An Introduction to ESOPs

An Instrument of Corporate Finance

Year-End Seminar

Doing Business in Central Pennsylvania and Beyond

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Introduction – What is an ESOP?

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- ESOP = "Employee Stock Ownership Plan"
- ESOP = tax-qualified retirement plan that invests, by law, primarily in employer securities
  - Congress structured the tax Code to specifically encourage ESOPs
  - But for an explicit prohibited transaction exemption in the Internal Revenue Code, this structure would be impermissible
- Defined Contribution Plan – each participant has an account (like 401(k))
- ESOPs have been around for a while
- The IRS and the DOL regulate them like 401(k) Plans, since they are tax-qualified retirement plans

Introduction – What is an ESOP? (cont'd)

- Instrument of Corporate Finance
  - Shareholder sale of stock can be tax-deferred
  - Creates market for shares in closely held corporation
  - Shares end up in "friendly" hands
  - Company can essentially deduct principal (finance debt with pre-tax dollars) since ESOP contributions are tax-deductible
  - Company can, in effect, operate virtually 100% tax free if S corporation owned by ESOP
- Two general types
  - Non-leveraged, deductible employer retirement plan contributions are made in cash, which is then used to purchase employer stock (can also be made directly in stock)
  - Leveraged, deductible employer contributions are made in cash, which contributions are then used by the ESOP to repay a loan used to purchase employer stock

Mechanics of an ESOP

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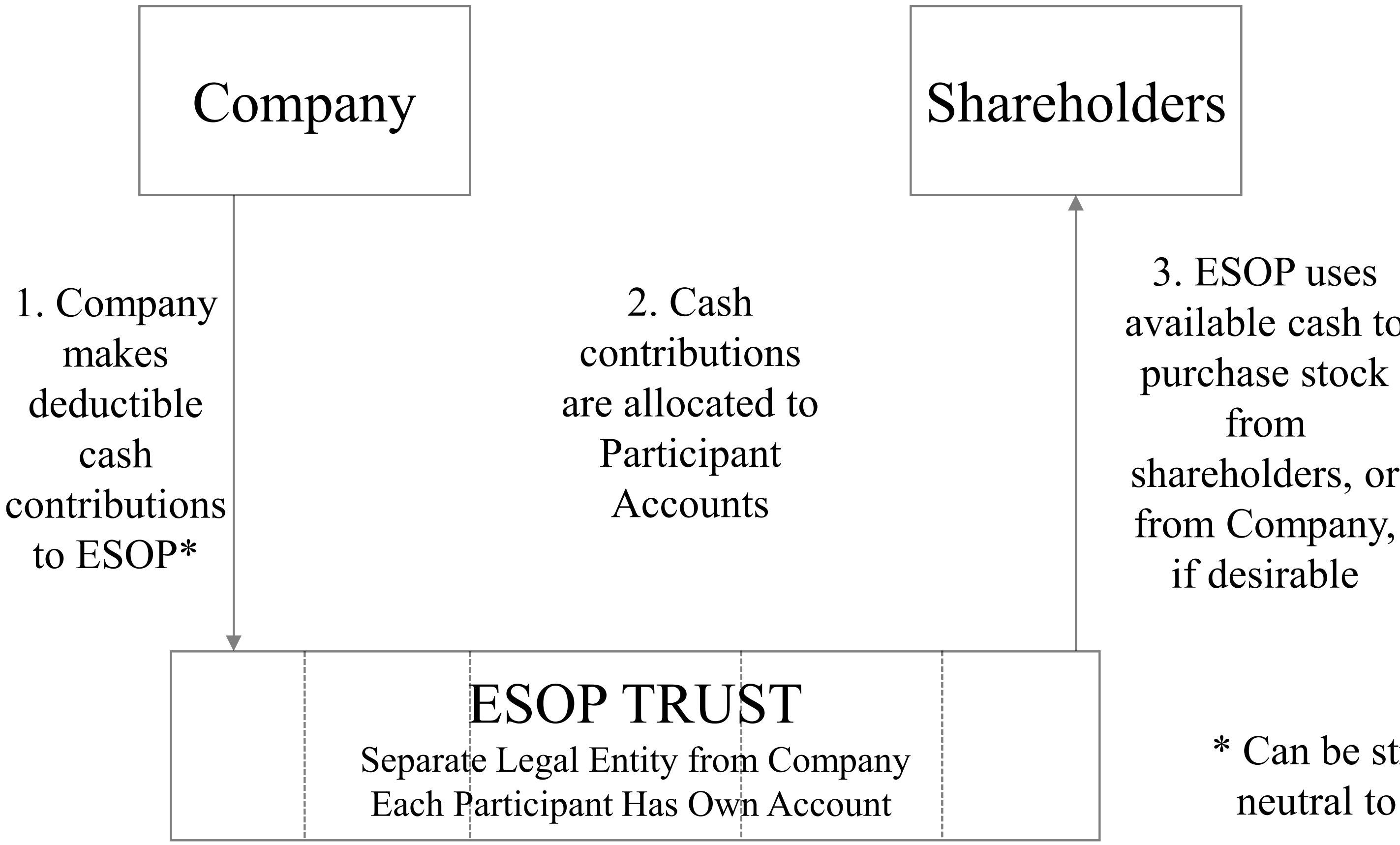
- Non-Leveraged ESOP



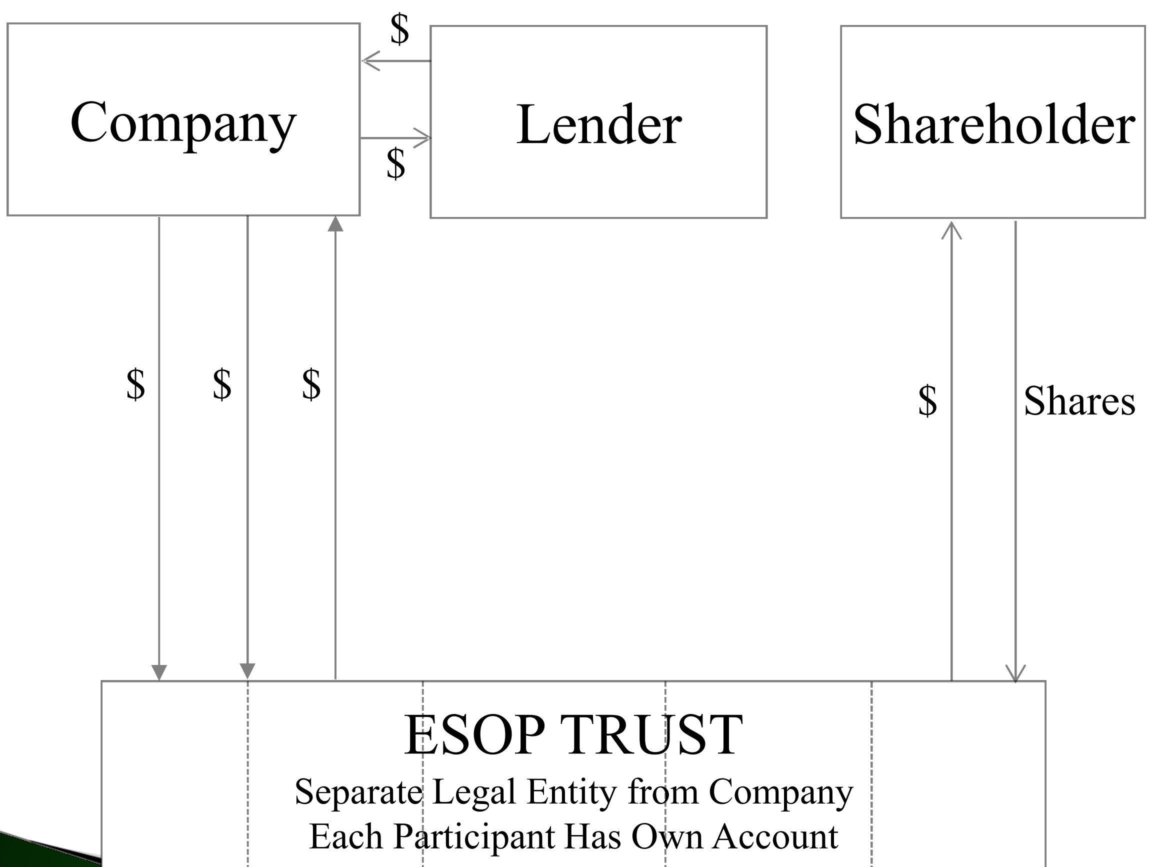
* Can be structured to be neutral to non-interest expense

Mechanics of an ESOP (cont'd)

- Non-Leveraged ESOP
  - Company makes deductible cash contribution to ESOP (could be made in stock)
  - No incremental cost to Company if ESOP replaces company contribution to 401(k) or profit sharing plan
  - ESOP uses cash to buy shares thereby creating a market for shares
  - Contribution is typically allocated proportionally based on eligible compensation

Mechanics of an ESOP (cont'd)

- Leveraged ESOP



1. Company borrows from Lender
2. ESOP borrows from Company
3. ESOP buys stock from shareholder (or newly issued shares)
4. Company makes annual cash contribution to ESOP*
5. ESOP makes loan payment to Company
6. Pro-rata shares are released from suspense account and allocated to Participant accounts
7. Company makes loan payment to Lender

* Can be structured to be neutral to non-interest expense

Mechanics of an ESOP (cont'd)

- Leveraged ESOP
  - Company loans directly to ESOP after borrowing from lender or guarantees loan from a lender directly to ESOP
  - ESOP uses loan proceeds to purchase large block of shares
  - Purchased shares are held in "Suspense Account" as collateral for ESOP loan
  - With each loan payment, tranche of shares are released from the suspense account and allocated to participant accounts
  - Allocation to participants is typically proportional based on eligible compensation

Benefits to the Selling Shareholder

Benefits to the Selling Shareholder

- Can have a tax-free sale of shares (Code Section 1042 Transaction)
  - Saves 20% capital gains plus 3.8% Medicare Surtax
  - Example:

	Sale to ESOP	Non-ESOP Sale
Sale Price	$15M	$15M
Basis	$5M	$5M
Gain	$10M	$10M
Taxes	--	$2.38M
After-Tax Proceeds	$15M	$12.62M

  - Step up basis on death

Benefits to the Selling Shareholder (cont'd)

- To take advantage of 1042 transaction –
  - Must be C corporation (so S corporation shareholders must revoke S election if currently S corporation)
  - Must sell at least 30% of the value of outstanding shares
  - Must buy "qualified replacement property"
- Creates market for shares – mechanism to create shareholder liquidity
- If selling shareholder is still majority owner (50% plus 1 share) post-transaction, can still maintain control
- Can be first step in generating initial liquidity for future possible sale

Benefits to the Company

Benefits to the Company

- Shares end up in “friendly” hands
- Company stays in local community rather than having remote ownership
- Company can fully deduct cost of sale. Example:

	ESOP	No ESOP
Principal Borrowed	$15M	$15M
Deduction for Principal Payments*	$6M	--
Effective Cost	$9M	$15M

- Total Tax Savings: $8.38M ($2.38M for shareholder and $6M for Company)
- * Assumes 40% effective tax rate

Benefits to the Company (cont'd)

- The reduction in tax liability effectively increases working capital
- If S Corp owned by ESOP, can operate 100% tax free
- Increases employee productivity because value of shares is tied to performance
- Can be used to finance expansion with newly issued shares – same tax advantage for principal payments

Benefits to Employees

Benefits to Employees

- Retirement Benefit is equal to value of company stock in their account
- ESOP account is tax-deferred
- No employee tax event until distribution
  - Possibly capital gains on distribution (instead of ordinary income)
  - Can rollover distribution to further defer tax event
- Since an "owner", feels like part of a team – incentivized to perform

Potential ESOP Candidates

Ideal ESOP Situations

- Closely held businesses with no transition strategy
- Middle market companies
- Non-sale situations – companies looking to raise capital for expansion (same tax advantage) or acquisition
- Companies with little leverage and competent management
- Minimum size: approximately 25 employees

Common Misconceptions

Common Misconceptions

- Owner will lose control of the Company
  - If owner maintains majority ownership, simply not true
  - Even if ESOP owns majority of Company, ESOP Trustee's role is to vote for Board members and Board appoints management
  - Depending upon situation, owner may even negotiate an employment agreement to be effective post-transaction
- Significant Transaction Costs
  - The transaction costs are no higher than selling to an outside party

Common Misconceptions (cont'd)

- Owner is selling short (not receiving full value)
  - ESOP Trustee cannot pay more than "adequate consideration," which is fair market value of shares as determined by an independent appraiser
  - In our experience, the price paid by an ESOP Trustee is typically similar to the price paid by a financial buyer
  - To the extent there is a strategic buyer that is willing to overpay compared to a financial buyer, the ESOP will likely not be able to match

Common Misconceptions (cont'd)

- Employees can examine the Company's books
  - Participants must receive statement showing value of their shares, but detailed financial information is not required to be disclosed
  - Some companies, as a matter of culture, choose to share some level of detailed financial information

Pitfalls and Risks

Pitfalls and Risks

- Unique fiduciary issues
  - The implementation of the ESOP (e.g., the price at which shares are sold and the choice of trustees and service providers) is fiduciary in nature
  - Trustee is generally responsible for decisions, such as voting and determining FMV
  - Internal vs. external trustee
    - External trustee advisable in conflict situations
  - Primary fiduciary is responsible for assuring that the ESOP does not pay more than "adequate consideration" (e.g., fair market value) for employer securities
  - Fiduciaries have an obligation to monitor and/or attempt to influence management if such activity is likely to enhance the value of the ESOP's investment in the company

Pitfalls and Risks (cont'd)

- Unique fiduciary issues (cont'd)
  - Potential personal liability
  - Indemnification and fiduciary liability insurance provides fiduciaries with protection
    - Fiduciary liability is not covered under E&O policy – requires separate policy
- Adequate Consideration
  - Purchase must be for "adequate consideration"
  - Based on a good faith determination of fair market value, which requires written documentation of value
  - If traded on NASDAQ or NYSE, value is determined by most recent trade
  - If not traded on NASDAQ or NYSE, value must be determined by an independent appraiser

Pitfalls and Risks (cont'd)

- Government Regulation
  - DOL Oversight
  - Documenting fiduciary process is key
  - IRS compliance for tax benefits
- Impediment to Future Sales?
  - ESOP Ownership can make future sale more cumbersome due to fiduciary considerations
  - ESOP Trustee likely will not provide same indemnification as other selling shareholders
  - Escrows and clawbacks are much more difficult due to prohibited transaction considerations
  - Deal can still be done (they are all the time) but these issues will be heavily negotiated and can affect price

Pitfalls and Risks (cont'd)

- Must properly size ESOP debt
  - Deduction Limits
    - Aggregate limit: cannot exceed 25% of eligible comp
    - Individual limit: cannot exceed the lesser of (i) $53,000 (in 2015) or (ii) 100% of a participant's compensation (capped at $265,000 in 2015)
  - Compensation limit of $265,000 (in 2015, adjusts for inflation each year)
  - Dividends are generally not considered contributions
  - Dividends can be deducted in certain cases
  - If ESOP loan is not sized properly, cannot repay debt

Pitfalls and Risks (cont'd)

- Accounting is complex, and often counterintuitive
  - Controlled by ASC 718-40 (formerly SOP 93-6)
  - Direct loan made by third-party to ESOP is considered Company liability
  - If leveraged, can be mismatch between comp expense and contribution deduction – comp expense is value of the shares released not amount contributed
  - Shares held in suspense account are not considered outstanding for capital or EPS purposes

Pitfalls and Risks (cont'd)

- Voting
  - NYSE or NASDAQ – participants can direct trustee on all matters for which shareholders are permitted to vote
  - If not NYSE or NASDAQ, trustee votes shares in its discretion unless it involves merger, consolidation, recap, etc.
- Diversification – Participant right to elect to diversify out of employer stock
  - Not publicly traded – age 55 and 10 years of service
  - Publicly traded – 3 years of service

Pitfalls and Risks (cont'd)

- Repurchase Obligation
  - Put Requirement – if not NYSE or NASDAQ, participant has right to require company to repurchase distributed shares at fair market value
  - Company must adequately plan for repurchase liability – this is an expense
- Ongoing Operational Costs
  - Annual valuation (if private)
  - Administration
  - Legal

Summary

Summary

- A well-designed ESOP can be part of a coordinated strategy and integrated with a broad spectrum of business goals which tie together tax benefits, shareholder objectives, employee benefits and executive compensation programs