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**KippsDeSanto & Co.**  
**Staff Training**  
**Introduction to ESOPs**

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# What is an ESOP?

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- An “ESOP”, or employee stock ownership plan, is a type of tax-qualified retirement plan with some very special features under applicable law
  - Designed to invest primarily in employer securities
  - Permitted to take on debt to purchase employer securities
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# Demographic Landscape

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- Aging business-owner population with assets concentrated in their businesses
- Population represents millions of businesses, nationally
- Consequently, there is a large population of businesses and owners seeking liquidity and a “way forward” for the long term

## Changing Capital Markets Landscape

- Until recently, private equity has been very active and very competitive in providing liquidity to the market for businesses
- Private equity “demand” to buy businesses has slowed very considerably
- Sellers need a flexible strategy locking in business value and achieving liquidity and diversification

# S Corporation ESOP Structure

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- Offers a unique opportunity to achieve partial or total relief from federal taxes at the corporate level
- Frees up cash for debt service
- Essentially a tax-favored employee leveraged buyout, with company assets and cash flows providing collateral and debt service

# Key Features

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- ESOP pays fair market value for outstanding shares
- ESOP can purchase 100% of shares in a single transaction
- Manageable and flexible process where supported by knowledgeable and experienced professional team

# Important Considerations

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- Procedural prudence is essential to a successful and equitable transaction
- Because of substantial “insider” involvement and potential conflicts of interest, it is important to apply a rigorous process to ensure fairness to all parties
- Process provides essential “insurance” for the parties to the transaction

## S Corporation ESOP Limits

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- Disqualified individuals (10% owners) must own less than 50% of total equity
- Testing includes deemed-owned shares through the ESOP as well as “synthetic equity”
- Violating these rules is catastrophic – a 50% excise tax on the company is just the beginning of the consequence of violation

# Liquidity Alternatives

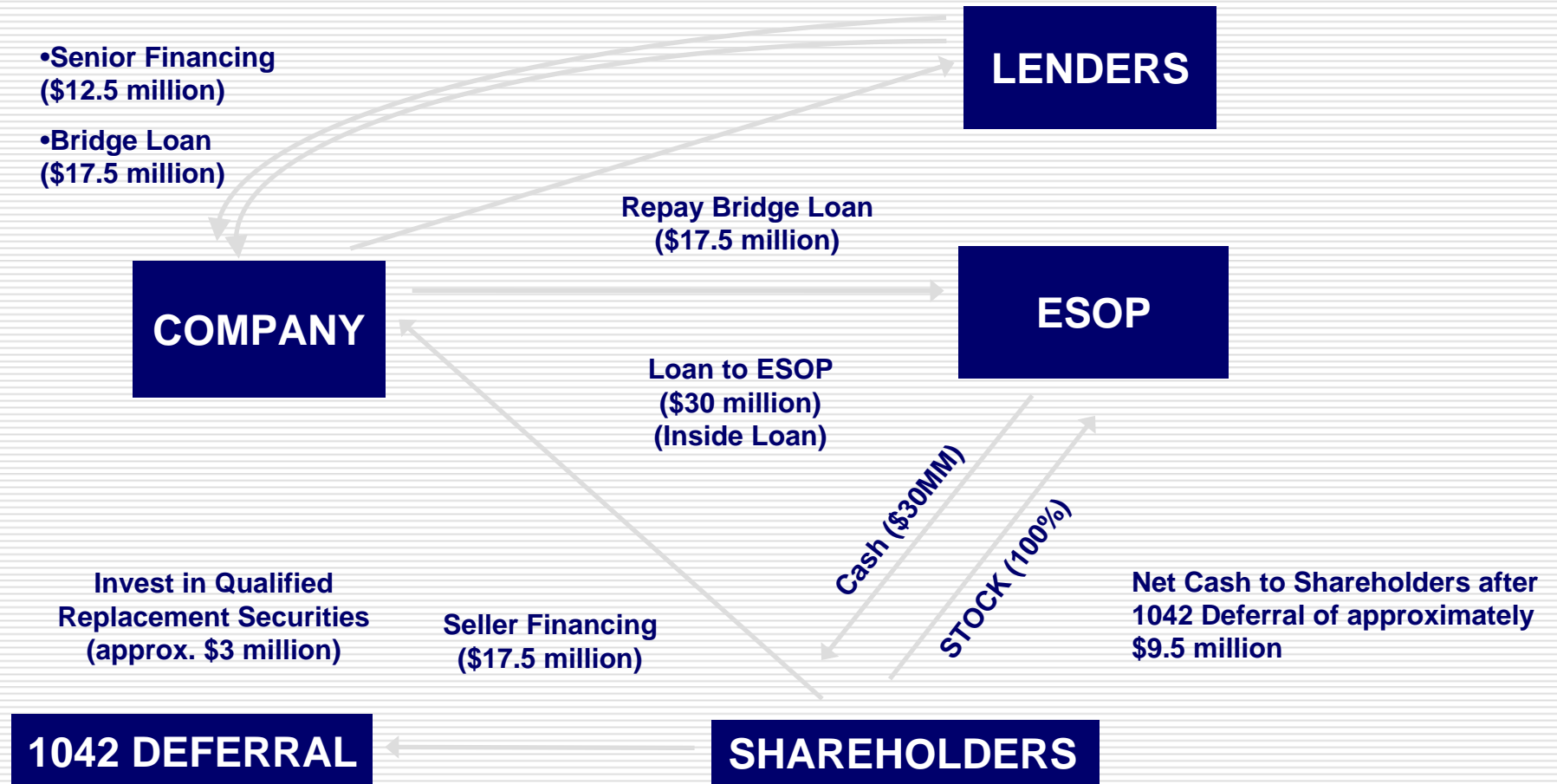
Action	Preservation of Corporate Independence	Creation and Retention of Wealth	Provisions for Liquidity	Minimizing of Shareholder Risk
<b>Sale to an Outside Party</b>	None	Generally most effective means to maximize shareholder wealth	Yes	Allows maximum diversification
<b>Sale to Managers ("MBO")</b>	Selling shareholders may retain partial or majority ownership	Over leveraging or undue strain on liquidity may limit financial flexibility	Yes, but must be balanced with future cash needs of the company	Future payments plus increased leverage may strain liquidity
<b>Sale to Managers and an Outside Equity Investor</b>	Third Party investor will likely require voting control or provision for future voting control	Will generally yield more value to shareholders than sale solely to managers	Yes	Generally entails smaller degree of contingent payments than sale solely to managers
<b>Employee Stock Ownership Plan ("ESOP")</b>	Requires employee ownership, which may or may not be considered desirable	Can provide significant tax benefits	Can provide tax-free rollover or fund self-tender or special dividend, but employees can redeem stock at retirement	Leveraged ESOP may provide diversification funding, but leverage may strain liquidity or increase financial risks
<b>Initial Public Offering ("IPO")</b>	Corporation remains independent, but existing shareholders may face substantial dilution and loss of voting control	Depending on timing of IPO, may yield highest valuation of company; allows future diversification	Yes, but shareholders will not typically be able to sell a large portion of their holdings in the IPO; secondary sales possible	Facilitates diversification over time; value upon liquidation subject to market fluctuations
<b>Recapitalization: Sale of a Minority/Majority Interest to a Private Equity Investor</b>	Can be organized in many different ways, but professional investors will likely require approximately 40% ownership	May provide a bridge for those shareholders who wish to retain their interests for potential future gains	Those shareholders wishing to liquidate their portions can be given that option	Continuing shareholders will likely undertake some form of liquidity event for the investor in the future
<b>Self-Tender</b>	If targeted, may provide substitute to outside sale	Over leveraging or undue strain on liquidity may limit financial flexibility	Yes, and can be targeted specifically	Facilitates diversification, but liquidity strain may increase financial risks
<b>Special Dividend</b>	Partial alternative to sale to outsider - reduces need for forced sale of stock	Over leveraging or undue strain on liquidity may limit financial flexibility	Yes	Facilitates diversification, but liquidity strain may increase financial risks

# Comparisons of Sales Proceeds

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- Assumptions:
  - EBITDA: \$5 million
  - Sales Price: \$30 million (6x)
  - Seller's Basis: -0-
  - Senior Financing Available: \$12.5 million (2.5x)
  - Seller Note (ESOP sale): \$17.5 million
  - Warrant @ 25% of company after debt repaid

# Transaction Overview



# Comparison of Sale Proceeds

	<u>Sale to ESOP</u>	<u>Sale to Outsider</u>
Price	\$30,000,000	\$30,000,000
Less: Taxes	\$ 0	\$ 8,100,000
Net	\$30,000,000	\$21,900,000
Return on \$17.5MM @ 8% for 5 yrs	\$ 8,200,000	\$ 8,200,000
Less: Taxes (@ 45% / 28%)	(\$ 3,690,000)	(\$ 2,296,000)
Net	\$ 4,510,000	\$ 5,904,000
Warrant	\$12,500,000	\$ 0
Less: Taxes (@28%)	(\$ 3,375,000)	\$ 0
Net	\$ 9,125,000	\$ 0
Return on remaining proceeds @ 8% - 5 yrs	\$ 9,500,000 <sup>(1)</sup>	\$ 4,400,000 <sup>(2)</sup>
Less: Taxes (@28%)	(\$ 1,248,000)	(\$ 578,000)
Net	\$ 3,211,000	\$ 1,487,000
<b>Total Proceeds</b>	<b>\$ 46,846,000</b>	<b>\$ 29,291,000</b>

<sup>(1)</sup>  $(\$30,000,000 - 17,500,000 = 12,500,000 - 3,000,000 = \$9,500,000)$

<sup>(2)</sup>  $(\$21,900,000 - 17,500,000 = \$4,400,000)$

## Comparisons of Sales Proceeds (cont)

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- Key Comparison issues:
  - Proceeds should be considered on a present value basis
  - Seller to ESOP retains varying levels of business risk until paid in full
  - ESOP generally best suited for a “gentle” transition over 3-5 years

# Advantages/Disadvantages

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- Advantages
  - May provide highest return to selling shareholders
  - Provides full or partial liquidity to owners
  - Provides significant tax advantages and may qualify the seller for tax-deferred capital gains
  - Can provide the owner with an ideal exit strategy
  - **Company may become a non-income tax paying entity as an S-Corp**
- Disadvantages
  - Generally requires leverage
  - Repurchase obligation
  - Perceived as complex

# ESOP Companies

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- What kind of companies should consider an ESOP buyout?
  - Private companies with 20 or more employees, are profitable and have borrowing capacity and cash flow sufficient to service debt.
  - Companies that may have limited options available to them for acquisition by a strategic or financial buyer.
  - Companies in which owners desire to gain liquidity, “lock-in” value and maximize returns in a gradual or “stage” sale of their company; and/or
  - Companies in which owners are motivated to provide a retirement benefit to their employees.

# Key ESOP Provisions

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- Designed to primarily hold employer securities (IRC § 4975 (e))
- May use debt to purchase assets (IRC § 4975 (d)(3))
- Tax Benefits for employees (IRC § 402)
- **Pre-tax principal repayment (IRC § 404 (a)(9))**
- **Tax deductible dividends (IRC § 404 (k)) – “C” corp.**
- Interest not included in IRC 415 limitation (IRC § 415 (c)(6)) – “C” corp.
- **Tax-deferred sale (IRC § 1042) – “C” corp.**
- **S-Corp eligible to sponsor ESOPs (IRC § 1361 (c)(6))**
- **Repeal of UBIT as it applies to ESOPs – “S” corp.**  
(IRC §§ 401(a), 501(a) and 512(e)(3))
- Stock Repurchase (IRC § 409 (h)(4))
- S-Corp Anti-abuse Provisions (IRC § 409(p))

# Considerations for selling an ESOP company

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- ESOP stock cannot be sold for less than FMV (the ESOP must receive “adequate consideration”)
  - Can S corporation tax benefit be added into the transaction value?
- The overall terms of the transaction must be fair to the ESOP from a financial point of view

# When might an ESOP Company consider a sale?

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- Proactive evaluation of change in capital structure
    - Need to take out an investor
    - Need for bigger platform – support growth
    - Need for stronger management succession
    - Pressures of repurchase liability
    - Flattening or declining stock price
    - Window of opportunity
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# When might an ESOP Company consider a sale?

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- Unsolicited Offer
  - To the board of directors
  - To the CEO or other officer
  - To the ESOP trustee

# Fiduciary Considerations with the sale of an ESOP company

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- First, fiduciaries want to evaluate common issues of existing ESOP companies
    - Funding of repurchase liability
    - Capital allocation “tension”
    - Capital access- Need / Desire for Liquidity
    - Have/Have Not Equity Allocation
    - Ability to drive continued share growth
      - Payoff of ESOP Loan
      - Transition from a growth company to a mature company
      - Dilution to existing shareholders
    - Management’s ability for equity participation
    - Tax benefits sustainability (C or S corp status)
    - Communications/culture
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# Fiduciary Considerations with the sale of an ESOP company

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- Will any premium suffice?
- How does this price compare to other possible prices?
  - Was the Company shopped? Should it be?
  - Was there an auction?
- How are suspense account proceeds being allocated?
- How should an earn-out or escrow arrangement be evaluated?
- How should indemnification provisions be structured?
- What else is going on?
  - Employment agreements
  - Non-compete agreements
  - Personal goodwill
  - Management incentive arrangements
  - Clawback provisions.
- **JOB SECURITY CANNOT BE CONSIDERED**

# Pass-Through Voting Requirements

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- Requires participants in an ESOP to have the right to direct the Trustee with respect to the manner in which shares of stock allocated to their ESOP account should be voted
- In the case of most private companies, the voting pass-through direction right applies only with respect to certain major corporate matters, including mergers, consolidations, recapitalizations, reclassifications, dissolutions, liquidations or sales of substantially all assets

# Mechanics of ESOP post closing

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- Termination of ESOP
  - Who handles logistics and manages the process?
  - Filing of Form 5310
  - Timetable for distributions
- Possible merger into Buyer's plan

# QUESTIONS?

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