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Introduction to ESOPs

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What is an ESOP?

- 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

- 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

- 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

- 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

- 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

- 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

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Liquidity Alternatives

Action	Preservation of Corporate Independence	Creation and Retention of Wealth	Provisions for Liquidity	Minimizing of Shareholder Risk
Sale to an Outside Party	None	Generally most effective means to maximize shareholder wealth	Yes	Allows maximum diversification
Sale to Managers ("MBO")	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
Sale to Managers and an Outside Equity Investor	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
Employee Stock Ownership Plan ("ESOP")	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
Initial Public Offering ("IPO")	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
Recapitalization: Sale of a Minority/Majority Interest to a Private Equity Investor	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
Self-Tender	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
Special Dividend	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

- 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

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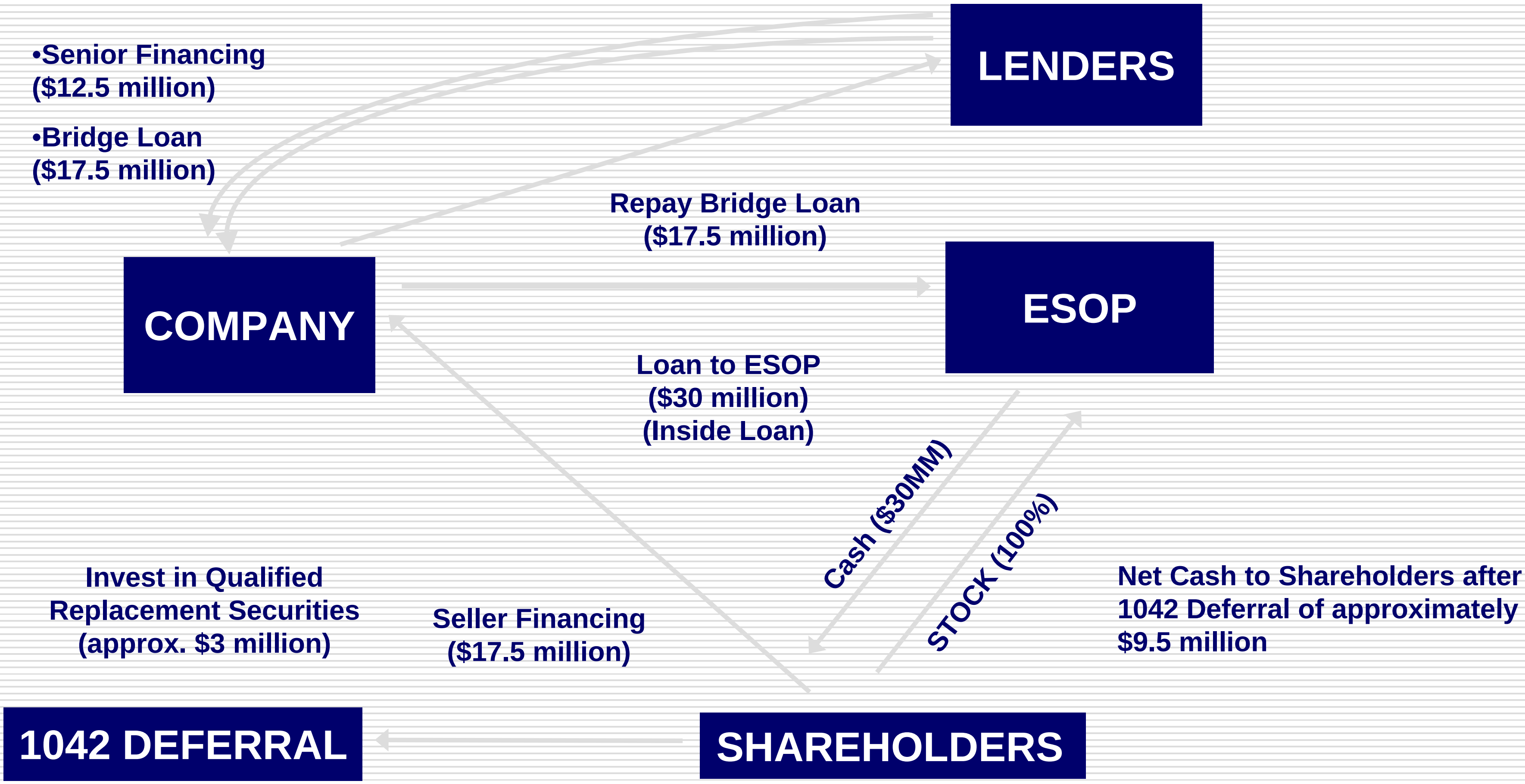
Transaction Overview



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Comparison of Sale Proceeds

	Sale to ESOP	Sale to Outsider
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	*$ 9,500,000*[1]	*$ 4,400,000*[2]
@ 8% - 5 yrs	$ 4,459,000	$ 2,065,000
Less: Taxes (@28%)	($ 1,248,000)	($ 578,000)
Net	$ 3,211,000	$ 1,487,000
Total Proceeds	**$ 46,846,000**	**$ 29,291,000**

[1] ($30,000,000 – 17,500,000 =12,500,000 – 3,000,000 = $9,500,000)

[2] ($21,900,000 – 17,500,000 = $4,400,000)

Comparisons of Sales Proceeds (cont)

- 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

- 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

- 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

- 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))

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QUESTIONS?

- *Michael Holzman – Morgan, Lewis & Bockius LLP* Phone: (202) 739-5685
  - Email: mholzman@morganlewis.com