IS AN ESOP RIGHT FOR YOUR COMPANY? HOW DO YOU KNOW? WHAT SHOULD YOU KNOW?

David R. Johanson, Partner, Hawkins Parnell Thackston & Young LLP
Overview

• Alternative Exit Strategies
• Criteria for Evaluating Alternatives
• Introduction to ESOPs
• Profile of an Ideal ESOP Candidate
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Overview (continued)

• Plan Design Considerations
• What is a “Repurchase Obligation”? 
• Corporate v. ERISA Fiduciary Standards 
• General Regulatory Framework 
• ESOPs and Other Retirement Plans 
• Summary of Pros and Cons of an ESOP 
• Concluding Remarks
Alternative Exit Strategies

• Sell to a Strategic Buyer
• Sell to a Financial Buyer
• Sell to an ESOP
Criteria for Evaluating Alternatives

• Purchase Price
• Personal and Corporate Tax Considerations
• Form of Consideration (Cash, Stock and/or Combination)
• Wealth Diversification and Liquidity Concerns
  – Partial or Complete Ownership Transition
• Legacy
  – Preservation of Organization and Employees
• Alignment of Management and Employee Incentives
• Time to Close
Introduction to ESOPs

• An ESOP is an employee benefit plan subject to the applicable provisions of the Internal Revenue Code of 1986, as amended (the “Code”), the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), and the regulations issued thereunder.

• ESOPs are designed to invest primarily in employer securities (“Company Stock”):
  - Not subject to the 10% limitation in investments in employer securities that apply to other ERISA plans; but
  - Participants have diversification rights under either Section 401(a)(28) or 401(a)(35) of the Code.
Introduction to ESOPs (Continued)

• ESOPs are not subject to the minimum funding requirements under Section 412 of the Code:
  - Although planning for future payment obligations to terminated employees is highly recommended.

• Subject to certain conditions, selling shareholders of a C corporation may elect to defer taxes on the sale of Company Stock to an ESOP under Section 1042 of the Code.
  - If the seller makes a Code Section 1042 tax-deferral election, then certain allocations to the ESOP Accounts of the selling shareholder in a transaction to which Code Section 1042 applies, his family members, and any other 25% or more shareholder are then prohibited under Section 409(n) of the Code.
ESOPs can be leveraged, which effectively doubles the limit on deductible contributions (for C corporations only):

- Contributions for general plan administration purposes are deductible under Section 404(a)(3) of the Code
- Contributions to enable an ESOP to service its Company Stock acquisition debt are deductible under Section 404(a)(9) of the Code
- Not subject to the minimum funding requirements under Section 412 of the Code, although planning for future repurchase obligations with respect to terminated vested ESOP participants is highly recommended
Introduction to ESOPs (Continued)

Benefits to Participating Employees

- No deduction from their wages is required or permitted
- Value of their ESOP benefits (primarily dependent on the fair market value of Company Stock) may grow over time
- Potentially very good retirement benefit based upon performance of Company Stock
Introduction to ESOPs (Continued)

Participating Employees only have a “beneficial ownership” interest in shares of Company Stock allocated under the ESOP.

- The ESOP Trust is the legal or record owner.
- The ESOP is not a direct stock purchase plan.
  - An ESOP is not an Employee Stock Purchase Plan (“ESPP”) under Section 423 of the Code.
- The ESOP is not a stock option plan (which grants participants the rights to acquire Company Stock at a future date).
Introduction to ESOPs (Continued)

Advantages of Selling to an ESOP:
Selling Shareholder

• Non-recognition of gain on sale (with an election under Section 1042 of the Code) for C corporation
  – If a 1042 election is made, the plan must own at least 30% of the company’s stock immediately following the sale to the ESOP
• Can be used to facilitate partial or complete ownership transition
Introduction to ESOPs (Continued)

Advantages of Selling to an ESOP (cont.):

C Corporation

- Tax deductible funds transfers to the ESOP Trust
  - Tax savings can be used productively – debt repayment, capex, acquisitions, etc.
  - Employer Contributions deductible under:
    - Section 404(a)(3) of the Code
      - Up to 25% of the eligible “Compensation”
      - Aggregated with employer contributions to other defined contribution plans
    - Section 404(a)(9) of the Code
      - Up to 25% of the eligible “Compensation”
      - Only if contribution used to make exempt loan payments
      - Interest payments excluded
    - Dividends deductible under Section 404(k) of the Code
      - Subject to certain conditions and restrictions
Introduction to ESOPs (continued)

Advantages of Selling to an ESOP (cont.):

S Corporation

- All future corporate income is “passed through” to the ESOP Trust, which is tax-exempt
- Tax deductible funds transfers to the ESOP Trust
  - Tax savings can be used productively – debt repayment, capex, acquisitions, etc.
  - Only the deduction for employer contributions under Section 404(a)(3) of the Code is available
  - S Corporation distributions may still be declared, and the ESOP Trust may use such proceeds to make exempt loan payments, however, the S distributions are not deductible.
Introduction to ESOPs (continued)

Advantages of Selling to an ESOP (cont.):

Either C or S Corporation

• Positive impact on corporate cash flow:
  • Employer Contributions to the ESOP may be made in shares of Company Stock
  • Employer Contributions to the ESOP used to acquire shares of Company Stock (pre-tax dollars) in lieu of stock redemption proceeds (after-tax dollars) may significantly impact the Company’s cash flow availability on a post-transaction basis
  • Particularly helpful if the Company is trying to maximize tax deductions while complying with any financial covenants with senior lenders.
Advantages of Selling to an ESOP (cont.):

Employees

• Retirement plan with substantial benefits

• Typically, independent studies have shown that ESOP corporations provide greater compensation and benefits

• Aligns incentives of management and employees through ownership interest - powerful tool for recruitment and retention
Profile of an Ideal ESOP Candidate

Selling Shareholder Characteristics
• Desires Fair Market Value
• Seeks personal wealth diversification
• Would like to take some value out of corporation on a tax-deferred basis
• Seeks to preserve corporation and employee legacy
• Wishes to provide employees with economic benefits
Profile of an Ideal ESOP Candidate (continued)

Sponsoring Corporation and Employee Characteristics

• Sufficient balance sheet strength to absorb ESOP acquisition debt (if any anticipated)
• Sufficient cash flow from operations to cover all ESOP acquisition debt and other long-term debt service requirements Historical and projected profitable operating performance (i.e., revenue generation and profit margins)
Profile of an Ideal ESOP Candidate (continued)

Sponsoring Corporation and Employee Characteristics

• Sufficient payroll to meet contribution requirements
• 15 to 20 employees or more
• Management depth and established plan for succession
• Participatory management environment
• Effective communications exist between employees and management
• S corporation or C corporation
Corporate Governance in an ESOP Corporation

- **ESOP TRUSTEE**
  - ESOP TRUST
  - Board of Directors appoints officers and…
- **NON-ESOP SHAREHOLDERS**
  - Shareholders elect Board of Directors
  - Board of Directors appoints ESOP Officers and…
  - Appoints ESOP Board of Trustees
  - ESOP Advisory Committee
    - Board of Trustees appoints ESOP Advisory Committee (optional)
Brief Description of Respective Roles

**ESOP Trustee**
- Elects Board of Directors
- Responsible for ESOP Administration
- Establishes Fair Market Value for Company Stock

**Board of Directors**
- Responsible for Major Corporate Actions
- Strategic Planning
- Appoints Officers and Board of Trustees

**Corporate Officers**
- Responsible for Day-to-Day Management of Corporation
Brief Description of Respective Roles (Continued)

**ESOP Advisory Committee (Optional)**
- Responsible for Learning How ESOP Functions and Communicating that to Corporation Employees

**Other Committees of the Board of Directors (Optional)**
- Suggested Committees:
  - Nominating Committee – Responsible for evaluating current directors and identifying and vetting potential new directors
  - ERISA Fiduciary Committee – Responsible for the selection and monitoring of ERISA fiduciaries of all employee benefit plans that the company maintains
  - Audit Committee – Responsible for the oversight of the annual audit of the company’s financial statements (if applicable)
  - Executive Compensation Committee – Responsible for the evaluation of the compensation packages awarded to executives (including the engagement of an independent analyst, as appropriate)
ESOP Corporate Governance (Continued)

• ESOP-owned corporations have up to two additional governance layers:
  - ESOP Trustee (Board of Trustees or institution)
  - ESOP Committee or Independent Fiduciary

• ERISA governs the ESOP Trust

• Employees have expectations as beneficial owners of the corporation through the shares of Company Stock held in their ESOP Accounts

• The interaction between governance systems can enhance value
ESOP Corporate Governance (Continued)

• Success in an ESOP-owned corporation encompasses:
  - Business survival & growth;
  - Increase in Company Stock value;
  - Repurchase of Company Stock from departing employees;
  - Adequate provision for employee retirement; and
  - Employee fulfillment of operational improvement initiatives to increase quality, productivity, profitability and value.
ESOP Corporate Governance (Continued)

What is different for ESOP-owned corporations?

- ERISA fiduciaries must protect participant interests as retirees—not as employees—and therefore, the sale of Company Stock may “trump” or override not selling and retaining employees’ jobs; however, there is a presumption that ERISA fiduciaries may continue to hold Company Stock;

- Board of Directors and ESOP Trustees-Independent Fiduciaries must seriously consider bona fide purchase offers; and

- Sub-S corporations that are 100% owned by an ESOP Trust have tax advantages that create value for the ESOP not easily matched by conventional buyers.
ESOP Corporate Governance (Continued)

Special considerations for ESOP-owned corporations:
- Voting of Company Stock and the direction “pass-through” to ESOP Participants with respect to significant issues;
- Tender or sale of Company Stock;
- Valuation of Company Stock;
- Effects of ERISA on corporate governance;
- Role of ESOP fiduciaries in corporate governance;
- Directors’ & Officers’ and ERISA fiduciary liability insurance;
- Indemnification Agreements; and
- Potential ERISA fiduciary conflicts.
How Does an ESOP Work? (Non-Leveraged)

1. Corporation makes annual tax deductible cash and/or stock contributions to ESOP Trust; and/or
2. ESOP Trust uses cash contributions to acquire stock from existing shareholders or the Corporation.
3. ESOP Trust allocates stock or cash to Participant accounts and tells employees how much stock has been allocated to their accounts and how much such stock is worth.
4. Employees receive stock or cash when they leave Corporation and must sell stock back to Corporation, which must purchase such stock.
How Does an ESOP Work? (Leveraged)

1. Bank loans funds to the Corporation, which loans funds to the ESOP Trust.
2. ESOP Trust uses loan proceeds to acquire stock from existing shareholders or the Corporation.
3. Corporation makes annual tax deductible cash contributions to the ESOP Trust; ESOP Trust makes payments on the loan; Corporation makes payments on the Bank loan.
4. ESOP Trust allocates stock to Participant accounts and tells employees how much stock has been allocated to their accounts and how much such stock is worth.
5. Employees receive stock or cash when they leave Corporation and must sell stock back to Corporation, which must purchase such stock.
Tax-Deferred Reinvestment under Section 1042 of the IRC C Corporations Only

ESOP Trust → Cash/Note → Selling Shareholder

Qualifying Employer Securities

QRP: Debt or Equity in a Domestic Operating Corporation (Stepped-up basis upon death)

QRP Excludes:
- REITs
- Mutual Funds
- Passive Investment Companies
- Municipal Bonds

Qualified Replacement Property (“QRP”)
Qualifying Employer Securities

• If not readily tradable on an established securities market, then:
  – Common stock (best dividend and best voting rights); or
  – Convertible preferred stock

• Selling shareholder did not receive pursuant to an incentive program

• Long-term capital gain

• Three-year holding period
Illustration of Potential Tax Savings

• Assuming the conditions of Section 1042 of the Code are satisfied, and the purchase price listed below:

<table>
<thead>
<tr>
<th></th>
<th>To the Company or Third Party</th>
<th>To the ESOP with 1042 Election</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Purchase Price</strong></td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td><strong>Combined Federal and State Long-Term Capital Gains Taxes (assumed blended rate of 37%)</strong></td>
<td>($370,000)</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Down Payment on QRP (assumed 18% required)</strong></td>
<td>N/A</td>
<td>($180,000)</td>
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<tr>
<td><strong>Net Proceeds</strong></td>
<td>$630,000</td>
<td>$820,000</td>
</tr>
<tr>
<td><strong>Additional Benefits</strong></td>
<td>None</td>
<td>QRP to pass to heirs on a stepped-up basis</td>
</tr>
</tbody>
</table>
Plan Design Considerations

Feasibility Study Recommended to Evaluate the Following:

• Eligibility to Participate (Broad base or narrowly tailored?)
• Minimum age cannot be set above 21
• Service requirement cannot exceed 1 year (with 1,000 Hours of Service)
• Gradual, immediate, or cliff vesting?
• Leveraged or non-leveraged?
Plan Design Considerations

Feasibility Study (continued)

• Internal Board of Trustees or Institutional/Independent Trustee?
• Independent fiduciary?
• What will the repurchase obligation be under the different variables?
What is a “Repurchase Obligation”?

Repurchase Obligation or Liability: The obligation of a corporation to provide a market for employer securities that are allocated under and distributed or distributable from the ESOP.
What is a “Repurchase Obligation”? (continued)

• If the employer securities are publicly traded, a market exists and the corporation does not have to repurchase Company Stock distributed to ESOP Participants.

• In all other cases, the employer or the ESOP Trust must repurchase the employer securities under “a fair valuation formula”. Section 409(h)(1)(B) of the Code.
Corporate v. ERISA Fiduciary Standards

• Corporate law generally presumes good faith by members of the Board of Directors making a Business Judgment, applying a gross negligence standard of review.

• ERISA holds fiduciaries to the highest standards of prudence, skill and care; ERISA fiduciaries must act solely in the interests of plan participants and beneficiaries.
Corporate v. ERISA Fiduciary Standards (Continued)

• A person serving as both a member of Board of Directors and an ESOP Fiduciary remains subject to the corporate standards when acting as a “grantor” – terminating or amending a plan – or when reviewing purely corporate functions.
  – This is not a bright line rule.

• ERISA fiduciaries are personally liable for breaches of their ERISA duties.
ERISA Fiduciaries

• Named “fiduciary” in the plan document or trust instrument.
  - ESOP Trustee(s): Directed and independent or insiders.

• Anyone who exercises any discretionary authority & control over management or disposition of plan assets.  Section 3(21) of ERISA.
  - Could, in theory, include:
    - Board of Directors
    - ESOP Advisory Committee
    - Plan Administrator
    - Company Executives (not typically)
    - Outside advisors (but only if s/he makes a fiduciary decision)
ERISA Fiduciaries (Continued)

ERISA Fiduciary Duties:

• Follow the Plan document (unless ERISA requires fiduciary to override the Plan)

• Protect the Plan from non-exempt prohibited transactions by being sensitive to potential and real conflicts of interest

• Assure that the ESOP Trust pays no more than fair market value for company stock (or any other asset that the ESOT acquires)

• Ensure that the ESOP is administered fairly without discrimination as provided by the Code and ERISA
ERISA Fiduciaries (Continued)

ERISA Fiduciary Duties (Continued):

• Ensure that ESOP participants receive all required information and disclosures as provided by the Code and ERISA

• Ensure that the ESOP and ESOP Trust obtain and retain their legal qualifications under the Code and are amended as required under applicable laws and regulations, from time to time

• Vote the shares of company stock held by the ESOP Trust when not required to be “passed-through” to ESOP participants
Conflicts of Interest

• Conflicts of Interest may arise:
  - Between the company and the ESOP
  - Between managers and the ESOP
  - Between Board of Directors’ members and the ESOP
  - Between the ESOP and the other shareholders

• When and how does it arise?

• Why do people overlook it?

• Ways to address it include:
  - Resignation of conflicted individuals
  - Appointment of independent advisors, outsiders, or committees
  - Abstention from action
# General Regulatory Framework

<table>
<thead>
<tr>
<th>Agency</th>
<th>Tax Matters</th>
<th>Fiduciary and Other Matters</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Department of Treasury</td>
<td>U.S. Department of Labor</td>
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<tr>
<td>(“DOT”)</td>
<td>(“DOL”)</td>
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<tr>
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<td></td>
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<tr>
<td>Internal Revenue Service</td>
<td>Employee Benefits Security Administration</td>
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<td>(“IRS”)</td>
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## Primary Sources

| Code (Title 26 of the United States Code) and case law | ERISA (Title 29 of the United States Code) and case law |

## Secondary Sources

- Treasury Regulations, IRS Notices, Revenue Rulings, and Revenue Procedures
- IRS Technical Advice Memos, General Counsel Memos, Private Letter Rulings (Not Precedential)
- Labor Regulations, Interpretive Bulletins, Field Assistance Bulletins, Administrative Exemptions
- Advisory Opinions (Not Precedential)
General Regulatory Framework (cont.)

Confirmation of Tax Qualification of ESOP

- IRS is the sole responsible agency
- Not absolutely required but highly recommended
- Consequences if the ESOP is not qualified or treated as disqualified:
  - Loss of deductions for contributions and distributions to the ESOP;
  - Loss of rollover eligibility of ESOP distributions;
  - Immediate inclusion in income of all ESOP account balances for each participant;
  - Excise taxes; and/or
  - Penalties and interest thereon.
General Regulatory Framework (cont.)

Confirmation of Tax Qualification of ESOP

- IRS issues a “Determination Letter” for individually-designed plans:
  - 5-year application cycle (based on sponsor’s EIN)
  - Application Fee (may be waived under certain circumstances)
General Regulatory Framework (cont.)

Confirmation of Tax Qualification of ESOP (cont.):

- Recent Development: IRS Rev. Proc. 2015-36 has expanded the pre-approved program to include ESOPs
  - 6-year application cycle (based on type of plan)
  - Application Fee (greatly reduced)
  - IRS issues a “Opinion Letter” or “Advisory Letter”
  - Details of conversion from individually-designed plan to pre-approved plan still under review
General Regulatory Framework (cont.)

Annual Return (Form 5500 Series):

• Due by the last day of the 7th month following the end of the plan year, unless Form 5558 is filed by such date for the automatic 2.5 month extension

• E-filing has been mandatory since 2009 (www.efast.dol.gov)

• Regulated by the DOL Office of the Chief Accountant

• Sanctions for late or non-filing but may be reduced or abated under certain circumstances
Other Required Disclosures:

- Summary Plan Description
  - Upon plan implementation, then periodically thereafter, depending on frequency and substance of plan amendments;
- Summary Annual Report (summary of Form 5500)
- Annual statement of accounts (aka “Participant Statement”)
- Plan Documents and certain related documents with a reasonable period of time upon written request
- EBSA provides regulatory oversight through its general investigative authority
Prohibited Transactions:

- Both the Code and ERISA generally prohibit transactions between certain parties and the ESOP that directly or indirectly involve ESOP assets unless exempted. Section 4975(c) of the Code; Section 406 of ERISA.

Exemptions:

- Statutory: Section 4975(d) of the Code and Section 408 of ERISA
- Regulatory: The DOT and DOL regulations promulgated thereunder
- Administrative: On an individual or class basis as granted by the DOL in its sole discretion
Prohibited Transactions (cont.):

- Penalties for prohibited transaction violations include:
  - Plan Disqualification;
  - Excise Taxes on parties to the transaction;
  - Civil and/or criminal sanctions on the plan sponsor;
  - Corrective contribution to the ESOP (or rescission of the transaction); and/or
  - Interest on any the taxes and penalties above.
General Regulatory Framework (cont.)

Corrections Programs Available:

• IRS Employee Plans Compliance Resolution System, Rev. Proc. 2013-12, as amended by 2015-27:
  • Self-Correction Program
  • Voluntary Correction Program
  • Audit Closing Agreement Program (“Audit CAP”)
• DOL Delinquent Filer Voluntary Compliance Program (“DFVCP”)
  • Form 5500 late or non-filers
• DOL Voluntary Fiduciary Correction Program (“VFCP”)
  • 19 listed transactions
  • Updates pending
ESOPs and Other Retirement Plans

• ESOPs can be in addition to other retirement plans or part of a hybrid plan

• Compatibility with other plans:
  • Combined with Money Purchase Pension Plans (prior to 2002, due to a change in the deductibility of ESOP contributions);
  • Combined with 401(k) Plans (“KSOP”); or
  • Separate from the 401(k) Plan, but accepting matching contributions (to satisfy 401(k) Plan safe harbor requirements) made to the ESOP

• Arrangements must satisfy limitations under the Code, so careful coordination with record keepers is required
Summary of ESOP Pros and Cons

• From the Shareholder’s Perspective:

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
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<tbody>
<tr>
<td>- Potential Tax Deferral for electing, selling shareholder (C corporation only)</td>
<td>- Dilution to shareholders (if less than 100% is sold to the ESOP)</td>
</tr>
<tr>
<td>- Viable Exit Strategy</td>
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</table>
## Summary of ESOP Pros and Cons

### From the Corporation’s Perspective:

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
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</thead>
<tbody>
<tr>
<td>- Tax Deductions</td>
<td>- Plan Administration Costs and Expenses</td>
</tr>
<tr>
<td>- Employer Contributions</td>
<td>- Typically higher than for other retirement plans due to need for independent ESOP advisors and independent valuation of Company Stock</td>
</tr>
<tr>
<td>- Certain Dividends (C corporations only)</td>
<td>- Balance Sheet Impact</td>
</tr>
<tr>
<td>- A good to exceptional tool for:</td>
<td>- Contra equity account (leveraged ESOPs only)</td>
</tr>
<tr>
<td>- Cash Flow Management</td>
<td></td>
</tr>
</tbody>
</table>
### Summary of ESOP Pros and Cons

**• From the Participating Employee’s Perspective:**

<table>
<thead>
<tr>
<th><strong>Pros</strong></th>
<th><strong>Cons</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>- Benefits provided <strong>without</strong> wage reductions or deductions</td>
<td>- Value of benefits subject to fluctuations of the Fair Market Value of Company Stock</td>
</tr>
<tr>
<td>- Opportunity to provide input on certain corporate matters</td>
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<tr>
<td></td>
<td>- ESOP Voting Requirements</td>
</tr>
<tr>
<td></td>
<td>- Open book management (potentially)</td>
</tr>
<tr>
<td>- Benefit payments eligible for favorable tax treatment upon distribution (rollover to an IRA or other eligible retirement plan)</td>
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</tbody>
</table>
Concluding Remarks

If, after careful analysis, the Company’s Board of Directors decides to implement an ESOP:

• Establish and document procedural prudence in all decisions
• Educate key decision-makers with respect to corporate and ERISA fiduciary standards
• Consult experts (legal, accounting, valuation, etc.), as needed
• Maintain adequate directors’ and officers’ and ERISA fiduciary liability insurance
• Read and understand the ESOP plan documents
Questions?

Thank you
David R. Johanson, the Partner-in-Charge of the Napa office and a Partner in the San Francisco, Los Angeles, and New York offices of Hawkins Parnell Thackston & Young LLP, has helped hundreds of corporations form ESOPs and create effective employee ownership through other equity incentives during the past almost 30 years. Mr. Johanson assists clients in designing ESOP and equity incentive plans and accomplishing ESOP-related transactions, including mergers and acquisitions of all kinds. Mr. Johanson also defends ERISA fiduciary actions in Federal Courts throughout the U.S and is actively involved in defending regulatory and enforcement actions by the Internal Revenue Service and the U.S. Department of Labor. Recognized nationally for his experience and expertise in the ESOP and executive compensation field, Mr. Johanson is a past chair (1993-1995 and 2005-2007) of the legislative and regulatory advisory committee of The ESOP Association. He also is a past chair of The ESOP Association’s advisory committee chairs council and is a former member of its board of directors. Mr. Johanson was honored at the 17th annual conference of The ESOP Association as the outstanding committee chair for 1993-94. Mr. Johanson served for more than ten years as General Counsel to The National Center for Employee Ownership and on its board of directors. Mr. Johanson writes and speaks frequently about employee ownership throughout the U.S.
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