

# Warranting Further Discussion: Why the Use of Financing Warrants in ESOP Transactions Benefits American Workers

Aziz El-Tahch, Matthew Hricko, Isaiah Aguilar, Lars Golumbic, and Andrew Salek-Raham

*The leveraged Employee Stock Ownership Plan (ESOP) structure was created by US Congress to enable American workers to gain an equity interest in their companies without using their own funds. A critical component in the financing of leveraged ESOP transactions is a “warrant,” which enables corporate sponsors of ESOPs to access the financing necessary to facilitate purchases of company stock by ESOPs. Warrants also afford substantial benefits to ESOPs by providing downside risk for ESOP participants, freeing up cash for more productive uses than servicing interest on debt and aligning all corporate stakeholders’ interests toward the common goal of increasing equity value.*

*Recently, however, the US Department of Labor (DOL) has taken the position that warrants necessarily reduce the fair market value of a subject company’s equity in an ESOP transaction. This position, which would discourage ESOP formation, is contrary to both the “fair market value” standard that governs ESOP transactions and the DOL’s long-held position on this issue. By helping to clear misconceptions around the use of warrants in leveraged ESOP transactions, we hope to contribute to the continued proliferation of ESOP ownership, resulting in a broader-based participation in wealth creation among American workers.*

The American Dream—the idea that anyone can achieve their own version of success regardless of their starting point in life—has always faced obstacles. For hard-working individuals wishing to improve their economic well-being and financial security, those obstacles have only multiplied over the past several decades, as more and more wealth has become concentrated in the hands of fewer and fewer American families. Fortunately, we have a ready-made tool in this country to encourage more inclusive and broad-based participation in the creation of wealth: employee stock ownership plans (ESOPs), a type of defined contribution retirement plan that primarily invests in the stock of the employer sponsoring the plan.

Aziz El-Tahch, Matthew Hricko, and Isaiah Aguilar are affiliated with Stout Risius Ross, LLC. Mr. El-Tahch is a Managing Director in the firm’s Valuation Advisory group and Co-Leader of the ESOP & ERISA Advisory practice. Matthew Hricko and Mr. Aguilar are Managing Directors in the firm’s Valuation Advisory Group. Lars Golumbic and Andrew Salek-Raham are affiliated with Groom Law Group, Chtd. Mr. Golumbic is a Principal and the Litigation Practice group’s co-chair. Mr. Salek-Raham is an Of Counsel and member of the firm’s Litigation Practice group.

Recognizing the social and economic benefits of employee ownership, Congress has repeatedly passed laws promoting the creation of ESOPs and established a framework to protect individual employees who participate in them. Congress’s efforts have borne fruit: As of 2018, about 14 million American workers held about \$1.4 trillion in assets through approximately 6,500 ESOPs.

Although there are many ways to form an ESOP, one of the most effective structures to transfer wealth to employees—without employees investing any of their own money—is known as a “leveraged ESOP” transaction. As the term suggests, in these types of transactions, an ESOP or its sponsoring company borrows against the company’s assets and earnings to obtain the financing needed to acquire employer shares from existing shareholders, which the company then pays down itself in the form of contributions made on behalf of the ESOP. Those company contributions, in turn, are used by the ESOP to release shares of employer stock into employee participants’ accounts. Under this structure, a company’s employees need not use a dollar of their own money to enjoy the benefits of these stock contributions. ESOPs are unique in this sense; they are the only type of retirement plan that Congress empowered to borrow and invest funds in this way.

Though a company’s employees do not use their own money to acquire company shares in leveraged ESOP deals,

financing these transactions is not free. Lenders, who are often the selling shareholders themselves, must be willing to provide credit. Similar to any bank, lenders in leveraged ESOP transactions may be willing to extend credit only if they are compensated for the risk of the loan through a market-based rate of return.

One of the most important tools available to borrowers seeking such financing—whether done in the context of an ESOP transaction or any other leveraged corporate transaction—is what’s known as a “warrant.” Warrants are a type of derivative security that corporate borrowers issue to lenders in connection with a stated interest rate to obtain subordinated financing. Warrants give their holders the option of acquiring newly issued shares in the borrowing company—or, more often, cash tied to the value of such shares—at some point in the future. If the borrowing company’s stock increases above the “strike price” of the warrant (which is the amount of money the warrant holder has to pay to exercise the warrant), the warrant will have positive value. However, if the borrowing company’s stock remains at or below the strike price, the warrant will simply expire and be worth nothing. Typically, lenders will take warrants in exchange for accepting a below-market cash interest rate on the loan. The combination of warrants and a lower stated interest rate enable the lender to achieve a market-based expected rate of return commensurate with the risk of the loan while providing the borrower with credit that it otherwise would be unable to obtain.

In addition to facilitating access to capital, warrants provide important benefits to borrowers and, in the context of ESOP transactions, a company’s employees. Warrants (a) decrease the amount of annual cash required by the sponsoring company to service the loan (due to the lower stated interest rate); (b) create significant downside protection for the ESOP and ESOP participants in the event of company underperformance or a market downturn; and (c) align the financial interests of the ESOP, the sponsoring company, and the lenders themselves behind the goal of maximizing the future value of the ESOP’s equity. In short, it is a rare win-win for the ESOP, the sponsoring company, and the selling shareholders acting as lenders in a leveraged deal.

Unfortunately, despite the meaningful benefits of warrants in leveraged ESOP transactions, the use of warrants has recently come under attack by the US Department of Labor (DOL), as well as plaintiffs’-side law firms. The DOL’s position can be summarized as follows: Because warrants are necessarily expressed as a percentage of a sponsoring company’s shares, using warrants as a financing tool reduces the ESOP’s effective ownership interest. According to the DOL, it follows that the fair market value of a subject company acquired by an ESOP—and thus, the amount

ESOPs pay and sellers receive—should be reduced as a result of these warrants.

As detailed below, the DOL’s view flies in the face of generally accepted valuation and corporate finance theory, as well as the DOL’s own long-standing position on this topic. If the DOL’s view of warrants is widely adopted, companies considering a leveraged ESOP may not be able to access the full amount of the financing required for a given acquisition, or they will be burdened by high cash interest expense with no downside protections. Debunking misconceptions about warrants, therefore, is imperative if millions of American workers are to benefit from the formation of new ESOPs.

We aim to assist in that effort. We detail the policy reasons underlying Congress’s goal of encouraging leveraged ESOPs (Part I), describe how parties to ESOP transactions use warrants to benefit ESOPs (Parts II and III), explain the DOL’s view of warrants against the backdrop of its decades-long stance on the effect of financing on fair market value (Parts IV and V), and demonstrate that the DOL’s position is problematic as a matter of policy and law (Parts V and VI).

### I. Congress’s Vision for ESOPs: A More Equitable Distribution of Capital

Congress first established the legal framework for creating and administering ESOPs in 1974 when it enacted the Employee Retirement Income Security Act (ERISA).<sup>1</sup> In doing so, Congress sought not only to codify a new type of employee benefit, but also to create tax incentives to encourage companies to create ESOPs that would transfer equity to American workers:

The ESOP is designed to accomplish corporate financing through an employee benefit plan. . . . The ESOP’s primary purpose, however, is not to serve as a retirement vehicle but, rather, to serve as an incentive for corporations to structure their financing in such a way that employees can gain an ownership stake in the company for which they work.<sup>2</sup>

Congress aimed to give workers an ownership stake to ward off the problems it believed would result from labor market disruptions caused by new technologies. Congress believed that, as technology advanced and replaced individual labor, American companies would become more efficient and profitable—a benefit for the country as a whole. But the benefits would be unequally distributed; those with an equity stake in American businesses would benefit more than the American worker, whose only “stock in trade” is the labor that new technologies would make obsolete. To help American workers share in

<sup>1</sup>29 U.S.C. §§ 1001 *et seq.*

<sup>2</sup>129 Cong. Rec. S16637 (1983). *See also* *ibid.*, at S16630 (“[T]he goal is to provide incentives for financing to be structured in such a way that, in the future, more Americans will have a chance to accumulate a capital estate.”).

America’s economic prosperity, they needed an equity stake in it.<sup>3,4</sup> But one can’t obtain an ownership interest without first having the capital with which to purchase it. Congress recognized this fact—that “the ownership of new wealth is largely a function of the ownership of existing wealth”—and saw that it was a catch-22 for American workers that needed to be addressed.<sup>5</sup>

The solution was the ESOP. Congress intended that employers would use ESOPs as a “technique of corporate finance”<sup>6</sup> that would help “break this monopoly of participation in the ownership of productive assets” by “broadening access to the financial logic of self-liquidating corporate debt.”<sup>7</sup> The phrase “technique of corporate finance” refers

primarily to the “*leveraged ESOP*,” an ESOP that uses borrowed funds to acquire employer stock, with the employer, or a related party, guaranteeing repayment of the loan. It is this guarantee, plus the underlying security provided for the loan, that puts the logic of corporate finance to work for a company’s employees.<sup>8</sup>

Congress thus authorized—and encouraged, through other measures<sup>9</sup>—ESOPs to borrow funds to finance acquisitions of employer stock. ESOPs could offer as collateral shares of the subject company and use the

company’s future cash flows—generated by its employee-participants’ labor—to pay down the debt and increase its ownership interest over time, much in the same way homeowners who pay down mortgages over time increase their equity in their homes.

## II. The Use of Warrants in ESOP Stock Purchase Transactions

Leveraged ESOP transactions are thus central to Congress’s goal of spurring employee ownership to expand wealth-building opportunities to the working class. The following sections describe in more detail the basics of how leveraged ESOP transactions are often structured.

### Leveraged ESOP deals

Nearly all ESOP transactions are fully leveraged acquisitions, meaning that the ESOP uses the ESOP sponsor company’s assets and earnings power—as opposed to a cash investment by the employees themselves—to obtain financing necessary to fund the ESOP’s acquisition of the company’s stock.<sup>10</sup>

A typical leveraged ESOP transaction involves two categories of loans.<sup>11</sup> The first—the “external loan”—comes from financial institutions, private equity firms, or the selling shareholders themselves.<sup>12</sup> The proceeds of the external debt that the company (or ESOP) incurs are used to buy out the existing shareholders through a combination of cash payments and promissory notes. The second type of loan—the “internal loan”—is between the company and the ESOP using a stock purchase agreement and a promissory note.<sup>13</sup> Under the stock purchase agreement, the ESOP buys shares of the company and, under the promissory note, the ESOP agrees to pay the company for those shares over time. The company makes tax-deductible contributions to the ESOP, which the ESOP immediately returns to the company as installment payments on the internal loan, triggering the release of shares to employees.<sup>14,15</sup>

<sup>3</sup>129 Cong. Rec. S16633-34 (“Thus, each round of new investment [in technology] further threatens [laborers’] power to earn a living. Instead of being part owners of the system, they find themselves pitted against it. If this new technology is to have a welcome context for its use, we must begin to strike a new balance between social and economic objectives.”).

<sup>4</sup>Congress also saw ESOPs as a democratic, capitalistic counter to communism. 129 Cong. Rec. S16635 (“The path that expanded ownership takes faces in exactly the opposite direction from that taken by those who favor ownership by the State. Expanding ownership financing seeks to steadily increase the number of capital owners instead of preventing anyone from owning capital by making the State the only owner. Employee ownership has far-reaching implications for those who share the democratic vision.”).

<sup>5</sup>129 Cong. Rec. S16634 (“Concentrated wealth holdings contribute to the cumulative and self-reinforcing nature of the concentration of wealth and income. The concentration of stock ownership leads to a situation where those who currently own stock are those best able to save significant amounts and, thus, best able to make additional investments, thereby increasing their stock ownership.”).

<sup>6</sup>129 Cong. Rec. S16637.

<sup>7</sup>129 Cong. Rec. S16634.

<sup>8</sup>129 Cong. Rec. S16637 (emphasis added).

<sup>9</sup>Congress created a series of corporate tax incentives, rules, and exemptions within ERISA that are unique to ESOPs to encourage employers to establish them. For example, Congress created a series of ESOP-related tax benefits, including allowing those who sell shares to an ESOP to roll over their proceeds to other qualified investments on a tax deferred basis, 26 U.S.C. § 1042; making employer contributions to ESOPs tax deductible, 26 U.S.C. § 404(a)(9); making S corporation income tax free to the extent owned by an ESOP, 26 U.S.C. §§ 512(e)(3), 1361(c)(6); and making C corporation dividends tax deductible when passed through an ESOP, 26 U.S.C. § 404(k). Congress also encouraged ESOPs by carving them out of ERISA’s requirement to diversify trust assets, 29 U.S.C. § 1104(a)(2); created an ESOP-specific exemption from ERISA’s prohibited transaction rules, 29 U.S.C. § 1108(e); and empowered ESOPs to borrow funds from third parties, which no other type of benefits plan is permitted to do, 29 U.S.C. § 1108(b)(3).

<sup>10</sup>See, e.g., NCEO, *Leveraged ESOPs and Employee Buyouts* (6th ed., 2017), 5–9 (“NCEO Leveraged ESOPs”).

<sup>11</sup>*Ibid.*, 5–6.

<sup>12</sup>*Ibid.*

<sup>13</sup>*Ibid.*

<sup>14</sup>NCEO *Leveraged ESOPs*, pp. 5–6; see *Hugler v. First Bankers Tr. Servs., Inc.*, No. 12-CV-8649, 2017 WL 1194692, at \*5 (S.D.N.Y. March 30, 2017) (describing similar financing structure); *Reich v. Valley Nat’l Bank of Ariz.*, 837 F. Supp. 1259, 1273 (S.D.N.Y. 1993) (same, and noting that “the ESOP obtained its six million shares without any initial cash outlay”).

<sup>15</sup>This is an example of a commonly used structure in ESOP transactions. There are many variations, but the use of both internal and external loans is common to virtually all of them.



In most leveraged ESOP transactions, the sponsoring company will access multiple tranches of external loans to finance the ESOP's acquisition. Generally speaking, these fall into two categories: senior and subordinated (or "mezzanine") debt.<sup>16</sup> Senior debt is secured by the sponsoring company's collateral and enjoys the highest repayment priority (and, therefore, has the lowest interest rate), but the amount that can be borrowed as senior debt is generally capped at a level insufficient to consummate the desired ESOP transaction.<sup>17</sup> Consequently, companies use subordinated debt to provide the necessary financing above the senior debt available to enable the ESOP to complete the acquisition.<sup>18</sup> Mezzanine financing is behind senior debt in repayment priority and is unsecured or partially-secured and, as a result, is meaningfully riskier.<sup>19</sup>

The priority and secured status of senior debt means the senior lender bears less risk than a subordinated lender and, as a result, senior debt has a lower required rate of return than mezzanine debt.<sup>20</sup> According to the Pepperdine Private Capital Markets Project's *Private Capital Markets Report—2020*, the expected returns on subordinated debt investments ranged from approximately 11.5% to 20.5%, depending on the size of the target companies. According to GF Data's May 2021 *Leverage Report*, the total rate of return for subordinated debt ranged from 13.8% to 15.1% for transactions ranging from \$10 to \$250 million.<sup>21</sup> A publication facilitated by the NYU Stern School of Business and Bond Capital Mezzanine, Inc., indicates that non-bank lenders commonly issue subordinated debt with a stated cash interest rate between 12% to 18% and "warrants to buy common stock, which the investor values based on the outlook of the company, *or* incremental interest paid on a 'pay-in-kind' or PIK basis" to achieve an overall required 15% to 25% rate of return.<sup>22</sup> In practice, the credit profile of a business, its industry, consistency of cash flows, the credit market at the time

of issuance, and the amount of equity investment behind a subordinated loan all impact the cost of subordinated debt. Given the incremental risk in holding an unsecured position in a company, the range of required rates of return on subordinated debt is much greater than the typical 4.5% to 6.4% interest rates for senior financing.<sup>23</sup> A leveraged transaction, whether ESOP or non-ESOP, may involve multiple sub-layers of subordinated financing, with each additional layer bearing more risk and, thus, requiring a higher required rate of return.<sup>24,25</sup>

### Structuring mezzanine debt repayment

Although borrowers most often pay the cost of senior debt with a cash interest rate on the amount of the principal balance, doing the same with mezzanine financing is often unfavorable to the borrower. A cash interest rate commensurate with the higher required returns on mezzanine debt would, for many borrowers, severely restrict their ability to use future cash flows and create little margin for error in terms of performance since company earnings are used to repay the debt.<sup>26</sup>

For these reasons, borrowers and lenders—again, in both the ESOP and non-ESOP contexts—commonly agree to structure mezzanine debt to include both a below-market stated interest rate and another type of repayment feature. Doing so does *not* push the cost of the mezzanine debt above market. The goal, in fact, is just the opposite: to combine an interest rate that, standing alone, would be below market for the debt but, when combined with the other repayment feature, results in a market-based rate of return for the lender and cost of debt for the borrower commensurate with the level of risk. Conceptually, it is a bit like paying for a \$5 ice cream cone—not with a five-dollar bill, but with three one-dollar bills and eight quarters: you overpay for your treat only if you accidentally give the cashier four one-dollar bills or nine quarters.

Mezzanine debt repayment features other than interest commonly include PIK interest, conversion rights (*i.e.*,

<sup>16</sup>For simplicity, we use the terms subordinated and mezzanine interchangeably when referencing debt instruments that are subordinate to senior financing.

<sup>17</sup>See Brealey, Myers, and Allen, *Principles of Corporate Finance* (10th ed., 2011), 601–602.

<sup>18</sup>Bond Capital, Corry Silbernagel, and Davis Vaitkunas, *Mezzanine Finance White Paper* (2d ed. Update 2016), accessed at <https://www.bondcapital.ca/wp-content/uploads/pdfs/2016-bond-capital-mezzanine-finance-white-paper.pdf>.

<sup>19</sup>*Ibid.*, 3.

<sup>20</sup>*Ibid.*

<sup>21</sup>The "rate of return" to lenders and "cost of debt" to borrowers are two sides of the same coin. If the rate of return to the lender is a market rate of return, the cost of debt to the borrower is also said to be market rate.

<sup>22</sup>Bond Capital, Corry Silbernagel, and Davis Vaitkunas, *Mezzanine Finance* (2d ed., 2012), 7 (emphasis added), accessed at [https://pages.stern.nyu.edu/~igiddy/articles/Mezzanine\\_Finance\\_Explained.pdf](https://pages.stern.nyu.edu/~igiddy/articles/Mezzanine_Finance_Explained.pdf).

<sup>23</sup>Pepperdine Graziadio Business School, Everett, Craig R., *2020 Private Capital Markets Report* (including bank lending for loan sizes \$5 million through \$50 million) (2020), 5, accessed at [http://digitalcommons.pepperdine.edu/gsbm\\_pcm\\_pcmr/13](http://digitalcommons.pepperdine.edu/gsbm_pcm_pcmr/13).

<sup>24</sup>*Mezzanine Finance White Paper*, 3–4.

<sup>25</sup>Please note rates of return can change frequently, and the referenced rates of return may not be applicable at the time of future debt issuances. However, the purpose of referencing such rates of return is to highlight the relative difference between the required rate of return for a senior loan versus a required rate of return for a subordinated loan.

<sup>26</sup>See *infra* Part III (discussing the benefits to ESOPs of using warrants).

convertible securities), and warrants.<sup>27</sup> Warrants are securities that give the holder the right, for a defined period of time, to buy shares of stock in the company at a pre-determined price (the “exercise price” or “strike price”).<sup>28</sup> A warrant is thus a derivative security, meaning the value of a warrant is tied to the value of the underlying company security—typically common stock. The value of a warrant at exercise is equal to the difference in the per share stock price of the company and the strike price, multiplied by the number of corresponding shares underlying the warrant.<sup>29</sup> By design, a warrant has no intrinsic value until the underlying stock price exceeds the exercise price of the warrant. At that point, the warrant can be profitably exercised and is said to be “in-the-money.” On the other hand, the warrant is said to be “out-of-the-money” when the stock price is below the exercise price because the warrant cannot be profitably exercised.<sup>30</sup> Upon exercise, the warrant holder either (a) buys the underlying common stock at the warrant’s exercise price or (b) receives the difference between the fair market value of the underlying common stock and the warrant’s exercise price in the form of cash or a note. If a warrant is out-of-the-money at its expiration date, the warrant expires with no value and the holder receives no payment.<sup>31</sup>

Figure 1 provides a hypothetical example of the cost of obtaining mezzanine debt under two different scenarios:

<sup>27</sup>PIK interest is “a financial instrument that pays interest or dividends to investors of bonds, notes, or preferred stock with additional securities or equity instead of cash.” Investopedia, *Payment-in-Kind (PIK)*, accessed at <https://www.investopedia.com/terms/p/paymentinkind.asp>. Convertible securities are “investment[s] that can be changed from its initial form into another form,” like convertible bonds or preferred stock that can be changed into equity or common stock. Investopedia, *Convertible Security*, accessed at <https://www.investopedia.com/terms/c/convertible-security.asp>.

<sup>28</sup>Mark Grinblatt and Sheridan Titman, *Financial Markets and Corporate Strategy* (Irwin/McGraw-Hill 1998), 79 (emphasis added).

<sup>29</sup>Robert W. Kolb, *Futures, Options, & Swaps* (2d ed., 1997), 558–559.

<sup>30</sup>Shannon P. Pratt, *Valuing a Business: The Analysis of Closely Held Companies* (McGraw-Hill 5th ed., 2008), 586–587.

<sup>31</sup>Warrants are commonplace in leveraged ESOP transactions, but ESOPs and their sponsor companies are not the only parties that use warrants. Issuing warrants with debt has long been a common financing instrument in connection with arm’s length transactions involving investors. BBVA, *Warrants: What are they and how do they work?* (September 22, 2016), accessed at <https://www.bbva.com/en/warrants-what-are-they-and-how-do-they-work/>. Warrants are a common financing instrument issued in connection with subordinated notes issued in private equity transactions. CooleyGO, *What You Should Know About Warrants*, accessed at <https://www.cooleygo.com/what-you-should-know-about-warrants/>. The structure of mezzanine/subordinated debt issued with warrants has similar attributes to convertible bonds (a straight bond with an option), although a few differences exist. For example, warrants are usually issued in private capital markets (as opposed to bonds being issued publicly), warrants can generally be detached (as opposed to bonds and the option being bundled), and warrants can be and often are exercised for cash, net of the exercise price (whereas bonds are exchanged for common stock). See Brealey, Myers, and Allen, *Principles of Corporate Finance, A Variation on Convertible Bonds: The Bond–Warrant Package* (11th ed. 2014), 621.

(a) a \$70 million subordinated note with an illustrative 13.0% market-based cash interest rate and 8-year term (the “Market-Rate Interest Note”); and (b) a \$70 million subordinated note with a 5.5% cash interest rate and 8-year term (the “Below-Market Interest Note”) with warrants. In either instance, both the lender and the borrower would be economically neutral to the issuance of a subordinated note with (a) a market-based 13.0% cash interest rate and no warrants or (b) a 5.5% cash interest rate that, when combined with warrants, would have an anticipated 13.0% all-in rate of return equal to the market-based cash interest rate.<sup>32</sup>

### III. Warrants Benefit ESOPs

Although issuing warrants to supplement below-market cash interest payments may yield an economically neutral result from an expected rate of return and cost of debt perspective, it does not mean that lenders and borrowers in ESOP deals are agnostic as to whether to use warrants. Quite the opposite: warrants bring distinct advantages to both parties. We focus below on the benefits of warrants to ESOPs, their participants, and their sponsor companies.

#### *Warrants relieve cash flow pressure*

As discussed, Congress’s clear intent was that leveraged ESOP transactions would allow employees to acquire an equity stake in their companies using the company’s future earnings (rather than their own savings) to repay transaction-related debt.<sup>33</sup> Because the capital structure of a company following a leveraged ESOP purchase transaction has a significant amount of debt by design, the demands on the company’s cash flow to service debt—payments of principal and interest—could be significant and cost prohibitive if the transaction involved mezzanine debt that requires cash interest payments at market-based rates. But, as discussed previously, including warrants in the financing package reduces the fixed, cash interest rate otherwise associated with the higher cost of mezzanine debt. As a result, the sponsor company and the ESOP benefit from greater free cash flows during the life of the loan relative to paying fixed market-based cash interest rates until the loan has been repaid (Figure 2).

This cash savings is particularly beneficial for companies that require extensive investments back into the business, such as high growth companies or companies

<sup>32</sup>The internal rates of return (IRR) presented herein are for illustrative purposes only and could vary materially depending on the specific facts and circumstances.

<sup>33</sup>See *supra* Part I.

*In Thousands of U.S. Dollars*

		For the Year Ending								
		Transaction	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
Initial Outlay [a]	\$	(70,000)								
Interest Payments [b]		0	9,100	9,100	9,100	9,100	9,100	9,100	9,100	9,100
Principal Payments		0	0	0	0	0	0	0	0	70,000
Payment for Warrants		0	0	0	0	0	0	0	0	0
<b>Total Debt Cash Flows</b>	<b>\$</b>	<b>(70,000)</b>	<b>\$ 9,100</b>	<b>\$ 9,100</b>	<b>\$ 9,100</b>	<b>\$ 9,100</b>	<b>\$ 9,100</b>	<b>\$ 9,100</b>	<b>\$ 9,100</b>	<b>\$ 79,100</b>
<b>Internal Rate of Return</b>		<b>13.0%</b>								

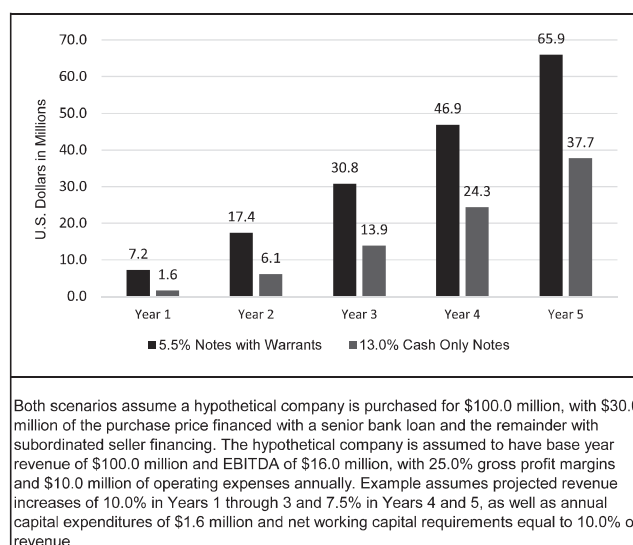
		For the Year Ending								
		Transaction	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
Initial Outlay	\$	(70,000)								
Interest Payments [c]		0	3,850	3,850	3,850	3,850	3,850	3,850	3,850	3,850
Principal Payments		0	0	0	0	0	0	0	0	70,000
Payment for Warrants [d]		0	0	0	0	0	0	0	0	66,667
<b>Total Debt Cash Flows</b>	<b>\$</b>	<b>(70,000)</b>	<b>\$ 3,850</b>	<b>\$ 3,850</b>	<b>\$ 3,850</b>	<b>\$ 3,850</b>	<b>\$ 3,850</b>	<b>\$ 3,850</b>	<b>\$ 3,850</b>	<b>\$ 140,517</b>
<b>Internal Rate of Return</b>		<b>13.0%</b>								

[a] Based on a \$100.0 million purchase price, with \$70.0 million financed with subordinated seller debt.  
 [b] Based on cash interest of 13.0% per annum. Interest calculation is based on beginning balance.  
 [c] Based on cash interest of 5.5% per annum. Interest calculation is based on beginning balance.  
 [d] Warrant payment is estimated based on the projected value of the common stock of \$205.00 per share as of Year 8 less an exercise price of \$5.00 multiplied by 333,333 warrants outstanding, representing 25.0% of the company's fully-diluted shares outstanding.

**Figure 1**  
Comparison of Market-Rate Interest Note vs. Below-Market Interest Note (with Warrants)

that require significant capital expenditures. ESOP-owned companies may also benefit from these additional cash flows by prepaying existing debt principal.<sup>34</sup>

<sup>34</sup>The US Government has validated the use of this financial instrument in select situations, including in April 2020 when the Treasury Department acquired the right to purchase up to 13,000,000 warrants (PSP Warrants) of the common stock of American Airlines Group Inc. (AAL) in connection with the issuance of low-interest loans during the COVID-19 pandemic. Additionally, the US Treasury Department obtained an option to purchase more common stock of AAL on the date of each increase of the principal amount of the promissory note in connection with low-interest loans to help the airline through government-imposed shutdowns. Similar to warrants issued in ESOP transactions, the PSP Warrants had an exercise price (\$12.51 per share, tied to the closing price of the common stock), no voting rights, and an expiration date whereby the warrants will be exercisable either through net share settlement or cash, at the company's option. Reuters, *Exclusive: Treasury wants warrants, repayment from major U.S. airlines on 30% of grant money – sources* (April 10, 2020), accessed at <https://www.reuters.com/article/us-health-coronavirus-usa-airlines-progr/exclusive-treasury-wants-warrants-repayment-from-major-u-s-airlines-on-30-of-grant-money-sources-idUSKCN21S1Y7> and AAL 8k filed April 20.



**Figure 2**  
Comparison of Cumulative Cash Flows

*In Thousands of U.S. Dollars*

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Year 6</u>	<u>Year 7</u>	<u>Year 8</u>	<u>Total</u>
<b>Subordinated Note with Warrants:</b>									
Interest [b]	\$3,850	\$3,850	\$3,850	\$3,850	\$3,850	\$3,850	\$3,850	\$ 3,850	\$ 30,800
Principal [c]	0	0	0	0	0	0	0	70,000	70,000
Warrants [d]	0	0	0	0	0	0	0	51,667	51,667
Total	<u>3,850</u>	<u>3,850</u>	<u>3,850</u>	<u>3,850</u>	<u>3,850</u>	<u>3,850</u>	<u>3,850</u>	<u>125,517</u>	<u>152,467</u>
<b>Internal Rate of Return</b>	<b>11.6%</b>								
<b>Subordinated Note without Warrants:</b>									
Interest [e]	9,100	9,100	9,100	9,100	9,100	9,100	9,100	9,100	72,800
Principal [c]	0	0	0	0	0	0	0	70,000	70,000
Warrants [f]	0	0	0	0	0	0	0	0	0
Total	<u>9,100</u>	<u>9,100</u>	<u>9,100</u>	<u>9,100</u>	<u>9,100</u>	<u>9,100</u>	<u>9,100</u>	<u>79,100</u>	<u>142,800</u>
<b>Internal Rate of Return</b>	<b>13.0%</b>								
<p>[a] Downside scenario assumes operating income 15.0% below base case level.                  [b] Based on 5.5% cash interest for the subordinated note.                  [c] Assumes no principal amortization on the subordinated note.                  [d] Based on 333,333 warrants outstanding (equal to 25.0% of fully-diluted equity) with an exercise price of \$5.00 per unit.                  [e] Based on cash interest of 13.0% for the subordinated note.                  [f] No warrants outstanding in the cash interest only note scenario.</p>									

**Figure 3**  
Subordinated Note Payments and Rate of Return—Downside Scenario

**Warrants shift risk away from the ESOP**

If a company underperforms in the years following an ESOP transaction—that is, its earnings are lower than were projected at the time of the deal—the company and ESOP benefit greatly if the transaction’s mezzanine debt uses an interest-plus-warrants structure rather than interest alone. In the latter scenario, the company and ESOP are responsible for the full amount of the higher interest rate, regardless of whether the company has cash flows available to service the debt. But in the interest-plus-warrants scenario, the underperforming company not only benefits from a lower cash interest rate, but also a likely lower warrant payout (if any), ultimately reducing the cost of the mezzanine loan.

Viewed this way, warrants are akin to *deferred, variable interest* that decreases when the sponsor company and underlying stock price underperform and increases when the sponsor company and stock price overperform. This structure shifts risk in a downside scenario away from the borrowing company and ESOP

and onto the lender.<sup>35</sup> This concept is presented in Figure 3. The expected cost of subordinated financing (*i.e.*, the IRR from the lender’s perspective) presented herein is for illustrative purposes only and will vary depending on specific facts and circumstances.

<sup>35</sup>Often, senior lenders will cap interest amounts that the borrower can agree to pay a subordinated lender. In those instances, the borrower will not be choosing between paying a high, fixed-market interest rate and interest-plus-warrants but will be choosing between a lower interest rate and warrants or a lower interest rate plus another type of financing instrument—most commonly, PIK. As alluded to above, *see supra* fn. 27, excess interest paid as PIK means that the excess interest is added to the current principal balance of the note and accrues interest at the stated interest rate of the note which by definition is a higher market rate of interest. The PIK amount generates additional interest paid as PIK and soon the principal amount of the note may grow exponentially. In a downside scenario, not only is the company at risk for defaulting on current payments, but the ballooning principal amount creates real risk of failure. Where an underperforming warrant may have no value, PIK amounts, plus their accrued interest, will always be owed regardless of performance results—just like a fixed cash interest rate.



### **Warrants ensure that the interests of all stakeholders are aligned**

Mezzanine lenders holding warrants commonly participate in the borrowing company's post-transaction management or operations. In the context of ESOP transactions, the mezzanine lenders are often the selling shareholders themselves, who may remain active in the company's operations and management.

By issuing warrants to these selling shareholders in connection with their subordinated debt, the ESOP ensures that selling shareholders have an incentive to maximize equity value post-transaction in order to generate their highest return. Indeed, the return on their warrants is tied to the company's stock price, which is primarily impacted by the company's financial performance. In short, issuing warrants ensures that the company's new creditors have financial interests that are directly aligned with those of the ESOP and its participants.

In summary, warrants issued to supplement a below-market interest rate on subordinated debt are a normal cost of obtaining mezzanine financing. Unlike interest, warrants enable a company to preserve cash, provide downside protection for a company's shareholders, and ensure that all company stakeholders' interests are aligned with the ESOP's: to improve the company's earnings and, with it, the value of the company's stock. Warrants thus benefit ESOPs and a company's employees—in ways that other financing instruments simply do not.

### **IV. ERISA, Courts, and the DOL Are Clear That Financing Costs Do Not Affect the Fair Market Value of a Subject Company in a Leveraged ESOP Transaction**

That warrants are merely a cost of financing has important implications in ESOP transactions. Specifically, ERISA prevents ESOP trustees and their appraisers from considering a borrower's financing costs when determining the underlying value of the subject company. Understanding why requires an overview of the legal landscape governing ESOP acquisitions of employer stock.

#### **ERISA's "adequate consideration" standard**

Under ERISA, an ESOP can acquire stock in the company so long as it does not pay more than "adequate consideration."<sup>36</sup> ERISA defines adequate consideration

<sup>36</sup>See 29 U.S.C. §§ 1106, 1108(e); *Henry v. Champlain Enters., Inc.*, 445 F.3d 610, 618 (2d Cir. 2006) ("Congress enacted in Section 408 a conditional exemption from the prohibited transaction rules for acquisition of employer securities by ESOPs.") (quoting *Donovan v. Cunningham*, 716 F.2d 1455, 1465 (5th Cir. 1983)).

as "the fair market value of the asset as determined in good faith by the trustee . . . and in accordance with regulations promulgated by the Secretary."<sup>37,38</sup> The term "fair market value" is defined as

the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset.<sup>39</sup>

The fair market value standard is an objective one; that is, the "willing buyer" and "willing seller" are "hypothetical persons rather than specific individuals or entities, and their characteristics are not necessarily shared by the actual seller or particular buyer."<sup>40,41</sup>

Under this objective standard, the fair market value of a subject company is not affected by the attributes associated with the particular parties involved in the transaction. For example, when an ESOP purchases a 100% interest in a corporation that qualifies for S corporation status under the Internal Revenue Code, the

<sup>37</sup>29 U.S.C. § 1002(18)(B).

<sup>38</sup>In 1988, the DOL proposed regulations to further define adequate consideration, as it "recognize[d] that plan fiduciaries have a need for guidance in valuing assets, and that standards to guide fiduciaries in this area may be particularly elusive with respect to [privately held securities]." Proposed Regulation Relating to the Definition of Adequate Consideration, 53 Fed. Reg. 17,632, 17,633 (May 17, 1988). Despite recognizing the need for guidance, the DOL never finalized the regulations or otherwise issued guidance regarding the meaning of adequate consideration. It instead has sought to regulate by after-the-fact enforcement.

<sup>39</sup>Rev. Rul. 59-60, 1959-1 C.B. 237 (1959); see also *Henry*, 445 F.3d at 619 (citing Proposed Regulation Relating to the Definition of Adequate Consideration, 53 Fed. Reg. 17,632, 17,633 (May 17, 1988)).

<sup>40</sup>*Perez v. Bruister*, 54 F. Supp. 3d 629, 675 (S.D. Miss. 2014); see, e.g., *Chesmore v. Alliance Holdings, Inc.*, 886 F. Supp. 2d 1007, 1048 (W.D. Wis. 2012) (describing hypothetical standard); *Hans v. Tharaldson*, No. 3:05-cv-115, 2011 WL 6937598, at \*4 (D.N.D. Dec. 23, 2011) (describing the hypothetical standard as "legally mandated"); *Eyler v. Comm'r*, 69 T.C.M. (CCH) 2200 (T.C. 1995) (the standard is "objective, using a purely hypothetical willing buyer and seller"), *aff'd*, 88 F.3d 445 (7th Cir. 1996); Pratt, *Valuing a Business* (5th ed., 2008), 42 ("[T]he willing buyer and willing seller are hypothetical persons. . . rather than any particular buyer or seller. . . . [A] price would not be considered representative of fair market value if influenced by special motivations not characteristic of a typical buyer or seller.").

<sup>41</sup>The fair market value standard's focus on a hypothetical buyer/seller differs from other standards of value, like "investment value," which do consider specific characteristics unique to the buyer and seller. See Pratt, *Valuing a Business* (5th ed., 2008), 41–43 (distinguishing between the standards). Indeed, Courts have held that ESOP trustees valuing privately held stock must not apply a standard that focuses on the specific characteristics of the ESOP as a buyer. *Valley Nat'l Bank of Ariz.*, 837 F. Supp. at 1283 (finding trustee liable because it "did not refer in its analysis to what a hypothetical, non-coerced buyer would pay, but rather analyzed the investment in terms of the same conditions paid by the ESOP . . . . The result was the investment value of the shares to the ESOP, not the fair market value, as Valley was required to pay under [29 U.S.C. § 1002(18)(B)]."); *ibid*, 1282 ("Investment value to the ESOP is not the same as fair market value, and it is the latter which is required by [29 U.S.C. § 1002](18).").



company's earnings after the acquisition by the ESOP are effectively free from federal income taxes because no taxes are paid at the corporate level and earnings passed through to the ESOP are not taxed because ESOPs are tax-exempt. Consequently, all else being equal, ESOP-owned companies are significantly more valuable than their non-ESOP counterparts. Yet some courts and the DOL have taken the position that ESOP trustees and their appraisers should ignore this ESOP-specific attribute when assessing the subject company's future cash flows to determine its fair market value because that tax-exempt structure is a characteristic of the particular buyer—the ESOP—and not a hypothetical buyer.<sup>42</sup>

***Dole v. Farnum: The DOL takes the position that financing costs have no impact on the adequate consideration analysis, and the courts follow***

Like the S corporation tax benefit, how a particular buyer finances its acquisition—whether it uses all cash, senior debt only, mezzanine debt with interest and warrants, or some combination thereof—is an attribute specific to that buyer that does not factor into the hypothetical buyer-seller analysis. This principle is axiomatic in the broader valuation world. In the ESOP space, it is specifically rooted in the DOL's informal guidance on the definition of adequate consideration and its litigation positions—most notably, its decision to file and then voluntarily dismiss its complaint in *Dole v. Farnum*.

The DOL filed *Dole v. Farnum* in 1990, alleging that ESOP trustees and their appraisers should determine the fair market value of a subject company by deducting the cost of repaying the acquisition debt's principal and interest from the company's projected future cash flows.<sup>43</sup> The public outcry over *Farnum* was deafening. Observers noted that the DOL's position was out of step with basic valuation principles and effectively “would doom

virtually all leveraged ESOPs.”<sup>44</sup> In response, the DOL withdrew its lawsuit and publicly recanted. Then-Assistant Secretary David Ball “admitted the lawsuit was ‘an aberration’”<sup>45</sup> and vowed that, in the future, the DOL “*will not consider the obligations assumed by a company in connection with the establishment of an ESOP in determining whether the plan paid adequate consideration for employer securities.*”<sup>46</sup> Congressional leadership at the time agreed and explained the DOL's valuation error:

The basic flaw in the DOL's position, which might have called into question the legality of nearly all leveraged ESOP's, is that *the complaint confuses valuation with financing. The price, or market value, is what a willing buyer will pay to a willing seller, and it does not matter whether the buyer uses cash on hand, or debt. . . .* Since the leveraged ESOP is the most logical way for employees, generally without adequate funds to pay for stock out of their pockets, and without the credit to borrow money, it is unreasonable to maintain that leveraged ESOPs are legal only if some seller is willing to sell to employees at less than fair market value.<sup>47</sup>

Courts post *Farnum* followed the DOL's lead, likewise concluding that a particular buyer's acquisition debt is not to be considered when determining fair market value under the hypothetical willing buyer/willing seller standard. For example, the plaintiff in *Scott v. Evins* alleged that the appraiser erroneously applied the hypothetical willing buyer/willing seller standard when it failed to deduct the value of the acquisition debt from

<sup>44</sup>An article in Pensions & Investments published shortly after the DOL withdrew the suit summarized the ESOP community's views:

Leon Irish, a partner with the law firm of Jones, Day, Reavis & Pogue, Washington, said the department's withdrawal of the *Dole vs Farnum* complaint will make it “hard to take its enforcement program seriously.” . . .

ESOP experts argued this theory violated basic principles of corporate finance, never had been asserted by the department in the 16 years since [ERISA] was enacted, and would doom virtually all leveraged ESOPs. . . .

“[The Department's withdrawal of the suit is] a great relief, because the complaint had severe implications for a great many leveraged ESOPs,” said David Binns, executive director of the ESOP Association, Washington. . . .

“I remain mystified as to why the decision was made to institute the suit,” said Edwin G. Torrance, an attorney who represents [the sponsor company].

Pensions & Investments, Oct. 29, 1990.

<sup>45</sup>*Ibid.*

<sup>46</sup>BNA Pension Reporter, Vol. 17, No. 49 (December 3, 1990) (emphasis added), 2010; see also Pensions & Investments, October 29, 1990 (quoting Assistant Secretary Ball as saying “the department will not consider obligations and liabilities arising in connection with the ESOP's acquisition debt”).

<sup>47</sup>Sen. Byrd, 136 Cong. Rec. S17793-01 (1990) (emphasis added).

<sup>42</sup>See *Chesemore*, 886 F. Supp. 2d, 1048 (“The tax shield represented a special advantage for an ESOP purchaser and, for that reason, was inappropriate to consider when valuing Trachte's fair market value between a hypothetical willing buyer and seller on the open market.”).

<sup>43</sup>*Dole v. Farnum*, No. 90-0371 (D.R.I. filed July 30, 1990); see Pension and Welfare Benefits Administration, Office of Information, U.S. Department of Labor, *News Release: Labor Department Sues Fiduciaries and Rhode Island Company Directors for Improper Use of Plan Assets*, USDL 90-434 (D.O.L.), 1990 WL 307811 (August 17, 1990) (“The complaint alleges that the fiduciaries violated ERISA when they allowed the plan to purchase stock at a price which exceeded fair market value and *because the plan fiduciaries failed to take into account the cash drain on [the company] caused by the ESOP financing.*”) (emphasis added).

the company's future cash flows.<sup>48</sup> The *Scott* court upheld the appraiser's analysis and ruled that acquisition debt should not be considered under the hypothetical willing buyer/willing seller standard:

The [Department's] proposed regulations do not state that the valuation must take into account any additional debt placed on the issuer as a result of the transaction. *The common stock of [the company] exists independently of the debt used to leverage the purchase*, whether or not guaranteed by the corporation (as was done here). When the stock was appraised, no such debt existed and was therefore properly not taken into account.<sup>49</sup>

Consistent with *Scott*, the court in *Reich v. Valley National Bank of Arizona* also concluded that the fair market value of stock for an ESOP transaction is determined independent of how the ESOP intends to finance the transaction.<sup>50</sup> The *Valley National Bank* court held that the fair market value standard requires that the trustee evaluate a company's value "from the point of view of a willing cash or cash-equivalent investor."<sup>51</sup>

In the dozens of ESOP purchase lawsuits it has brought since *Farnum*, the DOL has never taken the position that principal or interest payments on any kind of acquisition debt should decrease the subject company's fair market value. Indeed, as recently as 2014, the DOL reaffirmed its position that an ESOP's transaction-related debt obligations should not affect the fair market value of a subject company. In that year, the DOL entered into a settlement agreement with an ESOP trustee that prevented the trustee in future transactions from adding the amount of any below-market interest on transaction-related debt to a subject company's fair market value.<sup>52</sup> In other words, the DOL reaffirmed its position arising out of *Farnum* that the cost of transaction debt is a neutral event; it can neither increase nor decrease the fair market value of a subject company.

<sup>48</sup>802 F. Supp. 411, 412-13, 415-16 (N.D. Ala. 1992), *aff'd*, 998 F.2d 1022 (11th Cir. 1993).

<sup>49</sup>*Ibid.*, 415-416 (emphasis added); *see also* *ibid.*, 412 & fn. 6 ("[P]laintiffs contend omission of the contemplated leverage transaction was error . . . . The court does not agree with this contention."); *accord Estate of Blount v. Comm'r*, 87 T.C.M. (CCH) 1303 (2004) (applying hypothetical standard and holding that "[t]o treat the corporation's actual obligation to redeem the very shares that are being valued as a liability that reduces the value of the corporate entity thus distorts the nature of the ownership interest represented by those shares").

<sup>50</sup>837 F. Supp. 1259 (S.D.N.Y. 1993).

<sup>51</sup>*Ibid.*, 1282; *see also* Shannon P. Pratt, *Business Valuation Discounts and Premiums* (2nd ed., 2009), 10 (fair market value "is assumed to be a cash value").

<sup>52</sup>*See Perez v. GreatBanc Tr. Co.*, No. 5:12-cv-01648 (C.D. Cal. filed June 2, 2014), Dkt. 166-1, Agreement Concerning Fiduciary Engagements and Process Requirements for Employer Stock Transactions, accessed at <https://www.dol.gov/sites/dolgov/files/EBSA/about-eb-sa/our-activities/enforcement/esop-agreement-appraisal-guidelines.pdf>.

## V. The DOL's Recent Revival of *Farnum* in the Context of Warrants

When it comes to warrants used as payment for subordinated financing, the DOL recently has taken the exact opposite position. Specifically, the DOL has advanced the view that warrants are *per se* dilutive to an ESOP sponsor company's pre-transaction equity value and, as such, trustees and their appraisers must deduct the value of any acquisition financing warrants from the subject company's fair market value.

For example, in August 2017, the DOL filed a lawsuit styled *Acosta v. Wilmington Trust* alleging that an ESOP overpaid for stock in its employer company, HCMC Legal, Inc. ("HCMC Litigation"), because, among other things, the value of warrants issued in connection with the acquisition debt was not deducted from the purchase price.<sup>53</sup> The DOL hired an expert to perform an independent valuation of the subject company, and his analysis advanced the DOL's pre-*Farnum* view that transaction-related financing—this time, in the form of warrants—should reduce the value of the equity to be purchased by the ESOP.

And yet, for the reasons we have explained previously, there is no reason to treat warrants any differently than other costs of financing. When issued in conjunction with below-market interest on mezzanine debt to achieve a market rate of return, warrants are conceptually no different from market interest payments on equivalent debt; at bottom, warrants are deferred, variable interest. In other words, they are precisely the kind of "obligations and liabilities arising in connection with the ESOP's acquisition debt" that, in withdrawing *Farnum*, the DOL expressly advised should not impact the fair market value of a subject company in an ESOP deal. In fact, in a different matter involving warrants, the DOL's expert (before he was hired by the DOL as an expert in the HCMC Litigation) did *not* view the warrants as dilutive to value.<sup>54</sup>

<sup>53</sup>*Acosta v. Wilmington Tr. Co.*, No. 1:17-cv-6325 (S.D.N.Y. filed August 22, 2017), Complaint, Dkt. 3. The DOL has also made its new position on warrants clear in several publicly filed lawsuits. *See, e.g., Acosta v. Wilmington Trust Co.*, No. 1:17-cv-1755 (N.D. Ohio filed August 22, 2017), Complaint, Dkt. 1 (alleging that, after accounting for warrants, "the ESOP only received 65% of the future equity in Graphite, but paid for a 100% interest"); HCMC Litigation, Complaint, Dkt. 3, ¶ 43 ("[F]rom the ESOP's perspective, [the mezzanine lender's] and the sellers' ability to acquire up to 49% of HCMC stock, and thereby dilute the value of the ESOP's stock, severely diminished the value of the stock the ESOP purchased"); *ibid.* ¶ 44 (the appraiser's "report did not ascribe any value to the warrants in determining the fair market value of the ESOP's purchase. [The trustee and its appraiser] should have ensured that the valuation valued the warrants properly and reduced the price that the ESOP was willing to pay accordingly.").

<sup>54</sup>*Brundley v. Wilmington Tr., N.A.*, No. 1:15-cv-01494 (E.D. Va. filed November 10, 2015).

The long-standing consensus in corporate finance that financing costs do not affect the fair market value of the subject asset has not eroded. So what has caused the DOL to resurrect its pre-*Farnum* position in the context of warrants? One possibility is that the pre-*Farnum* theory among DOL officials simply never dissipated after the suit's withdrawal. Trade publications shortly after *Farnum* noted that the principles underlying *Farnum*'s filing enjoyed lingering support among a small cadre within the agency:

[T]here appeared to be a strong difference of opinion within the department over *Farnum*, between the solicitor's office and the Pension and Welfare Benefits Administration [precursor to the Employee Benefits Security Administration]. Even though the department has since withdrawn the lawsuit, *there is a "substantial minority" at Labor who support the principles of the Farnum case.*<sup>55</sup>

## VI. The DOL's Position on the Treatment of Warrants Is Problematic

Regardless of the reasons for, and timing of, the DOL's pre-*Farnum* revival in the context of warrants, its position is problematic as a matter of policy and inconsistent with generally accepted valuation theory.

### ***Adopting the DOL's position on warrants would harm employee ownership***

Should courts adopt the DOL's position on warrants, far fewer ESOPs would be able to acquire an ownership interest in their sponsor companies, reducing the number of American workers who otherwise would have reaped the benefits of employee ownership. To understand why, consider the choices available in such a world to ESOP trustees attempting to structure acquisition financing and determine an appropriate purchase price.

Some ESOPs might continue using warrants as a financing tool. Although ESOPs would enjoy the benefits of warrants—accessible mezzanine financing, relief from cash flow pressure associated with subordinated debt obligations, shifting risk to the lenders, aligning the interests of interested parties—they would not be able to compete with third party buyers in the marketplace. This is because, in the DOL's world, ESOPs using warrants must reduce their offers by the value of those warrants, while their non-ESOP competitors could offer full fair market value without any artificial restrictions. The only new ESOPs that would be created would be those buying from ultra-benevolent selling shareholders willing and in

<sup>55</sup>BNA Pension Reporter, Vol. 17, No. 49, (December 3, 1990), 2010 (emphasis added).

a position to take less than fair market value to pass their ownership interest to their employees.

The alternative—ESOP trustees deciding not to use warrants—would likewise harm employee ownership. Without warrants, ESOPs and their sponsors would have to either forego mezzanine debt—and, along with it, the ability to obtain a substantial interest in the employer all at once—or obtain mezzanine debt but pay exorbitant cash interest rates not offset by warrants. Devoting large amounts of sponsor company earnings to mezzanine debt repayment would prevent many such ESOP-owned companies from using their cash flows for more productive purposes that would benefit participants—for example, reinvesting it in the company's growth (which increases the value of participant shares) or paying down ESOP acquisition debt more quickly (which increases share values for employees).

In the DOL's world, ESOPs and their participants would therefore be stuck in a catch-22: with warrants or without, employee ownership suffers. This result is directly contrary to Congressional intent to expand employee ownership through the proliferation of new ESOPs.<sup>56</sup>

### ***The DOL's position is inconsistent with the generally accepted "fair market value" standard***

The DOL's view on warrants is not only problematic as a matter of policy, but also as a matter of valuation theory. As explained previously, the "fair market value" standard that Congress hardwired into ERISA is an

<sup>56</sup>*Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 416 (2014) (describing Congressional interest in encouraging the use of ESOPs and quoting the Tax Reform Act of 1976); *Grindstaff v. Green*, 133 F.3d 416, 422 (6th Cir. 1998) ("Congress has repeatedly expressed its intent to encourage the formation of ESOPs by passing legislation granting such plans favorable treatment, and has warned against judicial and administrative action that would thwart that goal.") (quoting *Donovan*, 716 F.2d at 1466).

Indeed, Congress predicted that courts or regulators would enact policies, like the DOL's position on warrants, that would frustrate Congress's vision:

#### INTENT OF CONGRESS CONCERNING EMPLOYEE STOCK OWNERSHIP PLANS

The Congress, in a series of laws . . . has made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free private enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees. *The Congress is deeply concerned that the objectives sought by this series of laws will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans.*

Tax Reform Act of 1976, Pub. L. No. 94-455, § 803(h) (90 Stat. 1520), 1590 (emphasis added).



objective standard: it does not account for the actual buyer's or seller's individual attributes, such as the method of financing. The DOL's view on warrants upends that objective standard and would require ESOP trustees to consider the ESOP's method of financing by deducting warrants from a subject company's value.

**The DOL's position is rooted in part in a misunderstanding of the actual economic impact of warrants**

The DOL's view that warrants reduce the fair market value of equity to be purchased in a leveraged ESOP transaction reflects a misunderstanding of basic corporate finance principles—specifically, the nature and purpose of warrants as a component of subordinated financing. When warrants supplement the return to a subordinated lender, and enable the lender to accept a below-market cash interest rate on the associated loan, the company and its shareholders receive a *definitive* benefit from a lower cash cost of the financing. In exchange, the lender receives a *potential* benefit in the form of a higher overall rate of return through future equity appreciation in the event the subject company performs well. Of course, the lender also assumes the risk that the subject company will not perform as well as expected or that the warrants could be worthless at expiration. Therefore, warrants issued in connection with financing a leveraged transaction (including leveraged ESOP purchase transactions) represent economic deferred, variable interest on the associated debt, as previously discussed.

Although warrants may be exercised into a definite number of the subject company's common shares that can be expressed as a percentage of outstanding equity, such percentage does not reflect the pro rata economic impact from such warrants. This is because the warrants have no intrinsic value until the underlying equity value of the subject company exceeds the warrant strike price. Because the common stock has no such strike price, the warrants are not truly share equivalents or economic equivalents to common stock and any *potential* dilution in the future is materially less than a simple calculation of fully diluted shares outstanding on the date of the transaction. Thus, when assessing the potential impact of warrants in a leveraged transaction, the warrants cannot be treated as a direct reduction in the subject company's fair market value. Rather, the warrants should be evaluated based on an assessment of (a) the benefits

provided by reduced cash interest payments on the transaction financing, and (b) their role in providing the lender with an all-in market rate of return in conjunction with a below market interest rate.

\* \* \* \* \*

The leveraged ESOP is one of Congress's most innovative ideas for growing employee stock ownership and building wealth among the American working class. As we have shown, warrants are a crucial component of the financing required for these leveraged transactions to occur; without them, ESOPs would be unable to access the mezzanine debt necessary for substantial purchases of employer stock. Warrants are not only necessary for leveraged ESOPs to grow, but they also afford substantial benefits to ESOPs that include them in their financing packages—warrants shift risk away from the ESOP, free up cash flows for more productive uses than servicing interest on debt, and align stakeholders' interests towards a goal of improving the value of the subject company's stock.

The DOL's recent position on financing warrants—that they necessarily reduce the fair market value of a subject company in ESOP acquisitions—threatens not only to eliminate these benefits but also to frustrate the creation of ESOPs and employee ownership, contrary to Congressional intent.

As a matter of law, the DOL's position is untenable. The fair market value standard Congress baked into ERISA's adequate consideration exemption is an objective, widely-cited, and recognized standard under which a buyer's financing methods and costs are irrelevant. The DOL and courts have expressly acknowledged this principle since the DOL's withdrawal of *Farnum*, and ESOPs and their service providers have relied on this guidance and precedent in the decades since. Simply put, there exists no logical or legal reason to treat financing warrants differently than cash interest on acquisition debt when determining fair market value.

But there *is* a reason to encourage ESOPs to continue to use warrants in acquisition financing packages: they contribute to the continued proliferation of ESOPs, of employee ownership, and, as a result, a broader-based participation in the creation of wealth among American workers.

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