ESOP may be a good way for you to sell your business and:

- reward employees;

- maintain the value of the business going forward; and

- allow you to exit the business with a reduced tax burden.

- A Nonqualified Deferred Compensation Table, showing executive contributions, company contributions, all earnings (not just any preferential portion), and year-end balance.

- A description of any benefits payable to a named executive officer on termination, change in responsibilities, or change in control of the company. The discussion must include the amount that would have been payable if the triggering event had occurred on the last business day of the company's most recent fiscal year, valuing any equity component based on the closing market price on that day.

Option Grant Disclosure

The revised option grant table will show:

- grant date fair market value;

- FAS 123R grant date;

- closing market price on grant date if higher than exercise price; and

- the date the compensation committee took action on the grant if different than the FAS 123R grant date.

The new rules will require detailed disclosure about any program for timing option grants in coordination with releasing material information to the public or establishing an exercise prices different than grant date market price. Companies that haven't previously disclosed a program of timing option grants to executives but have in fact done so in the last year will be required to confess. Similar rules will apply for below-market grants. **[Practice tip:** The SEC is investigating about 80 companies for backdating options. Any company that does not already have scrupulous procedures for documenting compensation committee decisions and grant dates should adopt them now. Companies also should ensure either that they don't have—or appear to have—market timing programs or discrepancies between exercise prices and grant date market value, or that they are prepared to disclose and justify those programs or discrepancies.**]**

Director Compensation

There will be a new Director Compensation Table similar to the Summary Compensation Table but covering only one year.

Form 8-K

Form 8-K will be changed to require disclosing only some types of compensation arrangements and material amendments to them and only for the principal executive officer, principal financial officer, and named executive officers.

Summary Compensation Table (sample)

Name and Principal Position (a)	Year (b)	Salary ($) (c)	Bonus ($) (d)	Stock Awards ($) (e)	Option Awards ($) (f)	Non-Equity Incentive Plan Compensation ($) (g)	Change in Pension Value and Nonqualified Deferred Compensation Earnings ($) (h)	All Other Compensation ($) (i)	Total ($) (j)
PEO (1)	2006 2005 2004	$	$	$	$	$	$	$	$
PFO (2)	2006 2005 2004	$	$	$	$	$	$	$	$
A	2006 2005 2004	$	$	$	$	$	$	$	$
B	2006 2005 2004	$	$	$	$	$	$	$	$
C	2006 2005 2004	$	$	$	$	$	$	$	$

(1) Principal executive officer (2) Principal financial officer

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The SEC's New Compensation Disclosure Rules: What Public Companies Will Have to Disclose Next Year

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On July 26, 2006, the Securities and Exchange Commission adopted its long-awaited new executive compensation rules. The new rules will apply to annual reports on Form 10-K for fiscal years ending after December 15, 2006 and proxy statements filed after December 15, 2006. Related changes in Form 8-K executive compensation reporting requirements will take effect this fall (60 days after the new rules are officially published).

Personnel in charge of gathering and assembling data for compensation disclosure will probably want to start early this year because of the changes. And compensation committees may be interested in how this year's decisions will be presented in next year's new disclosure format.

In this issue, we give an overview of the changes. We plan to provide more detailed information about some of the new requirements in future issues.

Compensation Discussion and Analysis

Proxy statements and 10-K's will have a new Compensation Discussion and Analysis section describing the most important factors used in making compensation decisions and spelling out the objectives and methodologies used. The CD&A will be officially "filed," meaning that it will be covered by the CEO and CFO certifications and that any misstatements or omissions could potentially subject the company and its officers and directors to liability under the Securities Exchange Act of 1934.

A revised Compensation Committee Report ("furnished" rather than "filed") must say whether the compensation committee reviewed the CD&A with management and recommended including it in the 10-K and proxy statement.

The performance graph will be moved from the proxy statement to the company's annual report to shareholders.

Summary Compensation Table

The new rules retain the Summary Compensation Table as the centerpiece of compensation disclosure, but with significant changes.

The Table. The new Summary Compensation Table (see example on the next page) will disclose the following information for five named executive officers for three years:

- Salary (column c).
- Bonus (column d).
- Stock awards (column e), such as restricted stock—measured by grant date fair value computed under FASB Statement of Financial Accounting Standards No. 123R.
- Option awards (column f)—also measured by grant date fair value computed under FAS 123R.
- Non-equity incentive plan compensation (column g).
- Change in pension value and nonqualified deferred compensation earnings (column h)—the annual change in actuarial present value of pension benefits plus any preferential earnings on deferred compensation.
- All other compensation (column i)—including perquisites unless total perks are less than $10,000. The new rules provide additional guidance on what is and is not a perk.
- Total (column j)—the total of columns c through i.

Named Executive Officers. The five named executive officers will be the principal executive officer, the principal financial officer, and the three other most highly compensated executive officers, measured by subtracting pension and deferred compensation earnings (column h) from total compensation (column j). The SEC did not adopt a proposal that would have also required disclosure for up to three non-executive-officer employees receiving more total compensation than any named executive officer but said it will re-propose this requirement in modified form for consideration later.

Other Tables

Outstanding Equity Awards at Fiscal Year-End Table. This table will give details about outstanding equity awards representing amounts that may be received in the future, including shares underlying options (both exercisable and unexercisable), exercise prices, and expiration dates for *each* outstanding option—not an aggregation of all of them.

Option Exercises and Stock Vested Table. This table will show amounts realized from these sources during the last year.

Retirement Plan and Post-Employment Compensation

There will be three main elements to this disclosure:

- A Pension Benefits Table, showing the actuarial present value of pension benefits for each named executive officer, using the same actuarial assumptions (except for retirement age) and measurement period as used for GAAP reporting purposes.

Claims of Adverse Employment Actions as Unfair or Oppressive Conduct Against Minority Shareholders

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Section 489 of the Michigan Business Corporation Act is designed to protect minority shareholders from oppressive actions by the company's directors. Under Section 489, any shareholder can bring an action in circuit court in an attempt to establish that the acts of the directors are illegal, fraudulent, or willfully unfair and oppressive to either the corporation or the shareholder. If the minority shareholder is successful in proving his or her case, the court may order any relief that it considers appropriate. Section 489 applies only to minority shareholder oppression in the context of private companies.

The statute specifically excludes claims for "willfully unfair and oppressive conduct" if the actions are permitted by an agreement, the articles of incorporation, the bylaws, or a consistently applied written corporate policy or procedure. As a result, a majority shareholder can contract around claims for willfully unfair and oppressive conduct when drafting the corporate organizational documents or buy-sell agreements.

Recently, the Michigan legislature amended the definition of "willfully unfair and oppressive conduct" in the minority shareholder context in response to a 2004 Michigan Court of Appeals decision, *Franchino v. Franchino*, which held that Section 489 did not protect minority shareholders when they suffered harm in their capacities as either employees or directors of a company. In light of the *Franchino* decision, Section 489 was revised to expand the scope of items that can be considered willfully unfair and oppressive conduct to include employment actions against a minority shareholder if those actions disproportionately affect an individual's rights as a shareholder.

Subsection (3) of Section 489 as revised now reads as follows:

> (3) As used in this section, "willfully unfair and oppressive conduct" means a continuing course of conduct or a significant action or series of actions that substantially interferes with the interests of the shareholder as a shareholder. Willfully unfair and oppressive conduct may include the termination of employment or limitations on employment benefits to the extent that the actions interfere with distributions or other shareholder interests disproportionately as to the affected shareholder. The term does not include conduct or actions that are permitted by an agreement, the articles of incorporation, the bylaws, or a consistently applied written corporate policy or procedure.

In the *Franchino* case, the court heard a dispute between two family members (father and son) who were the sole owners and only directors of a privately held Michigan company. The plaintiff (the son) had an employment contract which stated that his employment could only be terminated with the unanimous consent of all directors. After a number of disagreements between the father and son as to how to run the company, the father (the majority shareholder) removed the son from the board of directors, elected himself sole director, and then terminated the son's employment. In response, the son brought an action for minority shareholder oppression. In affirming the decision of the lower court, the Michigan Court of Appeals ruled that Section 489 as then in effect did not allow a shareholder to recover for harm suffered as an employee or member of the board of directors. The section only protected a shareholder's interest as a shareholder, and since no adverse action was taken against the son in his capacity as a shareholder (terminating his employment did not relate to his interest as a shareholder in the company), he had no claim under Section 489.

While at first the revised Section 489 seems like a windfall for employees, it is important to read the section carefully. Remember, the action must impact the employee's *interests as a shareholder* or any distributions that would be received *as a shareholder*. As a result, merely firing an employee who happens to be a minority shareholder would be insufficient to sustain a claim of oppression. Rather, the adverse employment action must disproportionately impact that individual's rights as a shareholder in some way. If a minority shareholder receives any particular benefits, as a shareholder, by virtue of his or her employment, and those benefits are adversely affected by virtue of an adverse employment action, then the shareholder can make a claim for oppression under revised Section 489.

Even with the passage of this amendment to Section 489, Michigan corporations still have the ability to terminate employees who are minority shareholders. A claim for oppression only arises when the employment termination or other adverse employment action disproportionately impacts the employee's interests as a shareholder. Even with this new amendment, no clear rules exist as to the circumstances in which a minority shareholder has a claim for shareholder oppression under Section 489.

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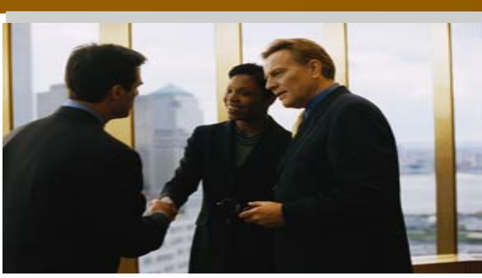

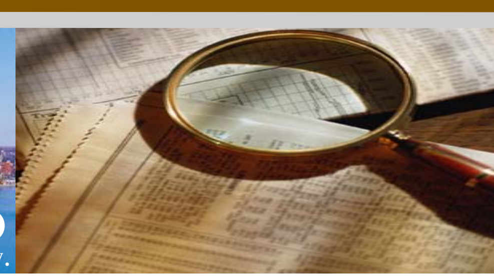

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