ESOPs & Government Contractors

A Winning Combination

Tracy Holzman
Blue Ridge ESOP Associates

Michael R. Holzman, Esq.
Morgan, Lewis & Bockius LLP

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Agenda

- Overview of the M&A and ESOP market for government contractors
- What is an ESOP and how does it work?
- Change in Control issues
- Financing ESOP buyouts
- 8(a) status and ESOP transactions
- Contributions, Cost reimbursements and overhead

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ESOP M&A Overview

- **Factors to Consider with Change in Control Transactions**
  - **New SBA Recertification Rules could affect M&A market for strategic buyers**
  - **After-tax proceeds in an ESOP transaction are often equal to or can exceed offers from other third party buyers**
  - **Government contractors are good ESOP candidates because of business stability and strong cash flow (especially when costs are reimbursed)**
  - **Consideration of marketability discount and premium for control is a factor in ESOP transactions**
  - **Financing v. valuation**
  - **Pricing multiples vary based on type of work, customers and employees**
  - **S Corp. ESOP benefit is increasingly used to facilitate transactions**
  - **More sophisticated transaction structuring makes ESOP transactions yield more benefits for all stakeholders (sellers, ESOP, management, etc.)**

ESOP M&A Overview (continued)

- **Factors to Consider in Minority Ownership Transactions**
  - **Assists with business succession planning**
  - **Flexibility in transferring ownership**
  - **Lower valuations due to a lack of control discount**
    - **With appropriate planning, valuation discounts can be offset**
  - **Maintain operation and control for the business owner**
  - **Participation in future capital appreciation for the selling shareholder**
  - **Transactions are easier to finance**

Why Bother With an ESOP

•***Because*** the Owner(s) benefit

•***Because*** the Shareholders benefit

•***Because*** the Employees benefit

•***Because*** the Company Benefits

A **win-win** situation for…
EVERYONE

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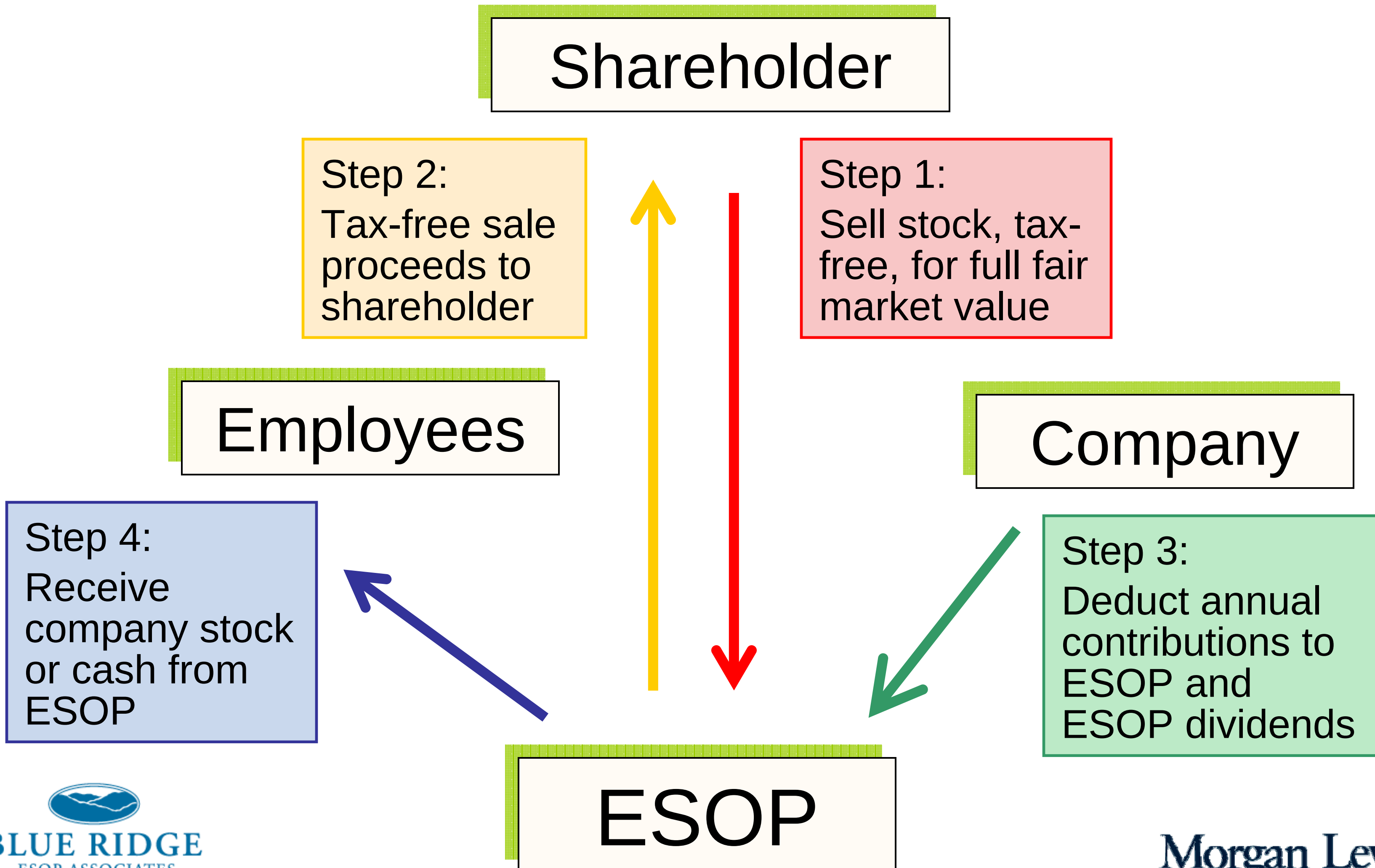
So, What is an ESOP?

- An ESOP is a retirement program designed to invest in company stock. This ultimately benefits the employees and indirectly, customers.
- There are ~ 11,000 ESOPs in the U.S. covering 8 million employees (8% of the private sector work force)*

*Source:

www.esopassociation.org/pubs/stats.html

The Players



Shareholder
Step 2:
Tax-free sale proceeds to shareholder
Step 1:
Sell stock, tax-free, for full fair market value
Employees
Company
Step 4:
Receive company stock or cash from ESOP
Step 3:
Deduct annual contributions to ESOP and ESOP dividends
ESOP

Shareholder Benefit

- Tax-free sale of proceeds for sale of stock to an ESOP
- Retain control of company regardless of amount of stock sold to ESOP
- Tie employee compensation to company performance, leading to a more productive workforce
- Effectively transfer ownership of the company to employees, if desired

Employee Benefits

- Shared ownership of a company provides employees with an incentive to improve both individual and company performance
- Employee receives a retirement benefit equal to the value of company stock in their ESOP account
- Employees receive tax-deferred growth until their benefit is distributed
- Gains in employee stock value are taxed as capital gains, not as ordinary income

Company Benefits

- Company pays down the debt with pre-tax dollars
- Annual contributions and dividends are tax deductible
- Company can increase working capital through significant reduction of tax liability
- To the extent that the company has cost-plus contracts, the costs in connection with the ESOP are reimbursable to the company
- If a company is a S-Corporation and owned 100% by its ESOP, the company can operate tax-free

How Does It Work?

- Company creates a trust to which is makes contributions
- Contributions are allocated to individual employee accounts within the trust
- The shares of company stock and other plan assets allocated to employees' accounts vest
- Employees receive vested portions of their accounts at termination or retirement

Unique to Government Contractors

- To the extent that there are cost-plus contracts, the ESOP costs are reimbursable to the company
- Impact of reimbursable costs on bidding contracts
- Preserving 8(a) status
- New SBA Reporting Rules
- Change of control/ownership provisions in government contracts
- Communication with contracting agencies about ESOP plan
- Government Contractor lending- the Assignment of Claims Act
- Design of ESOP loan to maximize ESOP cost reimbursement

A Good Idea!

An ESOP can…

…let owners **cash out tax-free** while **retaining control**, and **resolving transitional issues**

New SBA Recertification Regulations

- Effective June 30, 2007, any M&A transaction (including asset deals requiring novation, as before, as well as stock purchases and reverse mergers) will require either (1) a recertification, or (2) notification to the customer if the size standards are exceeded
- The new regulations are applicable to all contracts with durations of more than five years
- These new rules are expected to impact M&A activity of government contractors

ESOP as a Buyer of Company Stock: Valuation Definitions

- <u>Adequate Consideration</u>: fair market value as determined by the ESOP trustee
- <u>Fair Market Value</u>: a value, expressed in cash or its equivalent, at which a willing seller and a willing buyer, both being informed of the relevant facts about the business, could reasonably conduct a transaction, neither person acting under compulsion to do so
- <u>Financial Fairness</u>: the ESOP company may not pay more than fair market value to acquire another company taking into account all of the terms and conditions of the sale
- <u>Strategic Value v. Fair Market Value</u>: accounting for premium for control and discount for lack of marketability

Financing ESOP Buyouts

- ESOPs are typically leveraged and financed with a combination of bank debt, subordinated debt and seller notes
- Bank debt is the cheapest capital, but is the most restrictive
- Subordinated debt is more expensive, but less restrictive
- A given cash flow can only support so much debt
- ESOP buyout debt is financed PRE-TAX so the equity cushion is effectively built in

Bank Debt

- Banks will first evaluate cash flow to determine the maximum senior debt capacity
- It will then evaluate the collateral base and lend at the "lesser of the two"
- Government receivables are typically excluded from a company's borrowing base
- However, they CAN be used if properly assigned
    - This is done through an Assignment of Claims process
    - This helps increase the collateral capacity and therefore the borrowing amount

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Assignment of Claims Act

- The Assignment of Claims Act (1940) allows a contractor to assign monies due if certain conditions are met
  - Contract specifies payments in excess of $1,000
  - The assignment is made to a bank or trust company
  - The contract does not prohibit assignment
  - It is only assigned to one party and the assignee sends written notice of assignment to certain parties
- These assignments can be used as collateral for bank debt

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Types of Contracts

- Fixed-Price Contracts
- Incentive Contracts
- Indefinite-Delivery Contracts
- Time and Materials, Labor-Hour, and Letter Contracts
- Basic agreements and ordering agreements

Types of Contracts (cont.)

- Cost-Reimbursement Contracts
- Cost Contracts
- Cost-sharing Contracts
- Cost-plus-incentive-fee Contracts
- Cost-plus-award-fee Contracts
- Cost-plus-fixed-fee Contracts

Cost Reimbursability (Historic Perspective)

- For ESOPs that meet the definition of a pension plan, the contractor measures, assigns, and allocates the costs in accordance with Cost Accounting Standard ("CAS") 412
- For ESOPs that do not meet the definition of a pension plan, the contractor measures, assigns, and allocates the costs in accordance with CAS 415

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Pension ESOPs
CAS 412

- Plan documents must offer the plan participants:
  - (1) benefit payments for life, or
  - (2) benefits that are payable for life at the option of the participants
  - For pension type ESOPs, interest costs incurred by the ESOP are allowable provided the contractor's annual contribution to the ESOP meets general reasonableness criteria and does not exceed 25 percent of covered compensation
  - Plans that provide future payments for current work, and that are not pensions, are deferred compensation ESOPs
  - The Cost Accounting Standards Board has now concluded that all ESOP costs should be treated consistently as deferred compensation

Deferred Compensation ESOPs CAS 415

- The contractor's cost for an ESOP shall be measured by the contractor's contribution, including interest and dividends, if applicable, to the ESOP
- Contributions made in company stock shall be based on the market value of the stock at the time of the contribution
- An ESOP contribution shall be assignable to the cost accounting period only to the extent that the contribution is awarded to the employees in the accounting period

Challenges of Cost Reimbursability

- Calibration of expected cost reimbursements with ESOP loan amortization
- Projecting reimbursable ESOP costs, assigning them to contracts, and keeping competitive rates
  - It is important to communicate with the agency's contracting officer about the ESOP

Service Contract Act

- ESOP benefits must qualify as “Bona Fide” fringe benefits
  - Applies to any contract in excess of $2,500
  - Plan must contain a definite formula for determining the amount to be contributed by the contractor and a definite formula for determining the benefits for each of the employees in the Plan.
  - Timing of contributions for employees subject to the Service Contract Act

Maintaining 8(a) Status

- Disadvantaged owner must retain a 51% ownership interest in the company
- ESOP can acquire up to a 49% in the company and future ESOP stock sales can be planned as the company graduates from the 8(a) program
- 8(a) regulations offer an equity raising waiver that can apply to ESOP transactions

Change in Control Issues

- All contracts must be reviewed for Change in Control notice provisions
- Most contracts require that the agency's contracting officer be notified of any disposition of a controlling interest in the company
- Most agencies have no objection to an ownership change to an ESOP, but notice is still typically required
- Communication with the agency is important to assure continuity of business as expected

Overview of Equity Incentive Plans for ESOP Companies

- Management incentive plans are common in ESOP companies
- These incentive plans can meet a variety of goals
  - **Retention of key employees and contributors**
  - **Alignment of interests between management and shareholders**
  - **Provides performance incentives**
- **Can and should be used in 100% ESOP-owned companies**
- **Management incentive plans can take numerous forms**
  - **Profit sharing plans**
  - **Discretionary bonuses**
  - **Equity based compensation**
- **Equity based compensation will be our focus**

ESOP Evaluation Process

- **Characteristics of an Ideal ESOP Candidate**
  - **A Profitable Company with a value of at least $5M or more**
  - **A Company which employs at least 15 or more employees**
  - **A Company with Business Owners looking to incentivize employees**
  - **A closely held corporation with Shareholders looking for an exit strategy**
  - **A Company that has Shareholders who desire to sell their stock and leave the Company.**
  - **A Company with Shareholders desiring to realize maximum value on the sale of the Company**
  - **A Company with Shareholder-employees who want to plan for retirement**

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ESOP Evaluation Process

- Discuss shareholder objectives to determine if the ESOP is the right tool for the job
- Complete ESOP Feasibility Questionnaire and discuss preliminary observations
- Conduct detailed feasibility & transaction analysis
- Assemble deal team including ESOP advisor, attorney, appraiser
- Raise money, complete appraisal, negotiate price, close deal

Presenters

- Michael Holzman: Morgan, Lewis & Bockius LLP
  - 202.739.5685
  - mholzman@morganlewis.com
- Tracy Holzman: Blue Ridge ESOP Associates
  - 301.530.1305
  - tholzman@blueridgeesop.com

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