



ESOP Trends in the Marketplace Presented by:



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Circular 230

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Evolution of ESOP Transactions

- 1956 – Louis Kelso invents first ESOP for *Peninsula Newspapers*
- 1974 – Senator Russell Long introduce ERISA tax policy for ESOPs
- 1986 – Tax Act introduced 1042 for C Corporations
- 1987 – AVIS ESOP transaction
- 1998 – ESOPs are permitted to own stock in S Corporations
- 1998 and forward – ESOP transactions begin to resemble traditional M&A transactions including financial structures including warrants and market rate sub-debt

Current Trends in the Marketplace

Introduction

- Sophisticated pre-transaction structure analysis
- Investigation of an ESOP transaction in connection with other events
- Allowing a “market” process to include an ESOP transaction alternative
- Exploration of tax planning opportunities
- Development of sophisticated economic transactions
- Post transaction planning
- ESOP owned S corporations beginning acquisition strategy (typically “mature” ESOP situation)
- ESOP owned companies increasing attractiveness to strategic buyers (end of ESOP lifecycle)

Pre-Transaction Structure Analysis

- As ESOP transactions become more sophisticated, sellers and companies are benefiting from specialists involvement earlier in the process
 - Review and model transaction alternatives
 - Partial ESOP sale vs. 100% ESOP sale
 - Impact of the tax status of the company on the planning alternatives (S corporation vs. C corporation)
 - Explore other alternatives?
 - Understand and consider both seller goals and company objectives
 - Prepare company for ownership transition
 - Clean up financials (audited vs. reviewed vs. prepared financials)
 - Management evaluation
 - Highlight tools to drive performance

Pre-Transaction Structure Analysis

- (cont) As ESOP transactions become more sophisticated, sellers and companies are benefiting from specialists involvement earlier in the process
 - Prepare company for ownership transition
 - Understand governing documents
 - Be aware of buy-sell agreements/right of first refusal requirements
 - Be aware of timelines imposed by contractual agreements
 - Benefits of a planning “process”
 - Protects against unnecessary costs
 - Higher probability of achieving desired goals
 - A proper “process” provides protection against review by regulatory agencies

Investigation of an ESOP Transaction In Connection with Other Events

- Sale to an ESOP vs sale to a third party buyer (financial buyer or strategic buyer)
 - Review includes modeling of financial returns from each type of transaction and understanding impact of multiple “roads”
 - Example: Strategic multiples vs. tax savings offered by a sale to an ESOP
 - Impact of other valuations/letter of intent
 - Consequences of exploring third party buyers prior to/coincident with ESOP transaction
 - Review includes post-transaction operations and governance
 - Involvement in the business post-transaction
 - At the Board of Directors Level?
 - At the Management Level?
 - Review includes tax consequences of various transactions

The “Dual Track” ESOP

- Sellers have begun exploring a market process for purposes of selling the company
 - Market process = inviting multiple bidders to prepare an offer or transaction proposal for ownership transition
 - An ESOP transaction has historically been undertaken largely in a vacuum
 - Increased sophistication is allowing an ESOP to be considered to be an alternative buyer in a market process
 - Case Study: Fabric company in New York, New York
 - ESOP included in bidding pool (\$55MM offer with contemplated 1042 Transaction)
 - Increased market process resulting in offers ranging from \$65MM to \$80MM
 - ESOP may not always be resulting purchaser (cannot pay more than fair market value) but allows multiple bidders even in a limited process

Tax Planning Opportunities

Coordinating Seller and Company Tax Planning Opportunities

- “1042 Transaction” allows seller to defer recognition of gain on the sale of shares of stock to the extent such amounts are invested in qualified replacement property post-sales transaction
 - Requires a sale of shares of stock of a C corporation
 - Following the sale, the company may elect to be taxed as an S corporation with the start of the next fiscal year
 - Allows the seller to take advantage of a 1042 Transaction and allows the company to quickly take advantage of the S corporation “ESOP tax shield”

Tax Planning Opportunities

Coordinating Seller and Company Tax Planning Opportunities (cont.)

- What if the company is an S corporation at the time of the sale?
 - Many closely held/privately owned companies have elected to be taxed as an S corporation – can owners of these entities take advantage of the tax planning opportunities provided by a 1042 Transaction?
 - S corp → C corp → (five year delay) S Corp
 - The conversion to a C corporation allows the seller to take advantage of the 1042 Transaction tax attributes
 - During the five year delay period the company may take advantage of available tax deductions which may allow the company to almost eliminate corporate tax
 - Allows the company to reelect S corporation status at the end of the five year delay and take advantage of the S corporation “ESOP tax shield”

Financing Requirements

- ESOP transactions are being structured with sophisticated debt instruments
 - Senior debt requirements
 - Traditional bank debt requirements
 - Seller debt often takes the form of subordinated debt
 - Interest rates reflect increased risk given subordinated debt's position in the company's capital structure
 - May include warrant instruments allowing subordinated debt holders to participate in company "upside"
 - Preservation of intended tax treatment in the event of installment note treatment
 - Other financing efficiencies (*i.e.*, bridge loan structure)

Financing Requirements

- Seller financing concerns – post transaction options for the individual
 - 100% cash financed deals are uncommon
 - Sellers reviewing sophisticated investment models that allow for a 1042 Transaction
 - Diversification of both 1042 assets and other assets as a whole
- 100% seller financed deals

Post Transaction Structure/Concerns

- Post-Closing Governance
 - Involvement in the business post transaction
 - Board of Directors
 - Impact of contractual control of the Board of Directors on the valuation process
 - Members of Management
 - Preservation of the:
 - Shareholders' legacy
 - Company/Community jobs
 - Presence/Status in the geographic or industry community

Post Transaction Structure/Concerns

- Planning Opportunities
 - Vis-à-vis the seller
 - Estate Planning opportunities with warrants and junior notes
 - 1042 Transaction – what is a “sale” for QRP?
 - Financial protections and planning opportunities/wealth management
 - Vis-à-vis the employees
 - Management Incentive Plans
 - Use of equity awards
 - Retention of key employees and contributors
 - Alignment of interests between management and shareholders
 - Provides performance incentives
 - Vis-à-vis the ESOP
 - Repurchase liability obligations

ESOP Company Acquisition Strategies

- ESOP owned companies often have significant tax savings (S corporation tax shield or C corporation tax deductions for ESOP contributions) and commonly build “excess” cash
 - Competing needs for cash (repurchase liability, compensation for employees, growth opportunities)
 - Becoming common for ESOP owned companies to develop an acquisition strategy for continued growth
 - Possibility to leverage ESOP ownership to provide tax advantages to target sellers may allow an ESOP owned company to compete with more strategic buyers using less cash
 - ESOP involvement in an acquisition strategy

Sale of an ESOP-Owned Company

- ESOP owned companies are common targets for acquisition
 - Considerations....
 - Timing/Maximizing Value of ESOP's Investment
 - Liquidity needs
 - Non-ESOP shareholders
 - Unable to re-pay debt from operating cash flows
 - Repurchase obligation
 - Changing risk profile
 - Receive an unsolicited offer
 - Market conditions

Questions ?

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