LENDING ISSUES IN ESOP BUYOUTS

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Topics We Will Cover

- Quick Overview of Leveraged ESOP Structures
- What's the Same, What's Different in an ESOP Financing?
- Tax and ERISA Considerations for Lenders
- Solvency Opinions and Fraudulent Conveyance Analysis
- Documentation Issues and Closing the Deal
- Lessons from the Trenches

Three Basic ESOP Structures

1. Typical "Simple" ESOP transaction
   – Seller liquidity and tax deferral
2. Typical "simple" S Corp ESOP transaction
   – Tax shield
3. Emerging "financially layered" ESOP transactions
   – Tax shield and combination of debt and equity-like investments

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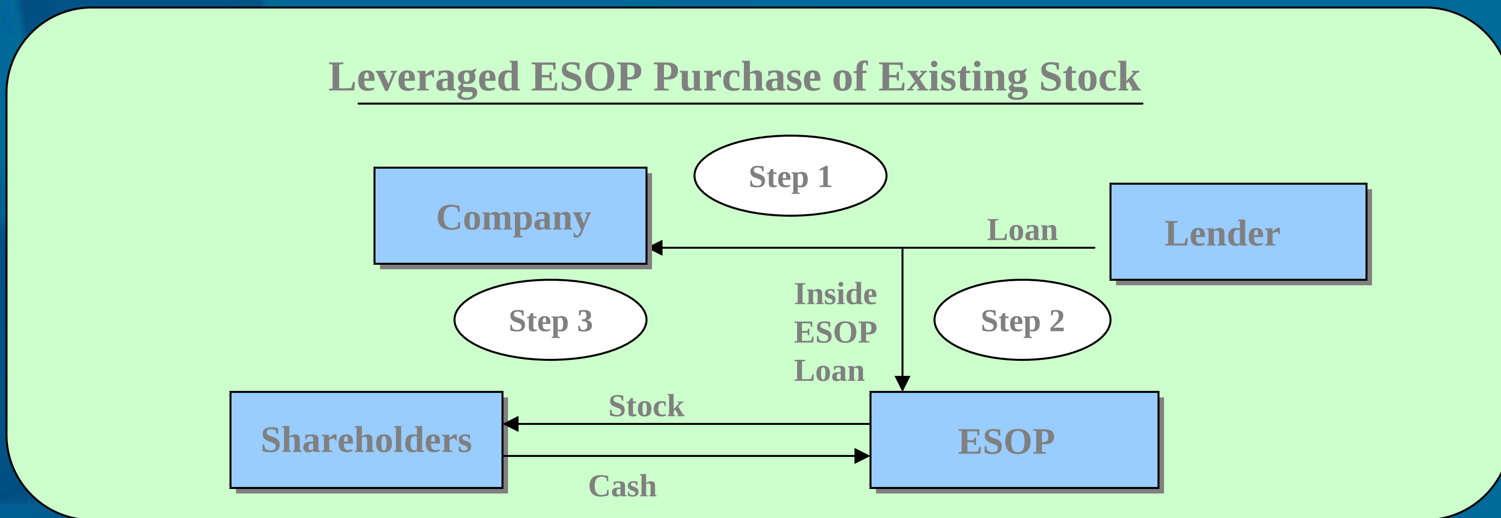
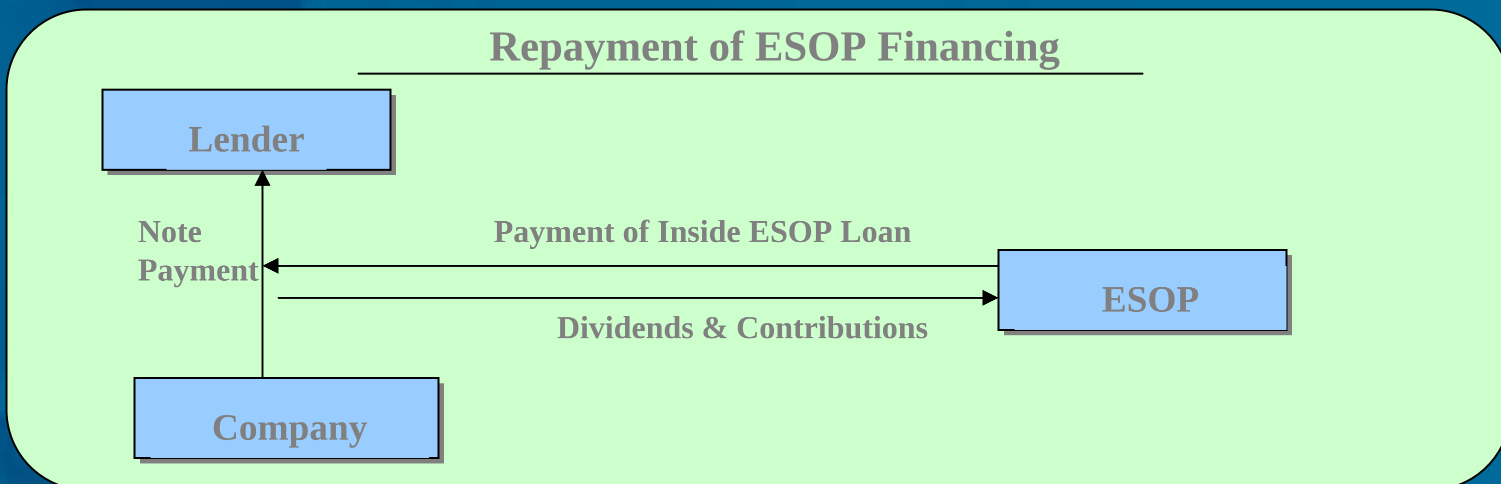
1. Basic C Corp ESOP Transaction





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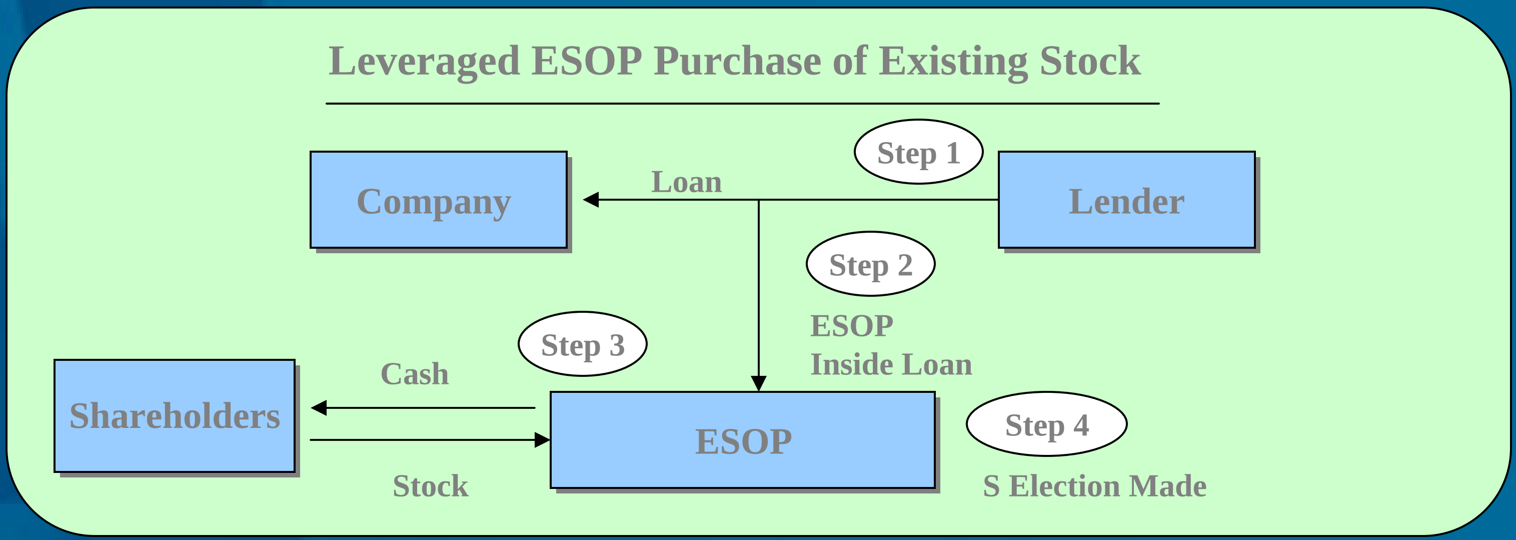
1. Basic C Corp ESOP Transaction

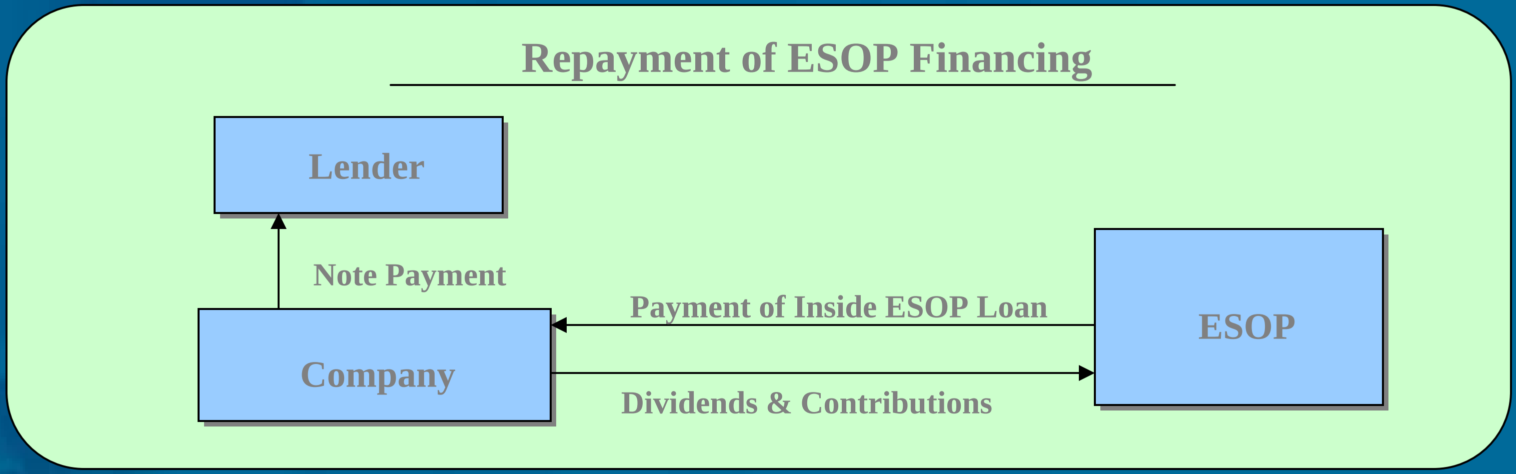
- Company establishes ESOP
- Company borrows funds from bank (Step 1) and re-lends proceeds to ESOP (Step 2) ("Inside Loan")
- ESOP uses funds to buy at least 30% of shares of Company (or value) from shareholders (Step 3)
- Shares are held in a suspense account

1. Basic C Corp
ESOP Transaction

- Company makes tax-deductible contributions (and/or dividends) to ESOP in amount equal to P&I due on Loan
- ESOP repays Inside Loan to Company and Company repays debt to bank
- As Inside Loan is paid down, shares are released and allocated to employees participating in ESOP

2. Typical S Corp ESOP Transaction





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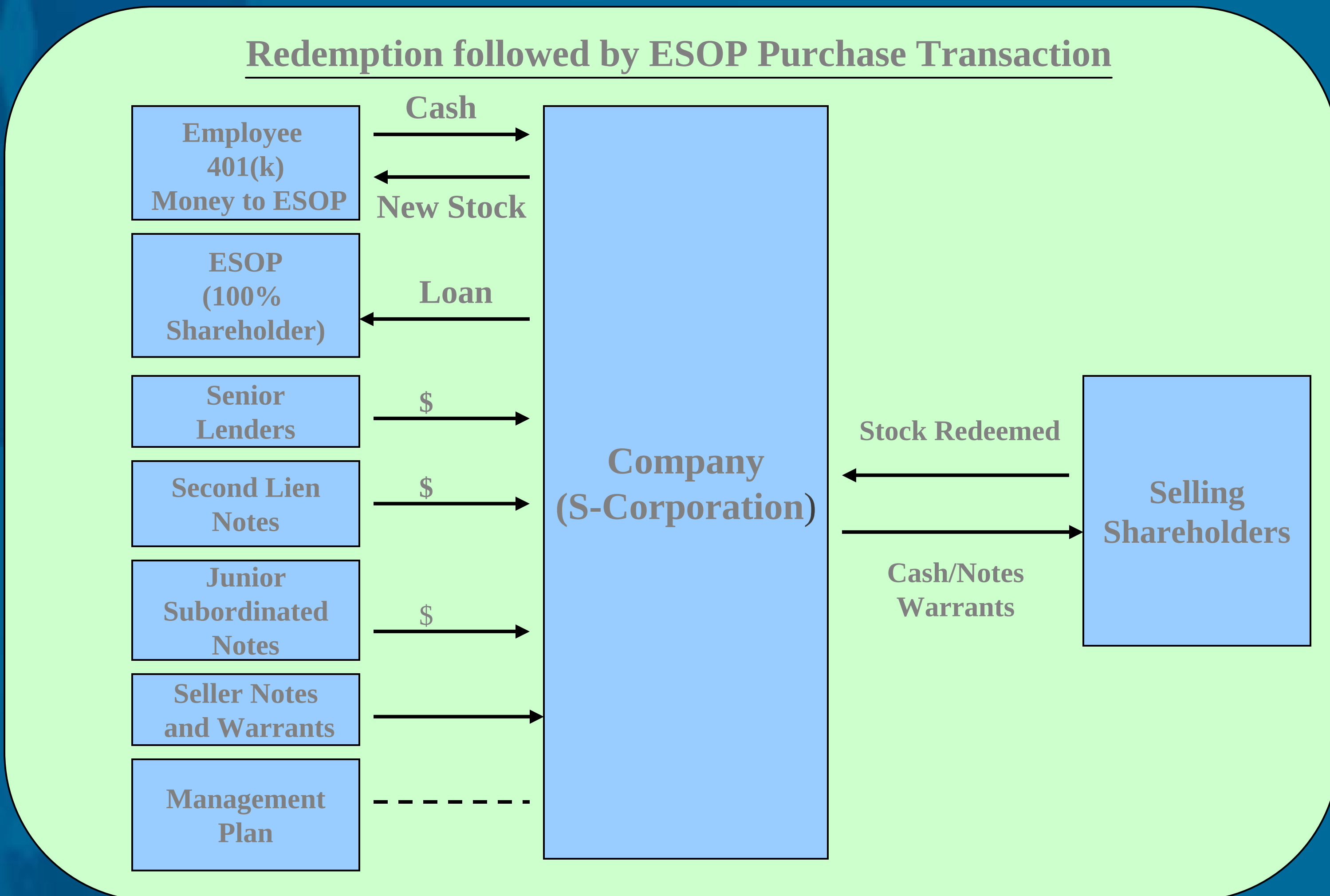
2. Typical S Corp ESOP Transaction

- S-Corp (or C Corp that converts to S-Corp) establishes an ESOP, which purchases stock from shareholders
- Financing is provided by bank loan to Company, which is re-loaned to ESOP, as under first example.
- Seller financing may be needed, via subordinated Seller Notes

2. Typical S Corp ESOP Transaction

- Once ESOP owns 100% of S Corp, no federal income tax on Corp's income
  - S Corp pays no income tax
  - No shareholder level tax, because sole shareholder (ESOP) is a tax-exempt trust
- Must comply with Section 409(p) tests
- Additional cash flow from tax savings can be used to fund faster repayment of acquisition debt, or fund expansion projects

3. More Complex S Corp ESOP Transaction - Layered Financing



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3. More Complex S Corp ESOP Transaction - Layered Financing

- Company redeems 100% of stock from shareholders, and ESOP purchases stock from Company
  - Result: ESOP owns 100% of stock
- Company may fund transaction with combination of indebtedness – senior debt, second lien debt, junior subordinated, mezzanine, and/or seller notes with warrants

3. More Complex S Corp ESOP Transaction - Layered Financing

- Employee 401(k) accounts may also be used as source of funding
  - Employees may elect to transfer funds to ESOP to purchase stock
- Shares are immediately allocated to employees and not held in suspense
- Company establishes management incentive plan for current and future key employees
- Company obtains benefits of being a 100% ESOP-owned S Corp; must comply with Section 409(a)

What's the Same, What's Different?

- Regulatory issues: Tax and ERISA compliance

- Players:
  – ESOP trustee: different type of buyer
  – Independent financial advisor: value and fairness

- Leverage:
  – Can be a high degree of leverage, which messes up the balance sheet
  – Multiple financing layers
  – More parties to manage

What’s the Same, What’s Different?

- But, the parties are ultimately aligned:
  - All want Company and ESOP to have expected tax benefits
  - All want transaction to comply with ERISA

Tax and ERISA Considerations for Lenders

- S Corp requirements: Single class of stock
  - Sub debt
    - Is it “true debt”?
  - High debt/equity ratio
    - When does debt become equity?
  - Warrants
- Why do lenders care?
- How do lenders get protection?

Tax and ERISA Considerations for Lenders

- Repurchase obligations/diversification
  - Regular repurchase liability studies
  - Covenant restrictions
- Section 409(p) compliance
  - Issues usually triggered by warrants, stock options, deferred compensation

Solvency Issues in Leveraged ESOP Transactions

- Solvency is a concern in any leveraged transaction, because of potential to create a fraudulent conveyance
  - State UFTA and UFCA
  - Federal Bankruptcy Code
- What is a fraudulent conveyance?
- A transfer (including the grant of a security interest) or incurrence of an obligation, IF:
  - Debtor gets less than reasonably equivalent value, AND
  - One of the following pertains:
    - Insolvent or became insolvent as result of transfer
    - Unreasonably small capital
    - Intended to incur debts that would be beyond ability to pay as they come due

Definitions of Insolvency

- Definitions of “insolvent”
  - Balance sheet test: Does fair value of assets exceed fair value of liabilities?
    - “Value” doesn’t mean fire sale, or book value
    - But “value” doesn’t mean sitting out a business cycle until values recover
    - “Going concern” value is relevant, but some courts are suspicious of inflated value of good will
  - Cash flow test

The Consequences of a Fraudulent Conveyance

- The consequences of a fraudulent conveyance:
  - Security interest can be cancelled, leaving lender unsecured
  - Stock purchase can be undone, and payments (or notes) can be recovered from sellers
  - While lenders often look to the trustee as an ally on this issue, trustee is less affected by a FT than lenders

Solvency Certificates and Opinions

- Protection for Lenders: Solvency certificates and solvency opinions
  - Not foolproof; not a safe harbor
  - Bankruptcy trustee is not estopped from arguing that certificate/opinion was not true
  - However, by having a solvency analysis done, one can help a court resist the temptation to apply 20/20 hindsight later

Solvency Certificates and Opinions

- Time and cost
  - Equivalent of a detailed appraisal
  - Some opinion providers charge a risk premium

- Need for guidance up front regarding methodology and conclusions
  - Opine on each guarantor subsidiary and entire group
  - Consider intra-group support agreements and subrogation rights

Subordination Agreements and Other Loan Documents

- Basic Loan Documentation
  - Financial covenants – adjust for impact of the ESOP
  - Prohibitions on distributions and stock repurchases – adjust for “round trip” payments and stock repurchases
  - Representations, warranties, events of default, opinions and closing conditions relating to the ESOP, S Corp status, and ERISA compliance
  - Collateral assignment of ESOP transaction documents

Subordination Agreements and Other Loan Documents

- Subordination and Intercreditor agreements
  - Increased importance as debt replaces equity
  - Different agreements with different levels of debt/lien holders
  - Payment blockages
  - Standstills
  - Waivers and consents in bankruptcy (cash collateral, DIP financing, adequate protection)

Getting to Closing – “Herding the Cats”

- **Who is the Quarterback?**
- **Managing Seller and Company expectations**
- **Educating and managing the syndicate**
- **Involving the Trustee and Financial Advisor early**
- **Coordination with the Company’s employee communication plan**

Lessons from the Trenches

- **"Measure Twice, Cut Once"**
  - **Spend time *up front* on planning, structure and communication among *all* parties.**
- **"We Are All Part of the Circle of Life" (otherwise known as "The Whack-a-Mole Effect")**
  - **If you change one aspect of transaction, it will have an effect on the other parts**
  - **Communication, transparency and flexibility are key**
- **"When you Have to Herd Cats, Pick the Right Cats"**
  - **Reduce execution risk by getting committed team players who are problem solvers**

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