

Morgan Lewis

Presentation of ESOP Strategies 2008



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Introduction to Morgan Lewis

- ❑ It is essential that a team of blue-chip ESOP advisors is assembled to assist the company in exploring an ESOP buyout transaction
- ❑ **Morgan Lewis & Bockius** – ERISA and transaction attorneys specialized in ESOP transactions to act as legal counsel to the Company, including designing/structuring the transaction, preparation of all transaction and ERISA documents and disclosure schedules for loan documents, negotiation of the bank documents and assisting with transaction negotiations

Morgan Lewis & Bockius

- ❖ **Morgan Lewis.** Morgan Lewis is a national, full service law firm and is an industry leader that has the largest ESOP practice in the country with experience and resources in the private equity ESOP area.
- ❖ **Reaching beyond conventional legal concepts.** The Morgan Lewis ESOP practice delivers creative and effective solutions to transactions involving private equity liquidity and investments in an ESOP company structure. The Morgan Lewis ESOP group has represented private equity firms, trustees and fiduciaries, lenders, management groups, investors groups, and public companies involved in sophisticated ESOP transactions, ESOP restructuring, ESOP investor group transactions and litigation. Apart from other law firms, Morgan Lewis has attorneys that have experience with private equity ESOP transactions and corporate governance for private equity ESOP companies.
- ❖ **Private Equity Experience.** Morgan Lewis' ESOP group advises, designs and implements many pass-through entities involved in private equity transactions from a corporate, tax, securities, and ERISA standpoint. Because of its experience, the Morgan Lewis ESOP practice group has designed and structured transactions using pass-through entities and ESOP structures to harness the benefits associated with the use of an ESOP as a means of corporate finance (whether it is a purchase of a company using an ESOP structure, sale of a portfolio company to an ESOP, or co-investing with an ESOP).
- ❖ **Creating Solutions.** The attorneys in the Morgan Lewis ESOP group reach beyond conventional legal concepts to find solutions.

II. THE PROCESS

The Process

- ❑ **THE KEY TO A HIGH INTEGRITY ESOP TRANSACTION IS PROCEDURAL PRUDENCE**

The Process

□ **Strong Creative ESOP Team:**

- Strong investment banker (with ESOP experience)
- Strong ESOP legal team
- Reputable valuation firm
- Knowledgeable lender
- Experienced ESOP trustee

3 Aspects of an ESOP Transaction

1. The sale of stock to the ESOP

- Purchase price cannot be more than fair market value (“adequate consideration”)
- Tax structuring and design of sale control the tax consequences to the company and selling shareholders

2. Financing

- Typically leveraged transactions

 - Senior debt

 - Mezzanine debt

 - Private Equity

 - Seller Financing

- There are often many layers of financing in an ESOP transaction

3. Post Transaction Operations

- Corporate Governance
- Compensation structure

ESOP Overview

- ❑ An ESOP Transaction is a unique opportunity to
 - Sell company stock for cash at fair market value
 - Principals continue working (if desired) and receive market-level compensation
 - Participate in the increase in value (potential upside)
 - Save taxes
 - Provide unmatched retirement benefits for your employees; and
 - Provide incredible career opportunities for key employees

III. 100% ESOP BUYOUT

Tax Efficiencies

- ❑ The ESOP buyout is the most tax-efficient transaction available to business owners
 - Sellers may defer (possibly permanently) taxes on sale of company (must be a C-Corp at the time of sale to take advantage of this 1042 tax deferral)
 - As a C-Corp, use ESOP deductions (contributions and tax-deductible dividends) to significantly reduce or eliminate taxable income
 - As an S-Corp, use tax-exempt status to operate with pre-tax dollars into perpetuity
- ❑ One strategy may be to take advantage of the tax-deferral as a C-Corp and then get back to S-Corp when permissible to become a tax-exempt entity

100% ESOP Sale

- ❑ Overview of a sale of the Company through an ESOP Trust using senior debt and “junior” (seller) financing
 - Appraiser prepares the preliminary valuation, feasibility study and works with Morgan Lewis to structure the entire transaction
 - Morgan Lewis assists client in selecting advisors required for the transaction
 - Senior debt lenders are selected - perform diligence and prepare term sheets/ proposals
 - Independent trustee and trustee legal/financial advisors selected (the “Buy side” of the Transaction)

100% ESOP Sale

□ Overview (continued)

- Morgan Lewis helps to prepare an offer to sell the Company stock, present that offer to the trustee, and assist in transaction negotiations
- Independent appraisal prepared by trustee's financial advisors
- Morgan Lewis finalizes negotiations with trustee and finalizes transaction/ERISA documents
- Fairness opinion prepared by trustee's financial advisors
- Review/finalize documents and execute transaction

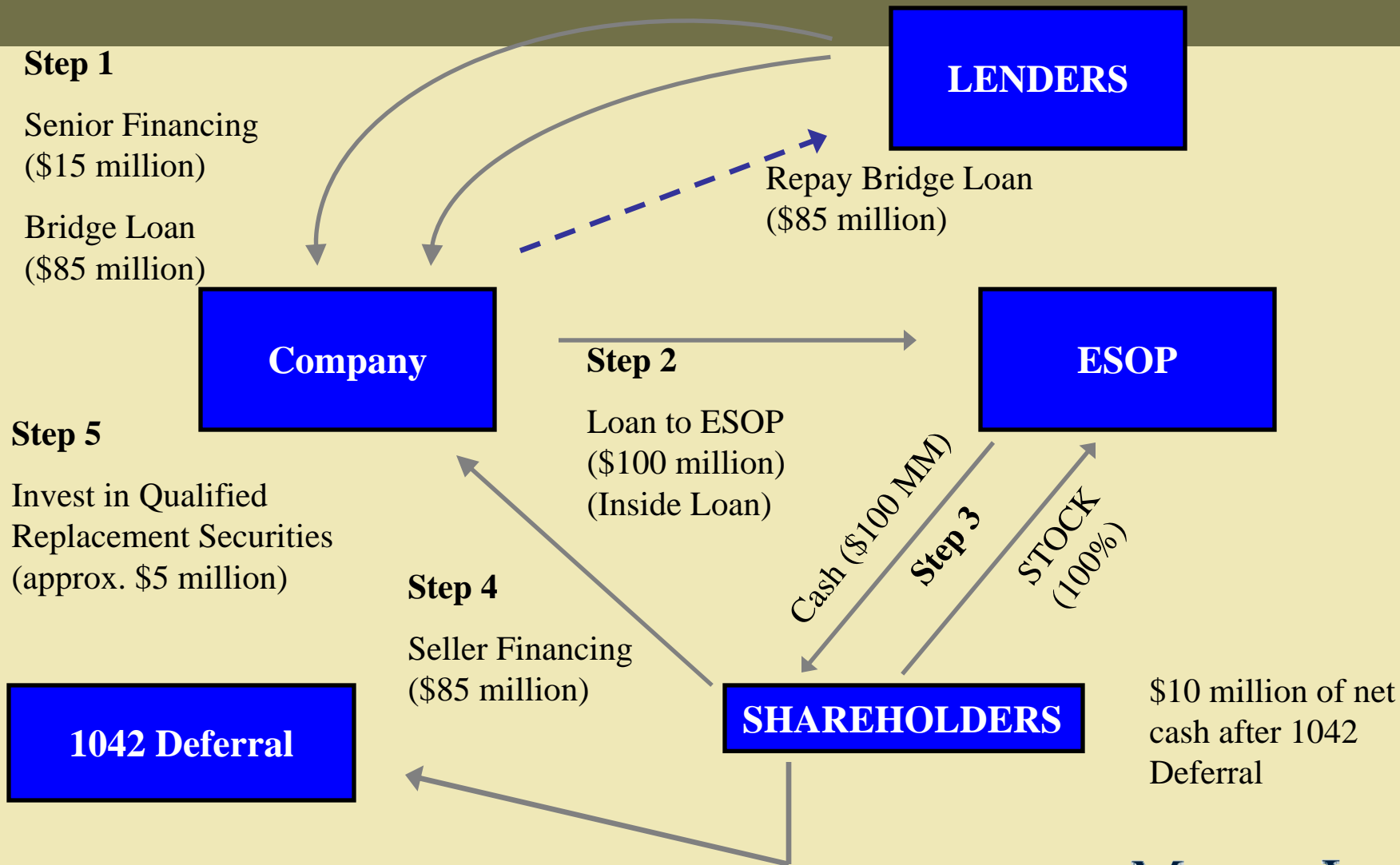
□ Additional Considerations

- “Procedural Prudence” in transaction and subsequent operations
- Advisable to include “outside” directors on Board within a reasonable time post-transaction

Transaction Assumptions

- ❑ Assumes Shareholders sell all outstanding equity in company to to an ESOP for \$100.0 million
- ❑ Need to assess working capital LOC need – assume \$55 million
- ❑ Assume \$70 million of total senior debt capacity (based on 75% A/R advance rate plus \$10 million unsecured portion)
- ❑ Sub-debt may also be sourced to reduce seller financing
- ❑ ESOP acquires 100% of equity for **\$100.0 million**:
 - **Bank/Lender financing of \$15 million**
 - **Bridge/Seller financing of \$85 million**
- ❑ Sellers potentially defer 100% of capital gains taxes on sale
- ❑ Company - owned 100% by an ESOP can utilize ESOP contributions and dividends to minimize income tax liabilities

Transaction Overview



100% ESOP Transaction Results

□ SELLERS

- Receive a total of \$100 million for the sale of stock:
 - \$15 million cash
 - \$85 million seller notes
- Sellers may defer (possibly permanently) capital gains taxes on entire sale by investing in qualified replacement securities (e.g. Floating Rate Notes or “FRNs”)
- **Capital gains tax savings up to \$20 million**
(assumes \$100 million price, stock basis of \$0 and 20% combined federal & state long-term capital gains tax rates)

100% ESOP Transaction Results

❑ SELLERS

- Receive “junior” financing returns of approx. 15% on seller carry-back; approx 8% to 9% cash interest to be paid on seller financing; balance of return will come from warrants
- Sellers “put” warrants to Company for cash after all acquisition debt is repaid

❑ MANAGEMENT

- Company executives entitled to “market comparable” compensation - salary, bonus, ESOP participation, and **synthetic equity** (management incentive plan units such as Stock Appreciation Rights)

100% ESOP Transaction Results

□ Company

- Possibly convert to a C-Corp prior to the Transaction to enable sellers to elect a 1042 tax deferral
- Shareholders sell 100% of shares to ESOP as a C-Corp
- Company remains a C-Corp for a minimum of 5 years and converts to an S-Corp and becomes a tax-exempt entity
- Company services its debt with pre-tax cash flows, significantly reducing financing risk and repaying **ALL** transaction debt much faster
- Enhanced cash flow is more attractive to senior lenders in future

Potential Upside to Sellers

❑ Warrants

- Part of seller note
- Right to exercise warrants for stock after repayment of acq. debt
- Sellers will likely put warrants for cash
- Capital gains tax treatment on gains

❑ Synthetic Equity Plan for Management (i.e. SARs)

- Units derive value based on underlying stock
- Pool set aside for management
- Act like options do in a public company
- Board distributes to management initially and then based on performance
- Considered deferred compensation
- Significant flexibility in plan regarding cashing out
- Ordinary income treatment

IV. 1042 Tax Deferral Option

Selling Shareholder Options

- Qualified Selling Shareholders in an ESOP transaction have two basic options:
 - Pay Capital Gains Tax
 - Take advantage of tax deferral options
 - Elect §1042 treatment

Selling Shareholder Pays Capital Gains Tax

Typically, an ESOP sale is structured as a stock sale (as opposed to an asset sale). Therefore, each shareholder is taxed at their individual capital gains tax rate on the sale

Selling Shareholder Elects §1042 Treatment

If the Selling Shareholder is eligible under §1042 of the Internal Revenue Code, the selling shareholders can defer capital gains tax on the stock sold to an ESOP. There are three general options available to a Selling Shareholder:

Passive/Hold Reinvestment Strategy

- Purchase a passive portfolio of qualified replacement property securities that are designed to remain constant over the shareholder's lifetime. The shareholder can choose to recognize the capital gain by the disposition of one or any of the securities (See Appendix B; disposition discussion).

Active Reinvestment Strategy

- Purchase "leveraged" qualified replacement property using Corporate issued Floating Rate Notes and a "monetization" loan. This strategy typically provides the shareholder with greater liquidity and flexibility, resulting in a higher investment return. The shareholder can choose to recognize the capital gain by the disposition of one or any of the securities.

Blended Reinvestment Strategy

- Combines both the passive and active strategies to further accommodate the shareholder's investment goals and objectives.
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Daniel L. Hogans, J.D.
Partner in Morgan Lewis's Employee Benefits and Executive Compensation Practice

- ❑ Focuses practice on benefits and compensation matters, including equity and incentive compensation plans, employment arrangements, nonqualified deferred compensation plans, ESOPs, ERISA, qualified retirement plans, and pension and profit-sharing plans.
- ❑ Prior experience:
 - Attorney Advisor in the Office of Benefits Tax Counsel at the U.S. Department of the Treasury.
 - Private practice for 10 years
- ❑ Education background:
 - College of William & Mary, Marshall-Whythe School of Law, 1993, J.D.
 - University of Virginia, 1990, M.S. (Accounting)
 - George Mason University, 1989, B.S. (Accounting)

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*Associate in Morgan Lewis's Employee Benefits and Executive
Compensation Practice*

- ❑ Counsels clients in the use of ESOPs and its applications, such as employee buyouts, ownership succession, and corporate reorganizations.
- ❑ Prior experience:
 - Associate at U.S.-based law firm, as member of employee benefits and executive compensation groups, in their tax section.
- ❑ Education background:
 - Georgetown University Law Center, 2004, LL.M.
 - Catholic University of America, Columbus School of Law, 2000, J.D., Cum Laude
 - Miami University, 1997, B.A.