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ESOPS- WORTH A CLOSER LOOK- A REVIEW OF ADVANTAGES, VALUATION AND STRUCTURING ISSUES, AND PITFALLS

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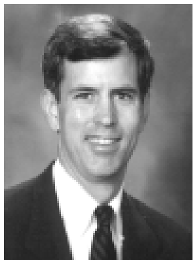
Introduction. The Employee Stock Ownership Plan (ESOP) offers a powerful tool in the succession-planning arsenal. Therefore, it is helpful to reiterate the financial, tax, valuation and economic considerations of the use of ESOP's. This article will summarize these factors and give specific examples of the dollar importance of the financial impacts that are compelling and enable the cash flows of a business to support a leveraged sale which might not otherwise work. Further, it will address the constraints imposed by the Department of Labor and the courts in the valuation of ESOP shares and how the attorney can use this to advantage in the front end structuring of a transaction. Finally, some of the qualitative advantages and disadvantages of ESOP's are reviewed. Note that this article only discusses the use of ESOP's with C corporations. While Congress recently passed legislation enabling subchapter S corporations to have ESOP's (beginning in 1998), many of the benefits cited in this article will be unavailable to S corporations. Therefore, conversion to C status will still likely be the preferred route in using an ESOP.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ESOP's- A Brief Review. ESOP's came into being in the 1970's as a result of a desire by Congress to encourage business owners to bring employees into a position of share ownership, under the umbrella of a qualified retirement plan, the ESOP Trust. The theory is that employees, once empowered as owners, would work in the best interest of their employers, enhance the performance and competitiveness of American corporations, and share in the fruits of the escalating value of the business. To induce business owners to create ESOP's, Congress provided very powerful tax and estate planning incentives, most of which continue to today and which will be discussed later.

Typical ESOP Structure. The most common structure typically involves the formation of an ESOP Trust, a separate legal entity, to facilitate the share purchase transaction. The Trust then borrows acquisition loan funds from a bank, which are in turn paid to the selling shareholder, thus transferring ownership of the shares to the Trust. The Trust then holds the shares for the benefit of the employees, with Trustees voting the shares as needed. Only in certain circumstances which require "pass through" voting, such as the merger, sale or liquidation of the business, do employees actually vote their shares. Thus, a major headache of theoretically having to consult employees and have them vote on every corporate decision is effectively removed, leaving these issues instead to the Trustees. Trustees of the ESOP typically include several key management employees, and sometimes an outside party, such as a bank or trust department. Although in theory (and for reasons of potential conflicts of interest) the former owner would not ideally be a Trustee, this is not the reality in most ESOP transactions.

The Company is the Source of the ESOP Loan Repayment. In order to fund repayment of its

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acquisition loan to the bank, the Trust relies on "ESOP contributions" made to it from the company. These contributions are typically made in the exact amounts needed by the Trust to meet its principal and interest payments on ESOP loan indebtedness. By law these contributions are limited to no more than 25% of "eligible payroll," although in reality it would be extremely rare for a properly structured ESOP to have insufficient payroll to support the full amount of the contribution needed to enable the Trust to meet its principal and interest obligations.

Since the ESOP Trust itself has no assets or source of income or cash flow absent the contributions from the company, its ability to repay the loan is dependent solely upon support by the company. Therefore, the bank will insist that the company provide a guarantee of the loan to the ESOP Trust, along with a pledge of its assets. Further, the bank will normally include a number of financial covenants in its loan agreement designed to insure that the company stays financially sound.

The Accounting Impact of ESOP Leverage. Because of the mutual interdependence between these two separate legal entities, the accounting profession places the ESOP debt on the books of the company itself as a liability, then shows the exact same loan balance outstanding as a deduction from shareholders' equity. As the loan is repaid, the liability on the company's books is reduced, along with a corresponding increase in shareholders' equity.

The situation just described involved selling voting common shares to the ESOP, however this is by no means the only structure. For example, many business owners are uncomfortable selling voting shares to an ESOP, and will instead re-capitalize immediately prior to the transaction, transferring non-voting shares instead, or using convertible preferred stock. Numerous potential variations enable the attorney and the business owner to structure a transaction that meets the owner's estate planning needs, as well as their fears about "employee ownership," while still reaping the enormous tax savings.

The Financial, Tax and Estate Planning Incentives To Create An ESOP Are Significant. In order to induce business owners to foster employee ownership, Congress extended significant incentives for the creation of ESOP's. These inducements include tax deferral and savings for the shareholder, advantageous borrowing costs to fund the transaction, and the deduction of ESOP contributions, the latter two factors dramatically lowering the after tax impact on the company required to fund the sale versus that found absent an ESOP.

The specific incentives include the following:

1. Deferral or Elimination of the Gain on Sale- By selling at least 30% of his or her shares to an ESOP, the business owner can indefinitely defer taxation on the gain from the sale, provided the proceeds are invested in "qualified securities" such as publicly traded stocks and bonds. By choosing dividend paying stocks, the owner can thus have an income stream to live on, plus allow for the proceeds of the sale to be invested on a pre-tax basis, with taxation deferred. If the seller invests the proceeds until death, the estate gets a stepped up basis deemed to equal fair market value. Thus, it is possible to pay no taxes on the gain at all. However, this does not eliminate the issue of estate taxation.

2. Tax-Free Interest Rates on Borrowings- If the owner sells more than 50% of the shares to the ESOP, the law provides that the interest income received by the bank financing the transaction will be tax free to the financial institution. Thus, the bank can provide highly advantageous pricing on its loan to the ESOP, often at well below the prime rate (typically 75% to 90% of the prime rate). By contrast, borrowing without the use of an ESOP might be at anywhere from 1% to 2% above the prime rate (or more). Thus, the company needs significantly less after tax cash flow to fund the repayment of acquisition loan borrowings, placing much less pressure on company finances than in a traditional sale of the business. The table below shows the annual and total life of loan interest savings inferred in a hypothetical ESOP transaction based on typical borrowing rates. In the $5 million loan example shown, this results in a total savings of $590,610:

Significant Interest Savings Can Be Achieved Using An ESOP To Transfer Ownership

	ESOP Loan	Traditional Loan	Annual Interest Savings By Using An ESOP, Year 1	Total Interest Savings With ESOP, Life Of 7 Year Loan
Prime Rate (Currently)	8.25%	8.25%		
Typical Interest Rate	85% of Prime	1% to 2% Over Prime		
Annual Interest Rate Based on Above Markup	7.01%	9.25% to 10.25%		
Interest on $5 Million Loan, Year 1 (ESOP based on 9.75%)	**$332,477**	**$464,867**	**$132,390**	
Total Interest Expense, Life of Loan	**$1,351,518**	**$1,942,128**		**$590,610**

3. Tax Deductible Nature of ESOP Contributions- The ESOP contributions made by the company to the Trust to fund repayment of the acquisition loan are deductible. This may not seem like an unusual advantage, but it actually is a quite powerful one. Since the contribution is equal to the interest and principal repayment needed by the Trust, this enables the company to effectively deduct, for tax purposes, not only the interest (as with most loans), but also the principal. By deducting the principal portion, the company is able to dramatically reduce the after tax cost to it of funding the transaction, enabling it to materially reduce the annual pressure on its cash flows to fund the loan repayment.

Just how big is this impact? Ignoring the $590,610 in lower interest costs cited previously, on a $5 million loan the deductibility of the principal results in total tax savings of about $2 million from the use of an ESOP, as shown below assuming a seven year fully amortized acquisition loan:

Significant Tax Savings Can Be Achieved Using An ESOP To Transfer Ownership

	ESOP Loan	Traditional Loan
$5 Million Loan, Year 1 Principal Repayments	$568,116	$515,505
Tax Savings, @40% Rate (Assumed), Year 1	$227,246	$0
After-Tax Cash Flow Required To Pay Principal, Year 1	$340,870	$515,505
Total Tax Savings, Life of Loan	**$2,000,000**	**$0**
Total After-Tax Cash Flow Required To Pay Principal, Life of Loan	**$3,000,000**	**$5,000,000**

In short, the total after-tax cash flow required from the above scenario to meet to principal repayments is $3 million from the ESOP structure, versus $5 million without. And this does not even consider the potential interest savings or the deferral of capital gains taxes. Thus, the owner who desires to sell part ownership of the business to the ESOP is able to substantially reduce the financial burden and risk on the company for doing so.

Other Potential Savings. Since the ESOP is a retirement plan holding the company's stock as its investment, owners will often terminate an existing profit sharing or other plan. It is very common to find that the savings from the termination of expenses associated with existing plans come close to or fully offsets the cash flow required to service the ESOP loan. Thus, the owner can often accomplish a sale of a portion of the business without significant additional cash flow impact.

Valuation Needed To Establish Fair Market Value. Valuations are needed in two ways related to an ESOP. First, the shares that the owner intends to sell are valued by an independent valuation firm to establish their fair market value for sale to the ESOP. Second, once the ESOP owns the shares, the Trustees must have the shares re-valued annually for purposes of establishing the repurchase price to buy-back shares from retiring, deceased and departing employees, as well as for the form 5500 filing with the Internal Revenue Service.

Typically, the initial transaction valuation is the more expensive of the two, as the valuation firm must undertake a thorough review of the business, the industry, and employ appropriate valuation methodologies to arrive at a sound and supported conclusion for the transaction. Follow-up annual re-valuations must meet the same exacting standards, however, the cost is typically less as the valuation firm now knows the business.

ESOP Valuation Experience Crucial. It is crucial that the firm being retained to perform the valuation have substantial ESOP valuation experience and business appraisers accredited by the American Society of Appraisers (ASA), the leading certifying body in the field. Since the transaction might be reviewed by both the Internal Revenue Service and the Department of Labor, the valuation must be well documented, supportable and unbiased. There are a number of unusual regulatory and tax court cases pertaining to ESOP's, so it is crucial that the valuation firm's professionals know their potential ramifications.

Further, ESOP's have unique considerations in how their cash flows are modeled to arrive at a final value that are more complex than in many closely-held company valuations. Finally, under ERISA the Trustees of the ESOP are fiduciaries to the plan participants, and thus must meet the "prudent man" rule and exercise a high standard of care in carrying out their duties. Poorly prepared valuations can lead to litigation against the Trustees by unhappy employees, the IRS, or the Department of Labor.

Other Benefits. An oft-cited benefit of having an ESOP is the belief that employees will have a vested interest in seeing to the success of the business that they did not previously have as non-owners. Whether this truly occurs is subject to debate, and may depend upon the example and attitude set by the business owner. Since there is no requirement for the company to share financial or confidential information with employees after a sale, very often the majority owner will continue

to keep the information to themselves. In our experience most owners will usually only sell a minority interest to an ESOP initially, and there is often little change in the dynamics of the involvement of employees within the company. Thus, the potential benefit of improved performance as a result of a newly motivated workforce, while laudable, should not be counted upon. Even if the owner truly views the sale as primarily a tax and estate planning tool (which many do), these reasons alone are more than enough to argue forcefully for considering an ESOP as an ownership transition option.

The Cons of ESOP's. Despite what some consultants who install them will tell you, ESOP's are not for everyone, and with them come certain risks and trade-offs. For many entrepreneurs who found companies the biggest downside is the feeling that they cannot trust the employees' inherent ability (actual or perceived) to run the business, although as noted earlier, there is no requirement that management of the company necessarily change.

ESOP Share Repurchase Liability. Another risk is the continuing contingent financial obligation placed on the company to repurchase the shares of departing employees. ERISA requires that the ESOP plan have a "put" option, enabling a participant to require the plan to buy-back his or her shares upon termination of employment, with the price based on the latest annual appraised fair market value. The good news is that ERISA allows the plan either to pay for the shares all at once, or alternatively, to extend payment over a period of up to five years in installments. Since most companies experience down years in profitability, this gives management the option to defer payment when cash is tight.

Since plans typically require vesting, companies with a highly transient workforce with significant turnover may have no repurchase needed for many departing employees. For companies that have low turnover, it is possible for individual employees to build-up sizable fund balances. Thus, some ESOP's will selectively purchase life insurance policies on the few employees with significant balances to lessen the impact of this obligation. At the time of ESOP implementation an actuary can use data on the characteristics of the workforce (such as age, years with the company, turnover) to forecast the potential annual future repurchase obligation. Knowing this, some companies then establish a sinking fund to set aside funds to cover this contingent obligation.

"Put" Reduces the Discount For Lack of Marketability. The ability of ESOP shares to be "put" back to the Company also has valuation implications. This put creates a "market" for the shares where there otherwise might have been none, particularly for a minority interest in a closely-held company. Therefore, the valuator might apply a much smaller discount for lack of marketability for the ESOP shares. The magnitude of the discount will be driven in large part by the financial strength and resources of the ESOP to effectively meet its repurchase obligation. Additionally, the Department of Labor indicates this discount will also be impacted by the degree to which the put obligation is an enforceable contract.

Litigation Risks. The repurchase obligation itself creates some risk for litigation, particularly if a departing employee is unhappy with the appraised value he or she is paid for their shares. Very few ESOP's ever experience such a lawsuit, particularly when they receive expert legal, tax and valuation support. However, this is nonetheless a risk.

Perhaps the biggest risk of litigation against Trustees is when they do not act in the best interest of plan beneficiaries. A good example of this is when the former owner sells majority control to the ESOP, but continues to remain a Trustee calling all of the shots. While there is nothing wrong with remaining a Trustee, the former owner may have difficulty shifting from a mode of thinking of the business as a personal piggy bank, to one of an investment for the benefit of the employees. A majority interest would normally be sold to the ESOP along with a premium in price for control. However, the Department of Labor, in its proposed ESOP valuation guidelines, makes it clear that true control must really effectively pass to the plan. It says the following regarding control premiums:

> *"Specifically, the Department proposes that a plan may pay such a premium only to the extent a third party would pay a control premium. In this regard, the Department's position is that the payment of a control premium is unwarranted unless the plan obtains both voting control and control in fact. The Department will therefore carefully scrutinize situations to ascertain whether the transaction involving payment of such a premium actually results in the passing of control to the plan."*

The regulations go on to say the following:

> *"Nonetheless, the retention of management and the utilization of corporate officials as plan fiduciaries, when viewed in conjunction with*

other facts, may indicate that actual control has not passed to the plan…"

The bottom line- the selling shareholder cannot have his or her cake and eat it too. The seller cannot receive a premium for control if effective control does not truly transfer.

Highly Cyclical Businesses Are Often Not Good ESOP Candidates. The biggest downside risk associated with share repurchase liability is when a company experiences a severe downturn and is forced to layoff substantial numbers of employees. Thus, at the time when a company can least afford it, it is forced to produce cash to fund significant share repurchases. This is partially mitigated by the right to elect installment payment, as well as that the total appraised value per share may also drop stemming from the downturn in business fortunes.

Therefore, companies with a high degree of cyclicality, such as general contractors, are sometimes not good candidates for an ESOP as their businesses experience highly volatile revenues, earnings and cash flows from one year to the next. Additionally, rapidly growing companies are sometimes poor prospects for an ESOP, particularly a highly leveraged one. Since fast growing companies must reinvest their cash flow back into ever growing levels of receivables and inventory to support their growth, there may little or no free cash flow available with which to fund repurchases or repay ESOP loan payments despite showing substantial bottom line earnings.

The Morning After- ESOP Value Declines. The selling price of shares to the ESOP is based on a "before" fair market value. However, in a leveraged ESOP transaction, the instant after the transaction occurs the company is still the same business, the only change being that it now has a much larger interest bearing debt obligation to the bank. Thus, the "after" value will necessarily decline, although normally not by the full face amount of the new debt. As noted earlier, the contributions needed to repay ESOP debt, including principal (unlike in other loans), is tax deductible. Therefore, the after-tax impact of the cash flows required to repay ESOP debt is much less ($2 million less in the earlier example on debt with a face value of $5 million) than a normal non-ESOP loan with the same face amount. The impact of the new ESOP debt is modeled using the discounted cash flow valuation approach, which determines the present value of the after-tax impact of the cash flows needed to repay the debt over the loan's life. Since the time value of money comes into play, the actual present value of the savings will be less than the $2 million cited, but still significant.

This instantaneous decline in value that occurs post transaction may be difficult for employees to grasp, and should be explained prior to the transaction so that they will not be surprised or alarmed when the first annual valuation update is communicated to them.

Degrees of Leverage & Ownership Affect Transaction Structuring. The percentage ownership to be sold to the ESOP and its value will dictate the options available for transaction structuring and whether or not outside equity or venture capital will be required.

Most ESOP transactions initially involve an owner selling a minority interest of between 30% and 50%. In most instances this size transaction only involves the use of an ESOP bank loan, without the need for external capital, although the business will need to have sufficient leverageable assets that can be used as collateral. Although the amounts will be company and financial institution specific, based on typical advance rates against receivables (75% to 80%), inventory (35% to 60%), equipment (50% to 75%) and real estate (75% to 80%), it is usually easy to determine if the business potentially has the collateral necessary to support a loan, assuming its earnings and other performance criteria meet bank credit standards.

Sale of a Significant Control Position. Transactions involving the initial sale of majority or 100% control to the ESOP may require an entirely different transaction basis. If the collateral and cash flows of the business are insufficient to support the size loan needed, additional equity and/or debt financing required to fund the shortfall. It is not uncommon that employees lack the funds themselves to make up this difference. One option is to seek outside venture capital, giving these sources partial control of the company. Numerous venture capital firms are actively seeking this type of transaction, each having different size investment and industry criteria.

Use of a Profit Sharing Plan. In some instances existing benefits plans themselves can fund the difference. For example, if a profit sharing plan is in place, the plan might be converted to an ESOP and some or all of its plan assets used to help fund the acquisition on behalf of the employees. The downside to this tactic is that employee retirement funds, which were probably held in a diversified mix of stocks and bonds, will now be concentrated to a larger or full extent in one security, the company's stock, increasing the risk of loss associated with employee retirement money.

Financial Modeling of Impacts. Before the owner and his or her advisors can realistically talk about the use of an ESOP a valuation is first needed- value drives everything else in the consideration and possible implementation of an ESOP. Having a value, though, is not enough. Using various hypothetical scenarios of share interests to be sold, a valuation advisor can then create sophisticated income statement, balance sheet and cash flow forecasts to verify the ability of the company to repay the ESOP debt under various capital structures that might be employed. This enables the client and attorney to reasonably discuss the options available and which one best meets personal tax and estate planning needs, along with a desired financial risk posture for the company.

In retaining valuation advisors, the attorney and owner should look to individuals that also have actual bank and credit structuring experience, as the willingness of the bank to fund a transaction will depend in large part on how well the valuation advisors can effectively communicate the substance and creditworthiness of the deal to the financial institution. Banister Financial's staff, for example, includes a former senior credit officer and corporate banker from the nation's 4th largest bank, and who previously approved and structured hundreds of acquisition loan transactions throughout the country. This knowledge of "what will fly" with the bank is paramount to the successful implementation of an ESOP. In fact, Banister Financial employs expensive and sophisticated financial and credit analysis modeling software employed by over half of the nation's top 50 banks. The result- our analysis comes in a language and format bankers understand.

The Phased in Approach. As noted earlier, most ESOP's initially involve the sale of a minority interest to the plan. However, this does not preclude the majority shareholder from selling all or most of the remaining shares to the ESOP at a future time, which many in fact will actually do. Once the ESOP has reduced or retired its existing loan obligation, it can then be re-leveraged to purchase the remaining shares. This approach works well for the business owner who wants a business transition strategy with lower overall financial risk, effectively transferring ownership in stages.

Under Department of Labor regulations, if the owner initially sells a minority interest to the plan, those shares must ordinarily be valued with discounts for lack of control (a minority discount) and lack of marketability, since they are not freely traded on an exchange. However, under certain circumstances, it might be possible to initially sell a minority interest to the ESOP at a control price per share provided that certain contractual and binding commitments are in place to phase in the ultimate sale of control.

Conclusion. While ESOP's are not for everyone, they nonetheless provide significant tax and financial advantages that may weigh heavily in their favor. The selling shareholder realizes greater fruits from the sale of the company to employees while also allowing the company to financially fund a transaction it might otherwise be unable to afford. Valuation issues are crucial to the identification, structuring and closing of ESOP transactions. Therefore, it is essential that qualified and experienced valuation, legal and tax professionals be engaged early in the process to insure a successful and optimal outcome. ♦

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