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JUNE 2007

U P D A T E

News of Developments in the Financial Sector and Related Areas

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Utilization of an ESOP/KSOP

An Employer Stock Ownership Plan ("ESOP") is an employee benefit plan designed to allow employees to become owners of stock of their employer. The ESOP invests primarily in employer's stock for the benefit of employees. To set up an ESOP, an employer creates a trust for its employees and funds the trust by (i) contributing its shares, (ii) contributing cash to buy its shares, or (iii) having the ESOP borrow money to buy its shares and then making contributions to the ESOP to repay the loan. The shares are held in trust under separate accounts for each participating employee. Generally, the employee receives the stock or a cash equivalent when he retires, becomes disabled or otherwise is no longer employed by the company. There are a number of advantages to having an ESOP, including the following:

- A closely held company can borrow money to purchase company stock with pre-tax dollars from shareholders who want to sell their stock;
- The owner of a closely held company may wish to sell his stock and to defer the capital gains on the sale;
- Proceeds from the sale of stock by the employer to the ESOP can be used for capital expenditures, retirement of debt and other business purposes;
- The ESOP gives employees a tax deferred benefit, allowing them to share in the growth of the company while at the same time creating employee satisfaction and longevity;
- The ESOP creates a market for stock in a closely held business; and
- The ESOP results in attracting and retaining employees.

There are basically two types of ESOPs, one being a non-leveraged ESOP with the employer contributing its shares to the plan and the other is a leveraged ESOP which borrows money to buy the employer's stock. A significant advantage of an ESOP is in a situation where a single shareholder or family owns a company and has made a decision to sell the company because of age, illness or other reasons. In this situation, if the owner sells to a third party, he will lose control of the company and possibly suffer immediate capital gains. If the owner sells to an ESOP, he may defer capital gains, continue to maintain control of the company and invest the proceeds in a portfolio of stocks and bonds while at the same time rewarding employees of the company. In this situation, once a company is then acquired by the ESOP, by making a subchapter S election for tax purposes, the company becomes virtually a tax-free operating entity by passing the tax obligations to the tax exempt ESOP trust, which is not liable for the payment of income taxes. This results in a significant benefit for the company and the ESOP, as the new shareholder, in that the pretax cash flow enables the ESOP to rapidly repay any transaction debt and to fund future growth and benefits to employees as owners of the company through the ESOP. Many employers have established a 401(k) plan for their employees, while others have established ESOP plans. A 401(k) allows an eligible employee to contribute part of his salary to a retirement plan on a tax deductible basis, while at the same time allowing matching contributions by the employer equal to some percentage of what the employee contributed to the plan, such as 50% of the employee's 401(k) contribution, but not more than 3% of his salary. A combined 401(k) and ESOP is known as a *KSOP*. ESOP stock purchased with a loan can be allowed as a matching contribution under a 401(k) plan. For example, if an employee contributes $2,000 to a 401(k) plan with a 50% matching formula, $1,000 worth of stock would be allocated to that employee as the annual matching contribution. This has the advantage of allowing all employer cash contributed to the plan to be used to repay the ESOP loan, thereby resulting in the earlier loan repayment. This also allows an incentive for employees to make 401(k) deferrals. In this situation, all cash contributed by the employer will be used to repay the loan using tax deductible dollars, while at the same time the cash doubling as a 401(k) matching contribution. Even if no loan is involved, the KSOP can still be used. The employer could contribute newly issued shares each year to the ESOP equal to the matching contribution of the employees, thereby improving cash flow to the employer, since a tax deduction is available to the employer for the fair market value of the contributed stock. The cash, which would have been otherwise used to make the employer contribution, may be retained by the company for capital expenditures and other purposes. An ESOP or KSOP is an effective tool in providing incentives to both employers and employees. Information on retirement plans is available on the Internal Revenue Service website at *www.irs.gov/retirement/index.html*.

Cases, Releases and Rulings

The Federal Deposit Insurance Corporation ("FDIC") has issued its report entitled *FDIC Outlook – Winter 2006* which reflects that weakness in the housing sector is being offset by continued strength in the corporate sector, commercial construction activity and exports. Negative trends that have emerged for banks, include a narrowing of net interest margins, increasing concentrations of traditionally riskier commercial loans and emerging signs of credit distress in subprime mortgage portfolios. In its report, the FDIC notes that local economic conditions are the most important determinants of credit quality and earnings strength at the majority of banks. The report is available on the website of the FDIC at *www.fdic.gov*.

In Watters v. Wachovia Bank, N.A., No. 05-1342, decided April 17, 2007, the United States Supreme Court upheld regulations promulgated by the Office of the Comptroller of the Currency ("OCC"), preempting the application of state banking laws to an operating subsidiary of a national bank. The ruling by the United States Supreme Court reaffirms four similar federal appeals court rulings finding the regulations issued by the OCC are a reasonable interpretation of the National Bank Act, in that federal law preempts inconsistent state law. In its ruling, the Court held that Wachovia's mortgage business, whether conducted by the bank itself or through the bank's operating subsidiary is subject to supervision by the OCC, and not to the licensing, reporting and visitorial regimes of the various states in which the subsidiary operates.