

The Journal

A New Option for Private Equity Firms: ESOP-Owned S Corporations

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Over the past few years, private equity firms have been structuring transactions that involve the use of employee stock ownership plans ("ESOPs"). These transactions are designed to take advantage of recent changes in the Internal Revenue Code which provide large tax-savings opportunities in private-equity transactions where ESOPs are used.

An ESOP is a special type of employee benefit plan that is permitted to use both borrowed money and funds obtained from other retirement plans to purchase employer securities. For years, ESOPs have been popular with owners of privately held corporations. They have been taking advantage of attractive tax incentives to sell all or a part of their ownership interests to ESOPs. If certain conditions described below are satisfied, a stockholder of a privately held C corporation can sell some or all of his or her stock to an ESOP on a tax-free basis. In addition, tax-advantaged financing is available for management groups and others to purchase stock with the use of ESOPs.

Until 1998, the ESOP tax incentives were available only to C corporations and their stockholders. This limitation minimized the appeal of ESOPs for private equity firms. However, in 1998 the U.S. income tax laws were changed to both: (i) permit ESOPs to hold shares of an S corporation; and (ii) provide an exemption from federal income taxation for ESOPs that hold S corporation shares. As a result, an S corporation that is wholly owned by an ESOP now is exempt from federal income tax if certain requirements are satisfied. Since 1998, there has been a flood of S elections by ESOP companies, and many new transactions have been structured to take advantage of the tax-savings available with the use of ESOP-owned S corporations.

Private equity firms and management groups now are using ESOP-owned S corporations for the following purposes: (i) to provide an exit vehicle for private equity firms, pursuant to which they can sell all or part of the stock of a portfolio company to management; (ii) to provide new investment opportunities for private equity firms; and (iii) to provide an acquisition platform for private companies owned jointly by private equity firms and ESOPs, pursuant to which they can ►

expand and make strategic acquisitions with the use of tax savings afforded by the new tax laws. This article will briefly describe the first of the above-described uses for S-corporation ESOPs -- how private equity firms can use the ESOP-owned S corporation to provide an exit vehicle for the disposition of portfolio companies.

How Private Equity Firms Are Using ESOPs

The combination of an ESOP and the S election can be used by a private equity firm to create an attractive exit strategy for portfolio companies that otherwise might be difficult to sell. The opportunity derives from the enhanced cash flows created by the special tax incentives for ESOP-owned S corporations. Because an ESOP is not subject to tax on its share of an S corporation's income, taxes are avoided to the extent of the ESOP's ownership (and completely avoided if the ESOP owns all of the outstanding shares of the S corporation). This obviously enhances the corporation's financial strength and creditworthiness. Many lenders are willing to loan more money to ESOP-owned S corporations than they will lend to other corporations because of the enhanced cash flows available to ESOP-owned S corporations.

The enhanced borrowing capacity of an ESOP-owned S corporation can be supplemented by accessing funds held in Section 401(k) plans sponsored by the corporation. Employees normally cannot withdraw funds credited to their Section 401(k) plan accounts without incurring both ordinary income tax on the amount withdrawn and, in the case of employees under age 59½, a ten-percent excise tax. However, these taxes can be avoided in the case of a transfer of funds from a Section 401(k) plan to an ESOP because that kind of transfer can be arranged as a tax-free rollover. This combination of enhanced borrowing capacity and access to employee funds often will enable management groups to buy out a portfolio company from a private equity firm on terms that equal or exceed alternative exit strategies, such as sales to third parties and public offerings. Alternatively, a combination of enhanced borrowing capacity and mezzanine debt or seller financing can facilitate a management buyout with an ESOP.

Example

Here is an example of how a private equity firm might sell a portfolio company to a management group by taking advantage of the tax-savings opportunities available for ESOP-owned S corporations:

1. The portfolio company borrows funds from its lending group, which typically will include both senior and mezzanine lenders. There are senior and mezzanine lenders that now specialize in loans to ESOP-owned S corporations.
2. The employees of the portfolio company are given a special one-time opportunity to transfer a portion of the funds credited to their Section 401(k) plan accounts to a newly formed ESOP. The transferred funds are used by the ESOP trustee to purchase treasury shares of the portfolio company. ▶

3. The members of the management group roll their stock options over as part of the transaction.
4. The portfolio company applies both the borrowed funds and the retirement funds that were transferred by the employees to the ESOP (and then used by the ESOP to purchase shares of the portfolio company) to purchase the stock held by the private equity firm. The portfolio company will be owned by the ESOP, and the management group will continue to hold existing stock options (and perhaps be awarded additional options).

After the transaction is closed, the sold portfolio company will elect to be taxed as an S corporation. This will greatly enhance its cash flow, and the additional cash will be used to pay off the acquisition indebtedness on an accelerated basis. If it is not possible for the portfolio company to obtain sufficient funds from employees and lenders to completely buy out the private equity firm, then the private equity firm may provide additional financing in exchange for a debt instrument and detachable warrants. This may be an attractive investment for the private equity firm because the warrants will enable it to retain an equity interest in a company that will operate on a tax-free basis. When the potential return on the warrants is combined with the interest rate to which the private equity firm will be entitled on its subordinated note, the internal rate of return for the private equity firm on the financing it provides should be very high.

For some private equity investors, an additional tax advantage is available. Where the investors are individuals, partnerships, or certain kinds of trusts, the transaction may be arranged on a tax-free basis. The requirements that must be satisfied in order for eligible investors to qualify for tax-free treatment in connection with a sale of a portfolio company are the following:

1. the portfolio company must be a C corporation on the date of the sale;
2. the ESOP must purchase the stock of the eligible investors and, immediately after the sale, the ESOP must own at least 30 percent of the outstanding shares of the corporation; and
3. the eligible investors must reinvest the sale proceeds in U.S. operating companies.

Conclusion

There are truly remarkable tax advantages that can be obtained through the use of ESOPs in connection with the sale of a business and by operating a business in the form of an ESOP-owned S corporation. As private equity firms and portfolio company management teams are learning about these tax benefits, more and more of them are using the ESOP-owned S corporation as a vehicle to facilitate dispositions of portfolio companies in transactions like the one described in this article. ■

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