# ESOP OVERVIEW

for

**Denver Estate Planning Council**

November 12, 2015

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# 1. Background on ESOPs

# Historical Background on ESOPs

## 1950s - 1960s

- Concept developed by lawyer and investment banker Louis Kelso
- Revenue Ruling 46 of 1953 - permitted any qualified retirement plan to borrow money for the purpose of purchasing stock
- Peninsula Newspaper, Inc. – the first known leveraged ESOP

## 1970s - 1980s

- Regional Rail Reorganization Act of 1973 – permitting ESOPs as a vehicle to enable corporations to finance their capital requirements
- ERISA of 1974 – detailed the workings of the ESOP concept
- Tax Reduction Act of 1975 – additional tax credit for ESOP contributions

## 1980s - 1990s

- Small Business Development Act of 1980 – preferential loan agreement treatment for companies which ESOP owned 51%>
- Economic Recovery Tax Act of 1981 – increased allowable deductible contribution from 15% to 25% of covered payroll
- Deficit Reduction Act of 1984 - IRC §1042 provided for tax-free rollover
- Taxpayer Relief Act of 1997 – made it practical for S Corp to have ESOP

## 2000s

- Economic Growth and Tax Relief Reconciliation Act of 2001- broadly improved ESOPs
- Tax reduction in 2001 changed contributable amounts to ESOPs alone or in combination with other tax qualified plans

# What is an ESOP?

- An ESOP is a qualified, defined contribution employee benefit plan, much like a traditional profit sharing plan that invests primarily in the sponsoring employer’s stock.
  - Unique among qualified benefit plans in its ability to borrow money may be used as a technique of corporate finance
- There are approximately 10,000 ESOPs in place in the U.S., covering 11 million employees (10% of the private sector workforce)
- A majority of ESOP companies have other retirement plans, such as defined benefit pension plans or 401(k) plans, to supplement their ESOP
- Total assets owned by U.S. ESOPs is estimated to be over $1 trillion at the end of 2013
- About 800 ESOPs - 7% - are in publicly-traded companies
  - Notable publicly-traded ESOPs include (employees own more than 10%) Proctor & Gamble Company; Anheuser-Busch Companies, Inc.; Chevron Corp.; Kimberly-Clark Corporation and General Mills, Inc.

# All Parties Can Benefit from an ESOP

**Seller:**

- Receive Fair Market Value
- Favorable Tax Treatment on Sale
- Flexibility; can sell any % of company
- Preserve Legacy as Independent Company
- Reward Management & Employees

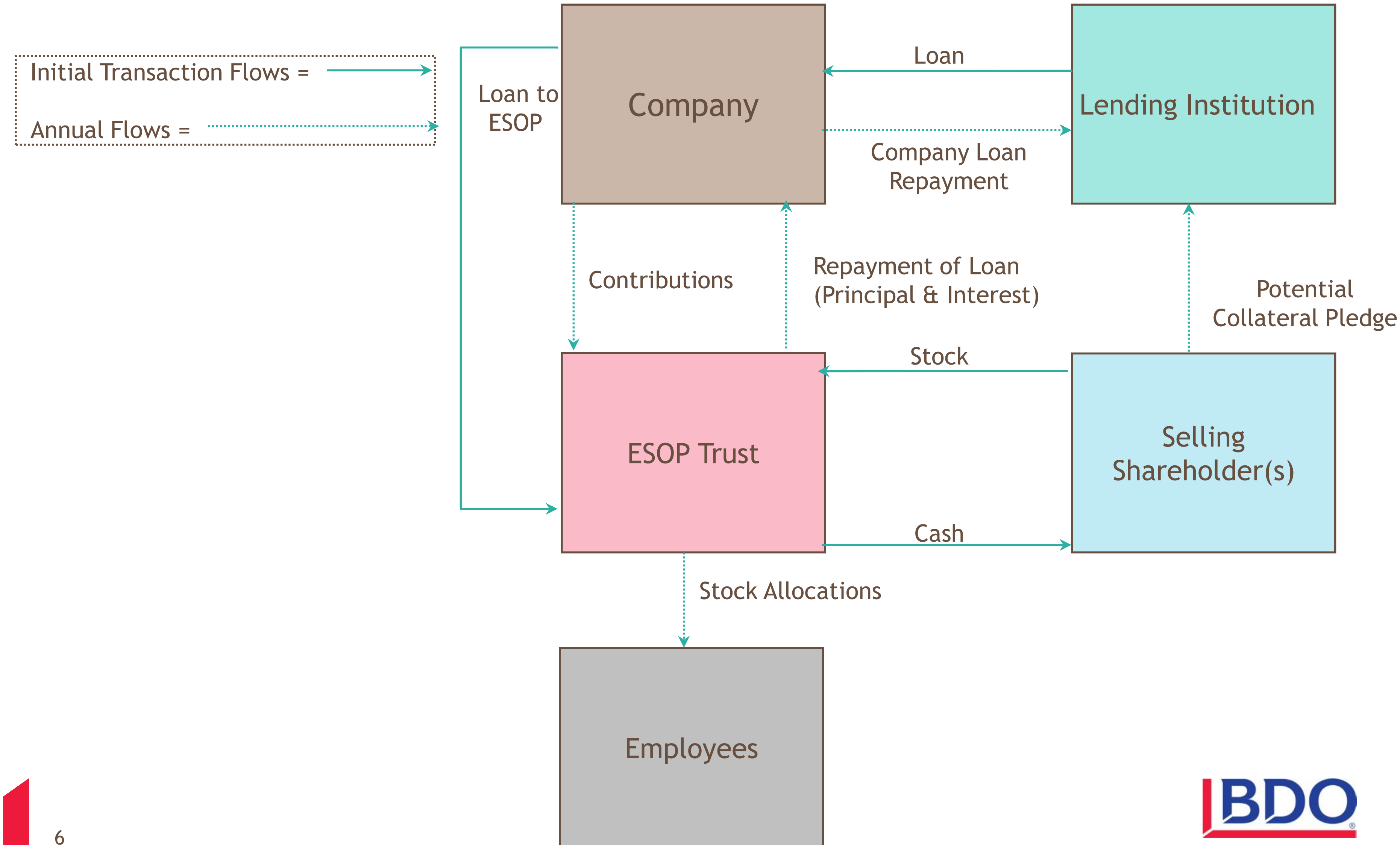
**Company:**

- Tax-Advantaged Financing
- Potential for Income Tax-Free Entity (100% ESOP-owned S Corporation)
- Repay Debt More Quickly with Enhanced Cash Flow
- Potential for Productivity Gains & Reduced Turnover

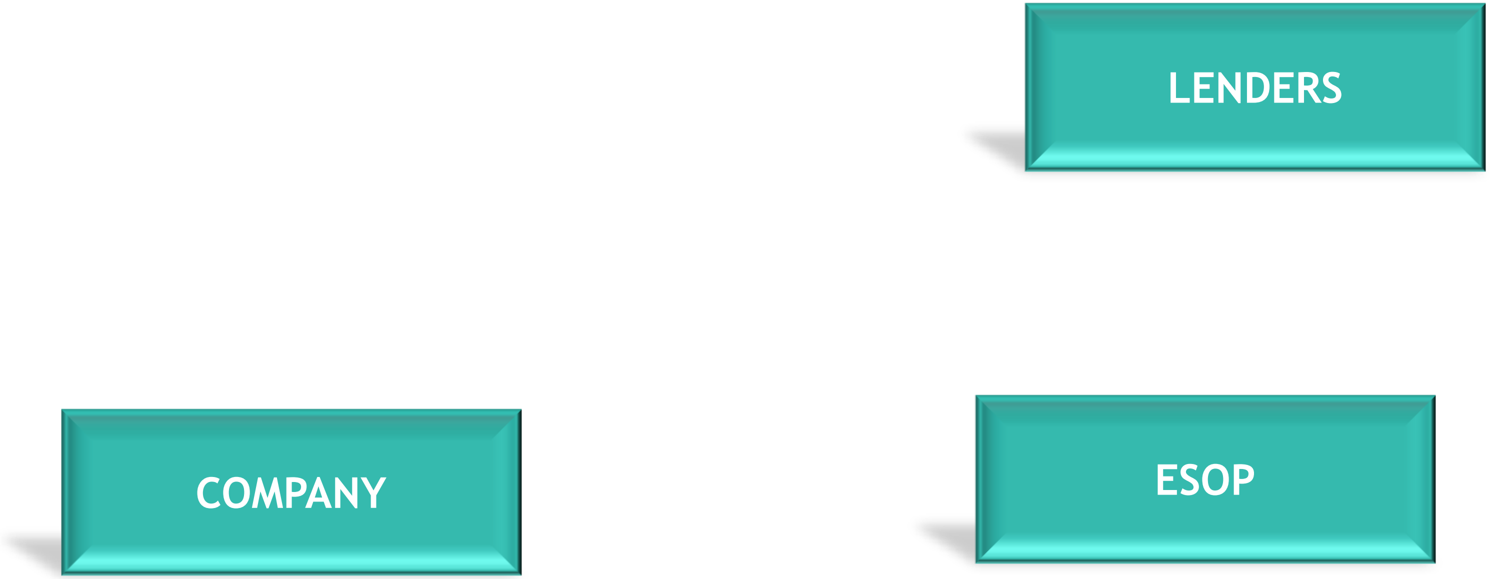
**Employees:**

- Valuable Retirement Benefit
- Ability to Participate in Value they Help Create
- Continued Employment
- Rewarding & Motivational
- Incentive for Management

# Traditional "C" Corp ESOP Transaction Scenario



# "S" Corp Transaction Example - 100% ESOP



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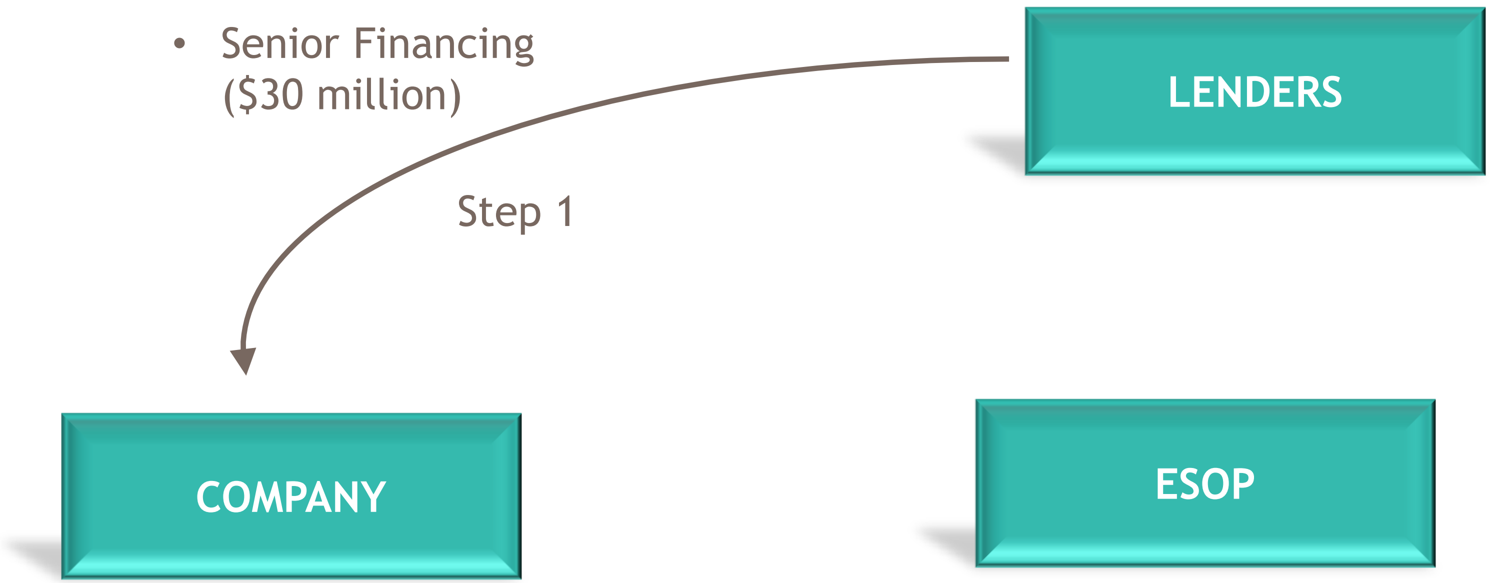

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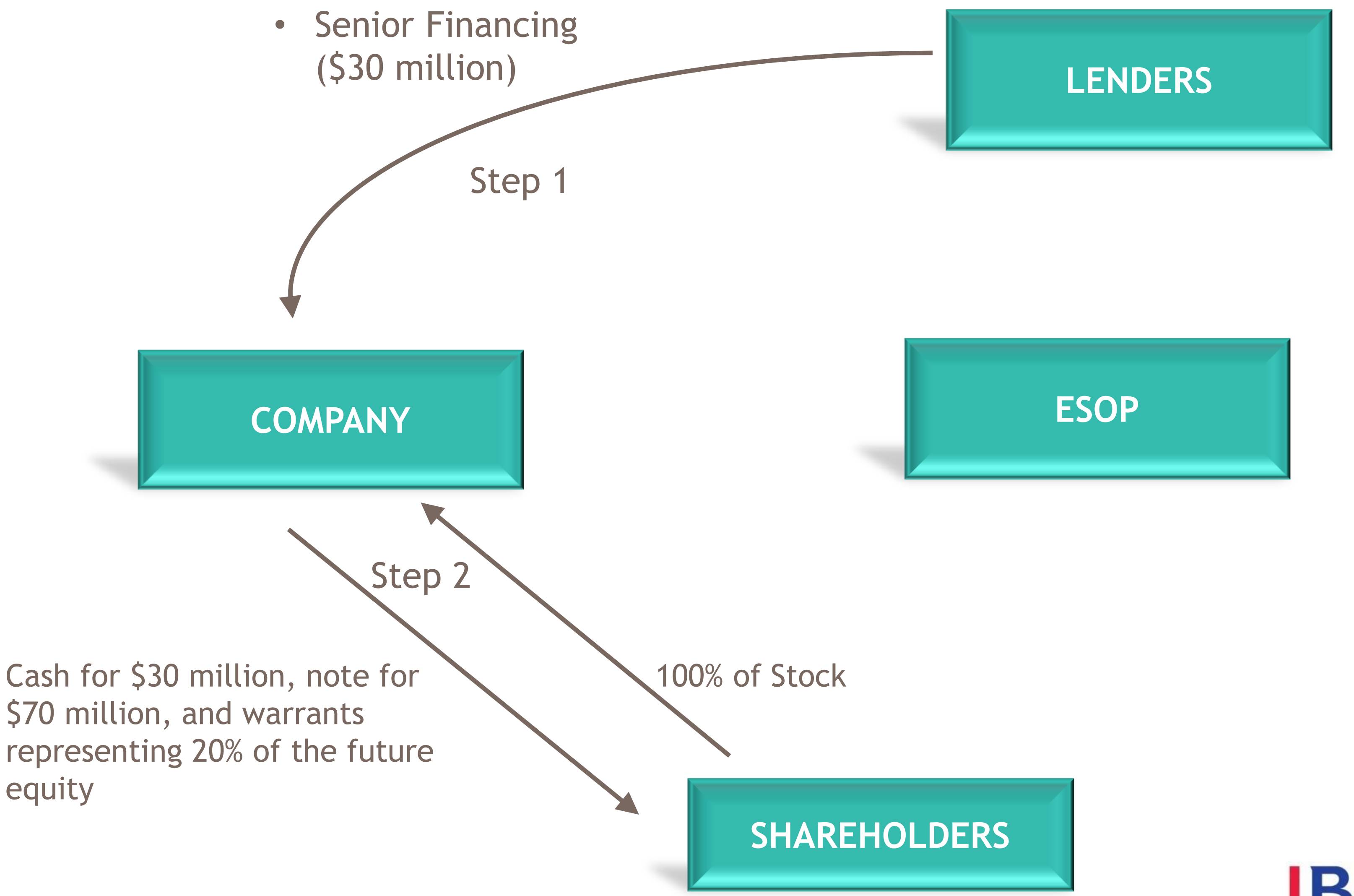

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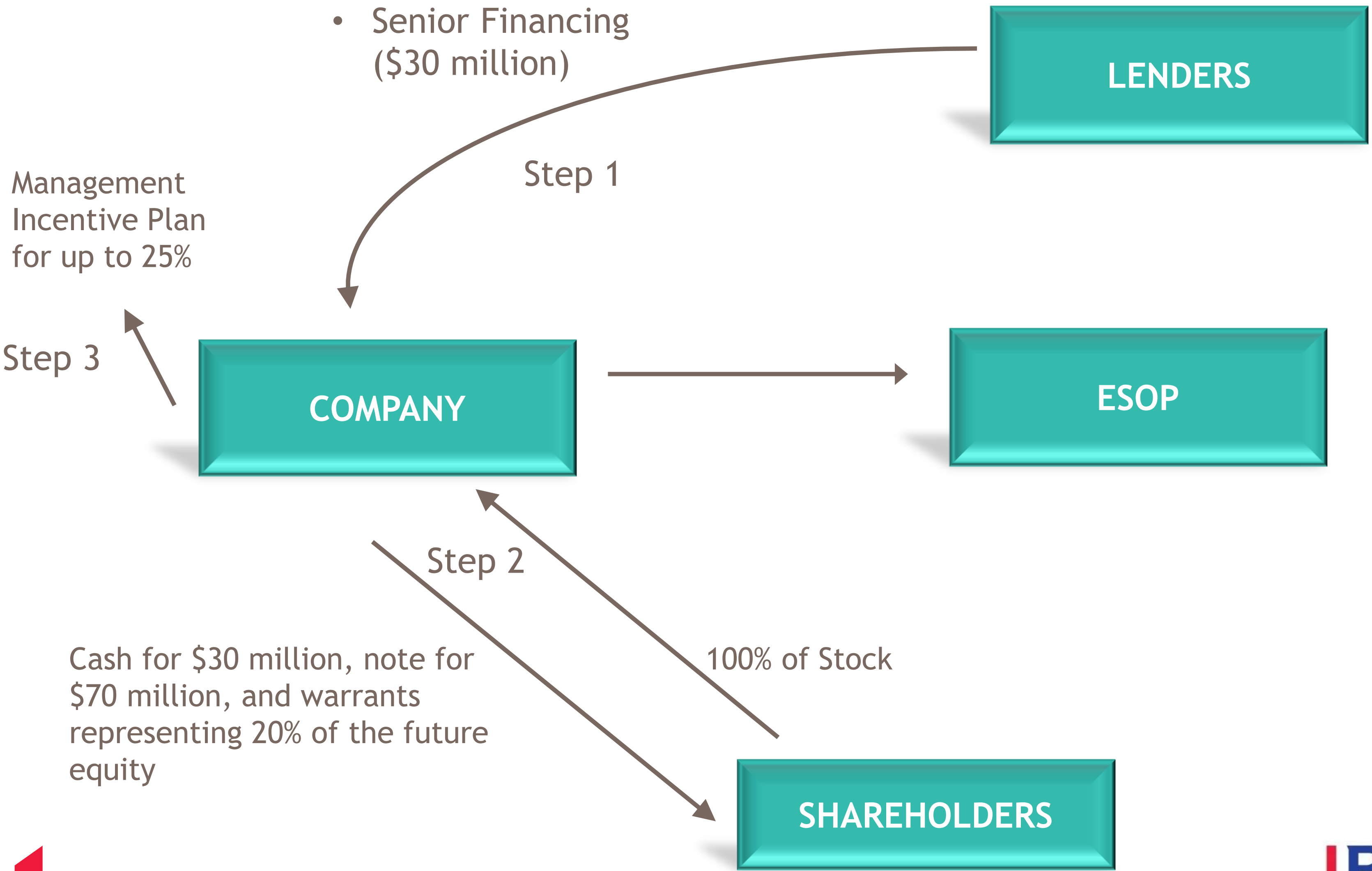

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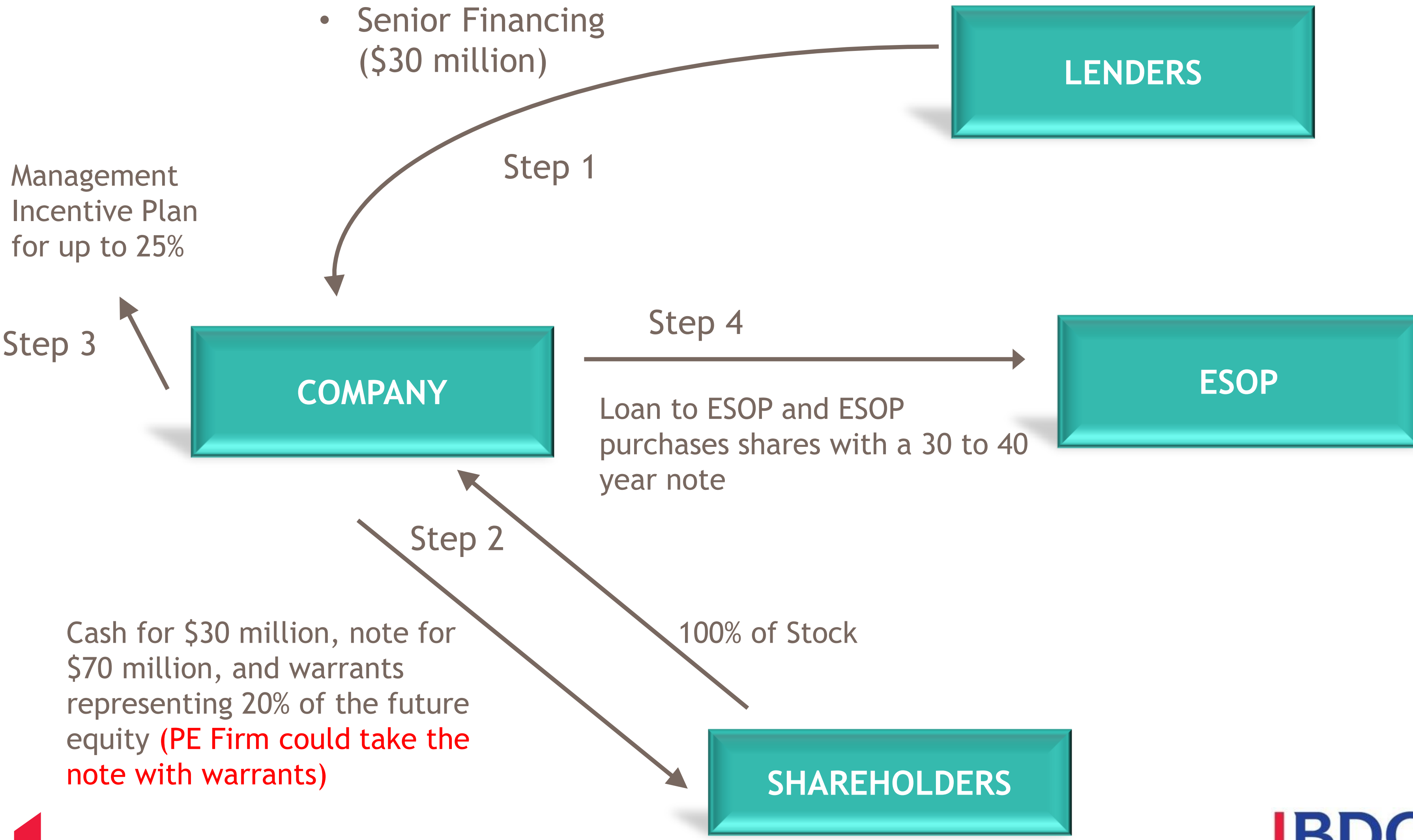

# ESOP Result

- ESOP owns 100% of the Company for Tax Purposes
- Seller will have contractual rights as long as the seller note is outstanding, and an equity kicker (e.g., warrants of 20% of post-ESOP value increase). Interest rate on notes and number of warrants vary based on structure. For example:
  - Interest on notes – 5% **(PE firm or hedge fund replaces seller, rate could be higher)**
  - 20% warrants
    - Pre-ESOP value of Company $100 million
    - Post-ESOP value of Company $20 million
    - 20% of increase value above $20 million
  - Seller gets $30 million cash up front, $70 million over time with interest, and 20% upside over Post-ESOP value ($16 million if Company value gets to $100 million) **(PE Firm or hedge fund could replace seller on the note)**
- Post-Transaction S Corporation and thus, Tax-Exempt Entity so more cash to service debt and fund company growth - $6 million a year tax savings if EBITDA is $15 million
- Governance will be implemented to stabilize the ESOP structure
- Management Incentive Plan (MIP) implemented to attract and retain key management to run the company

# Hypothetical ESOP Transaction Timeline (post-feasibility analysis)

| Project Phase | Time Required (in weeks) | Responsibility | Week: 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | Comments |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Organization and Internal Process | | | | | | | | | | | | | | |
| Execute Engagement Letter | 1 week | C | | | | | | | | | | | | |
| Engage Legal Counsel | 1 week | BDO, C , A | | | | | | | | | | | | |
| Prepare Timeline and Responsibilities | 1- 2 Weeks | BDO, C | | | | | | | | | | | | |
| Prepare Summary Memo of Transaction Structure | 1- 2 Weeks | BDO, C | | | | | | | | | | | | |
| Preliminary Discussions with Counsel & Trustee | 2- 3 Weeks | BDO, C | | | | | | | | | | | | |
| Identify Potential Transaction Issues | 1 week | BDO | | | | | | | | | | | | |
| Refine Transaction Structure | 1 week | BDO, C , A | | | | | | | | | | | | |
| Refine Summary Memo of Transaction Structure | 1 week | BDO, C | | | | | | | | | | | | |
| Preparation of Information Memorandum | | | | | | | | | | | | | | |
| Begin Drafting Transaction Memo (for Trustee/Lender) | 1 - 4 Weeks | BDO | | | | | | | | | | | | |
| Review and Revise Draft | 1 week | BDO, C | | | | | | | | | | | | |
| Approval of Final Draft | 1 week | C | | | | | | | | | | | | |
| Early Execution Activities | | | | | | | | | | | | | | |
| Initial Contact with Potential Lenders | 2 weeks | BDO, C , A | | | | | | | | | | | | |
| Legal Due Diligence Begins | 2 + Weeks | BDO, C , A | | | | | | | | | | | | |
| Engage ESOP Trustee | 1 week | BDO, C , A | | | | | | | | | | | | |
| Circulate Transaction Memorandum (for Trustee/Lender) | 1 week | BDO, C , A | | | | | | | | | | | | |

**Legend:** Stated Time Required   Possible Additional Duration   C = Company   BDO=BDO LLP and Capital Advisors   A = Attorney

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# Hypothetical ESOP Transaction Timeline (post-feasibility analysis)

| | Project Phase | Time Required (in weeks) | Responsibility | Week: 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 | 21 | 22 | Comments |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Financing Activities | Execution | | | | | | | | | | | | | | |
| | Lender Due Diligence | 1 week | BDO, C , A | | | | | | | | | | | | Assume Due Diligence Commenced in Week 7 |
| | Management Presentations to Lender | TBD | BDO, C | | | | | | | | | | | | |
| | First Draft of Stock Purchase Agreements | TBD | BDO, C , A | | | | | | | | | | | | |
| | Finalize Lending Agreements | TBD | BDO, C , A | | | | | | | | | | | | |
| | Finalize Stock Purchase Agreements | TBD | BDO, C , A | | | | | | | | | | | | |
| | Confirmatory Due Diligence | TBD | BDO, C , A | | | | | | | | | | | | |
| ESOP Activities | Plan Documentation | | | | | | | | | | | | | | |
| | Prepare Outline of Plan Provisions | 1 week | C | | | | | | | | | | | | Assume Preparation Commenced in Week 4 |
| | First Draft of ESOP Plan Documents | 5 weeks | BDO, A | | | | | | | | | | | | |
| | Review Draft of ESOP Plan Documents | 2 weeks | BDO, C , A | | | | | | | | | | | | |
| | Employee Communications | | | | | | | | | | | | | | |
| | Prepare Employee Announcement Materials | 2 weeks | C, A | | | | | | | | | | | | |
| | Prepare Employee Meeting Materials | 2 weeks | C, A | | | | | | | | | | | | |
| | Conduct Employee Meetings | 3 weeks | C | | | | | | | | | | | | |
| | Trustee Related | | | | | | | | | | | | | | |
| | Trustee Due Diligence and Analysis | 1 week | BDO, C | | | | | | | | | | | | Assume Due Diligence Commenced in Week 7 |
| | Management Presentations to Trustee | TBD | BDO, C | | | | | | | | | | | | |
| | Finalize Negotiations with Trustee | TBD | BDO, C , A | | | | | | | | | | | | |
| | Trustee Receives Fairness Opinion | TBD | BDO, C , A | | | | | | | | | | | | |
| | Closing Meeting and Document Execution | 1 week | BDO, C , A | | | | | | | | | | | | |

**Legend:** Stated Time Required Possible Additional Duration C = Company BDO=BDO LLP and Capital Advisors A = Attorney

# ESOP Tax Advantages

## Deductibility of Principal and Interest Payments

- Principal and interest payments of an ESOP loan are considered contributions to a tax-qualified employee benefit plan and thus are tax deductible
- For a C corporation, principal payments are deductible up to 25% of covered eligible payroll. Interest payments are deductible in full and may exceed the 25% of covered eligible payroll limit
- For an S corporation, the maximum deductible amount is 25% of covered eligible payroll and unlike a C corporation, both principal and interest are included in the 25% limit. However, an ESOP is a non-tax paying shareholder, so an S corporation that is owned 100% by an ESOP does not pay any tax.

## Deductibility of Dividends

- In a C corporation, dividends paid on stock held by the ESOP are tax deductible to the corporation if they are distributed to ESOP participants and do not count towards the 25% limit
- Furthermore, these deductible dividends may be used to pay principal and interest on the loan
- Dividends are not deductible for S corporation ESOPs

## ESOP Rollover

- Shareholders selling to a C corporation leveraged ESOP qualify to defer federal income taxes on the gain from the sale by purchasing “qualified replacement securities” with the proceeds from the sale

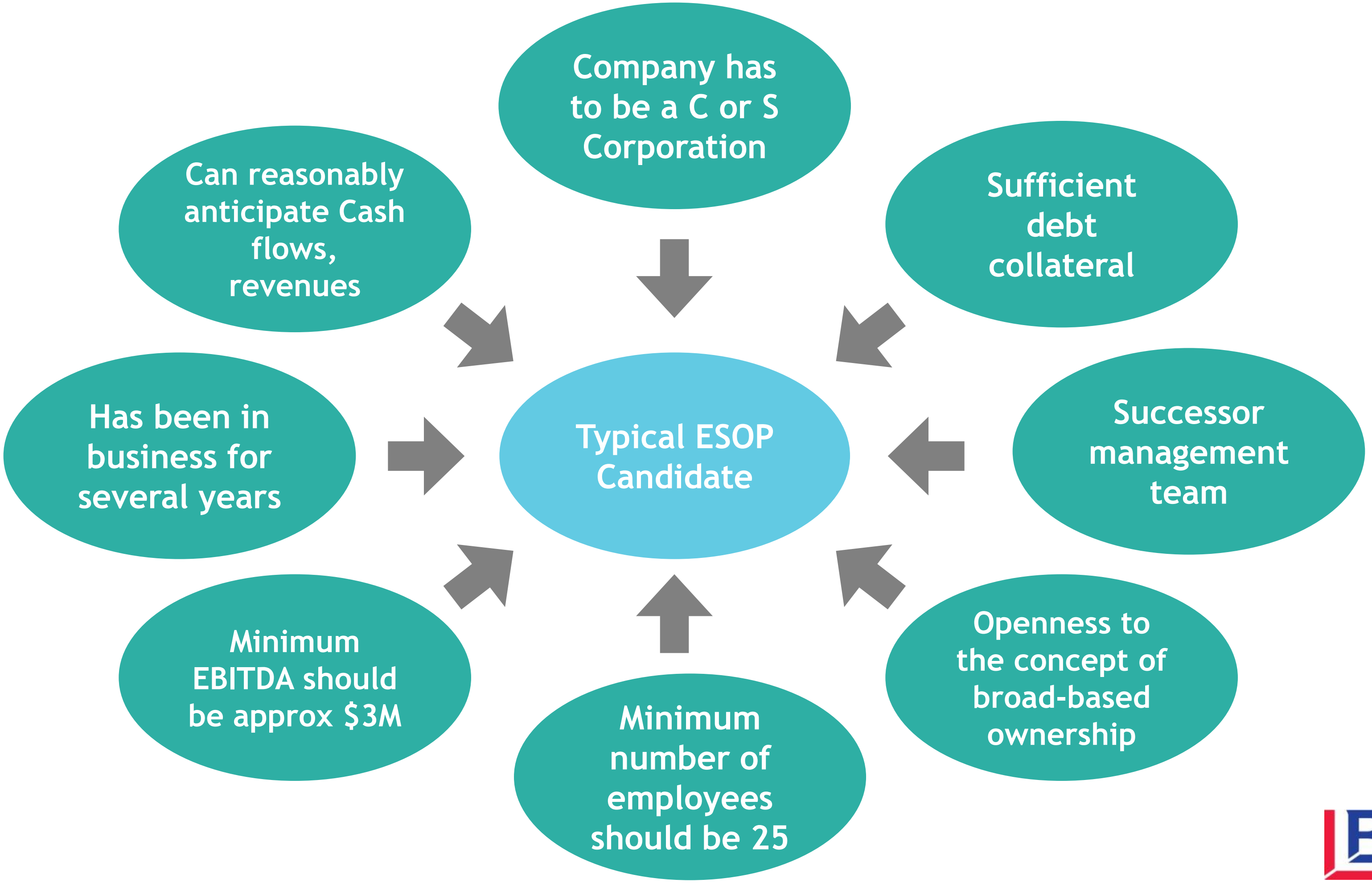
## Step-Up in Cost Basis to Seller’s Estate

- Should a selling shareholder “rollover” her assets in a IRC §1042 transaction, her estate receives a step-up in cost basis on the qualified replacement securities at death, thus eliminating the capital gains tax liability

# 2. ESOP Candidate Characteristics

# ESOP Candidate Characteristics

Although views differ on what exactly makes a good ESOP candidate, several characteristics reveal themselves as essential qualifiers. The list below is not exclusive, but can be used as a guideline



# Market Opportunity

There are several present dynamics that make an ESOP offering a highly-strategic move

| | |
|---|---|
| **Sizeable Market** | • It is estimated that within the next 10 years, baby boomer business owners will consummate approximately $6 trillion in business interest transfers<br>• According to OneSource there are over 500,000 companies that fit the typical ESOP profile<br>– Privately held company with over 25 employees and $10 million in revenues |
| **Business Model** | • There are many types of businesses that are not “classic” M&A candidates, but that can receive the benefits through an ESOP<br>• Quicker execution than M&A transaction<br>  – Closing timeline is 3-6 months, considerably less than a M&A engagement<br>• Employees view ESOPs far more favorably than M&A |
| **Macro Market** | • Lending environment is very receptive<br>  – Access to affordable debt combined with active lenders who support ESOP concept<br>• Strong backing in the legislative community |

# Benefits to Selling Shareholder (IRC §1042 )

The selling shareholders can defer the capital gains taxes on the sale of stock to the ESOP provided that:

- The Company is a "C-Corporation" at the time of the sale
- The ESOP owns at least 30% of the Company's stock post-transaction
- The selling shareholders reinvest the proceeds in "Qualified Replacement Property" within 12 months

## What is Qualified Replacement Property?

- Stocks and Bonds of U.S. Corporations, public or private, that derive no more than 25% of their gross income from passive sources
- U.S. Government & Municipal bonds do not qualify as QRP
- Mutual Funds do not qualify as QRP
- Limited Partnerships do not qualify as QRP

## Tax Savings of Sale to an ESOP

| | Taxable Sale | ESOP Sale |
|---|---|---|
| Sale Price | $30,000,000 | $30,000,000 |
| Basis | 5,000,000 | 5,000,000 |
| Appreciation | $25,000,000 | $25,000,000 |
| Federal Tax | $5,950,000 | $0 |
| **Net Proceeds** | **$24,050,000** | **$30,000,000** |

# Further Advantages to Owner(s)

- An ESOP is a very flexible exit strategy – can be a partial or total liquidity vehicle
- Owner can sell out at fair market value without the disruption of an M&A process
- Selling more than 50 percent of the equity does not mean relinquishing operating control. The ESOP trustee, who oversees the plan, is not a manager. This is in contrast to a sale or a minority recap
- ESOP vesting provisions prevent employee defections; unvested shares revert to the plan; vested shares are purchased from the employee at fair market value with longer-term payouts, often greater than 5 years
- A management incentive plan that rewards only selected team members can exist alongside an ESOP. The ESOP cannot be discriminatory but the incentive plan can be

# Benefits to the Company

Dividends and contributions to the ESOP are tax deductible resulting in a tax shelter equivalent to the value of the transaction

- A $30 million ESOP Loan paid over five years leads to an additional annual deduction (principal) of $6 million, which equates to $2.4 million in annual tax savings
- Over the five year life this is a total tax savings of $12 million
- The additional tax savings increases the cash flow available for debt service

Key Assumptions

- $30 million sale to ESOP
- ESOP Loan Principal Amount = $30M
- ESOP Loan = Company Loan
- 5.0% Interest (Senior and subordinate blended) and 5 Year Amortization Loans
- 40% Tax Rate

Company Tax Savings of 30% Sale to an ESOP

| | ESOP Sale | Taxable Sale |
|---|---|---|
| EBIT | $20,000,000 | $20,000,000 |
| Interest Expense | 1,500,000 | 1,500,000 |
| Pre-Contribution Income | $18,500,000 | $18,500,000 |
| ESOP Contribution | $6,000,000 | $0 |
| Pre-Tax Income | $12,500,000 | $18,500,000 |
| Taxes | $5,000,000 | $7,400,000 |
| Net Income | $7,500,000 | $11,100,000 |
| Plus: ESOP Contribution | $6,000,000 | $0 |
| **Cash for Debt Services** | **$13,500,000** | **$11,100,000** |

# Frequently Asked Questions

| Question | Answer |
|---|---|
| An ESOP would allow my employees to see details of the company's financials | The ESOP is only required to disclose minimal financial information on an annual basis. Confidential financial information is not required to be released. |
| An ESOP won't pay me as much as an outright sale | An ESOP pays 100% fair market value for company shares. A strategic/industry buyer **may** be able to pay a premium, but only if it can realize synergies. |
| I don't want the employees running the company | The employees do not actively participate in the management of the company. They are much like shareholders in a publicly-traded company. The owner/management team continues to run the company as it had before. |
| I don't like debt | The ESOP transaction allows the owner to get liquidity for their personal investment by having the company collateralize the loan, thereby protecting their personal wealth. While taking on outside company debt is usually the most beneficial to an owner, it is not a requirement. An ESOP can be completed by placing the owner as a lender, or by having the company buy shares of the owner out over time without the need for debt. |
| What if I want to sell the company after an ESOP is in place | The ESOP is not an impediment to a sale of the company. If the ESOP does not own a controlling block of stock, it cannot unilaterally block a transaction. If the ESOP does own a controlling block of stock, it just needs to make sure that it is receiving "fair value" for its shares. |
| Since my company is an S-corp, I can't take advantage of all of the tax benefits | The company can revert to C-corp status at any time and enjoy all of the available tax benefits. In order to keep the 1042 rollover benefit, it must stay a C-corp for at least 5 years after the transaction. |
| I don't want to stay at the company after I sell it | In any transaction, ESOP or otherwise, it is commonly expected that the owner will stay onboard for a certain period of time. If the company has a strong management team underneath the owner, the commitment to the company after the sale will be much shorter. |

# 3. ESOP Transaction Considerations

# Valuation Considerations – Value Standard

- Fair Market Value Standard
  - Per ERISA, the ESOP cannot pay more than adequate consideration (fair market value) for the stock of the Company
  - *Fair Market Value* is defined as the price at which an asset would change hands between a willing buyer and a willing seller where the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such asset
  - The ESOP Trustee will hire a financial advisor to render an opinion that the ESOP is not paying more than fair market value
- Fair Market Value may be less than the value that could be attained if the Company were sold to a strategic buyer (but elimination of taxes in ESOP sale evens playing field)

# ESOP Transaction Considerations - Financing

- One of the most critical elements to implementing an ESOP is the ability to obtain debt financing for the transaction
- There are several potential sources of debt financing
  - Senior Lenders – Asset Based
  - Senior Lenders – Cash Flow Based
  - Mezzanine Funds
  - Seller Financing
- General Lender Considerations
  - Collateral Base (real estate, inventory, receivables, etc.)
  - Cash Flow
  - Character
- Additional Considerations for ESOP Transactions
  - ESOP transaction is a highly leveraged transaction
  - Unlike debt financing for operations, the proceeds of the loan "leave the company"
  - Enhanced cash flow available for debt service from ESOP tax benefits

# 4. Company Advisor’s Role

# What is the Role of the Investment Banker

- Perform a feasibility analysis and ESOP transaction design – optimal capital structure, possible need for "seller paper"
- Work with company's tax advisor and legal counsel to draft ESOP documents
- Recommend an ESOP trustee and "sell" the valuation to the trustee and trustee's valuation advisor
- Conduct due diligence to determine and negotiate the best possible terms with lending institutions and create a working structure for the transaction
- Work with an Investment Advisor in the rollover of proceeds to QRP if such an election is made



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# Steps to Setting Up an ESOP

### Pre-Transaction

- Client introduction
- Assess whether owners are amenable
- NDA signed and financials received
- Engaged

### Feasibility Study

- Preliminary valuation
- Design study
- Financial analysis
- Repurchase obligation study

### Funding

- Contact potential lenders/Investors
- Disseminate private financing memorandum
- Draft ESOP plan document IRS “letter of determination”
- Execute NDAs
- Prepare management
- Initial management meetings with lenders and investors
- Assemble due diligence data room

### Negotiations

- Lender and investor due diligence
- More management meetings
- Assist in negotiating shareholder and loan agreement, including final terms
- Structure the ESOP

### Closing

- Select ESOP committee, trustees
- Closing

**3-6 Months**

# ESOP Transaction Considerations - Players

## The Company

- Company Financial Advisors
  - ESOP Feasibility Analysis
  - ESOP Transaction Design
  - Manage ESOP Implementation Process
  - Debt Placement
- Tax Advisor
- Corporate Legal Counsel
  - Prepare required corporate documents for ESOP implementation
- ERISA Legal Counsel
  - Assist in ESOP Transaction Design
  - Draft ESOP Documents

## The ESOP

- ESOP Trustee
- ESOP Trustee's Valuation Advisor
  - Valuation & Fairness Opinion to Trustee
- ESOP Trustee's Legal Advisor

## Selling Shareholders

- Financial Advisor
  - Assist in 1042 Rollover Process
- Legal Counsel
  - Review Transaction Documents

Contact:

James “Jay” Powers
Senior Director
BDO USA, LLP
1100 Peachtree St NE, Suite 700
Atlanta, Georgia 30309
(404) 979-7169
jpowers@bdo.com