

EPSTEIN BECKER & GREEN P.C.

# *Leveraged Employee Stock Ownership Plans*



May 29, 2007  
J. Todd Butler, Esq.



## LESOPs in General

- An employee stock ownership plan (“ESOP”) is a qualified retirement plan.
- The main difference between an ESOP and other qualified retirement plans is that in an ESOP the employees own the stock of their employer and they do so without using any of their own money.
- Created by congress in 1974 in the Employee Retirement Income Security Act.
- More than 11,000 ESOPs have been established, covering over 10 million employees throughout the United States.
- Congress has created incentives for business owners to establish an ESOP which result in the ESOP being an extremely advantageous exit strategy for business owners.

## LESOPs in General (cont.)

If structured properly, a leveraged ESOP can provide the following benefits:

- Shareholders can sell a minority interest of their stock to the ESOP trust for fair market value (the ESOP trust must own at least 30% percent for favorable tax treatment). Of course, shareholders can sell as much as 100% of the shares to the trust.
- Shareholders can receive significant cash at closing (senior lenders will, on average, lend up to 4x EBITDA).
- Shareholders pay no capital gains taxes on the transaction (i.e., keeping the part of the sale price (usually over 20%, depending on state of residency) that would have to be paid in a normal third-party sale).

## LESOPs in General (continued)

EPSTEIN BECKER & GREEN P.C.

- Shareholders can retain control of the company post - closing (if they so desire) or vest control in a management team (or next generation family members).
- Shareholders do not personally guarantee any financing. In certain circumstances, there may be a partial pledge-back of sale proceeds depending on the assets of the business.
- Company receives significant tax deductions enabling company to pay little or no corporate taxes and, if the company has been a c-corp. prior to the ESOP closing, potentially recapture taxes already paid.
- Employees get a retirement benefit windfall (i.e. not using any of their own money to fund plan) and defer taxes to later in life when tax bracket will likely be lower.

## General Application of LESOP to Small Business

EPSTEIN BECKER & GREEN P.C.

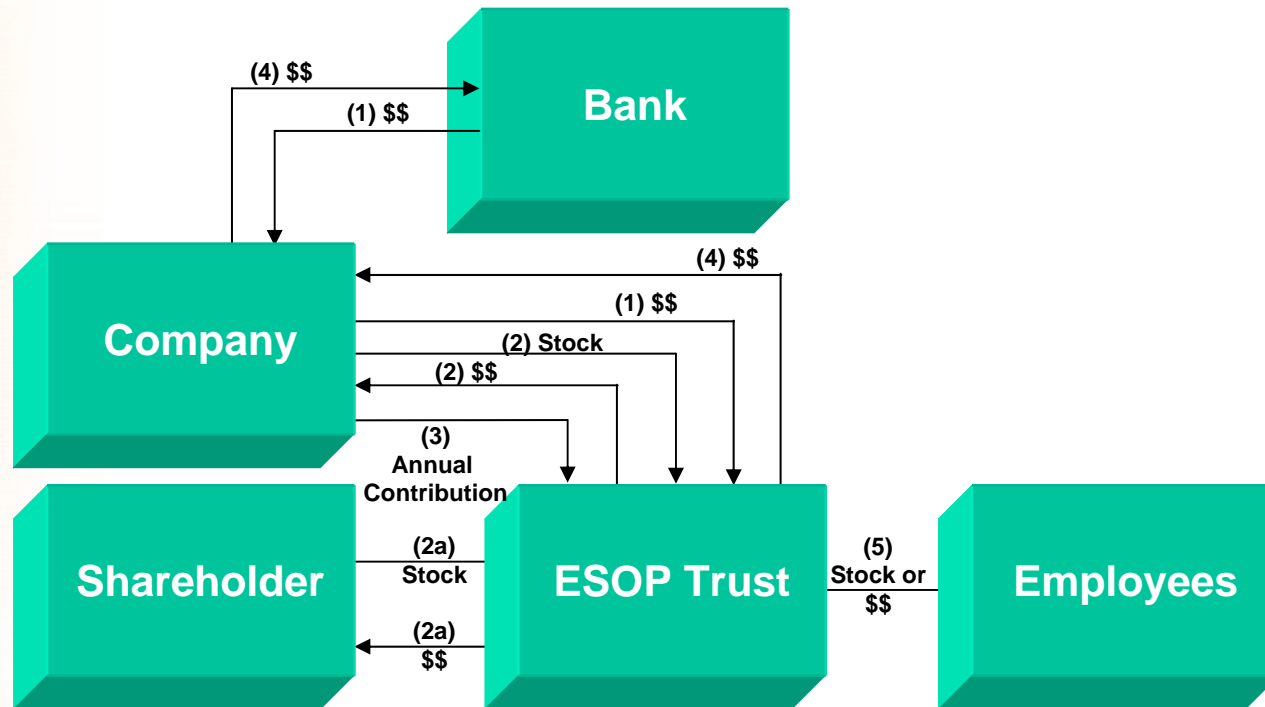
- Small business valued at approximately \$4.75 million.
- The company is an s corp.
- Last 12 mos. EBITDA of approx. \$950k (5x multiple).
- One shareholder owns 100% of the shares. Shareholder is a resident of the State of Georgia.

## Valuation Matters

EPSTEIN BECKER & GREEN P.C.

- The ESOP transaction is structured so that the ESOP trust buys preferred stock (with a dividend rate of 6 to 12%). As a result, the stock of the company to be purchased by the ESOP can be valued higher than it would otherwise (even as high, or in some cases, higher than a particular strategic buyer). The preferred dividend also allows the ESOP loan to be paid off more quickly and will increase tax deductions for the company.
- The initial valuation for ESOP purposes can typically be completed in approximately 2 weeks after the valuation firm has received all information necessary (e.g., financial statements, projections, business description, etc.).
- For the purposes of this proposal, we have assumed a value of \$4.75mm for the company. The actual valuation determined by the valuation firm could be more or less than such assumed value.

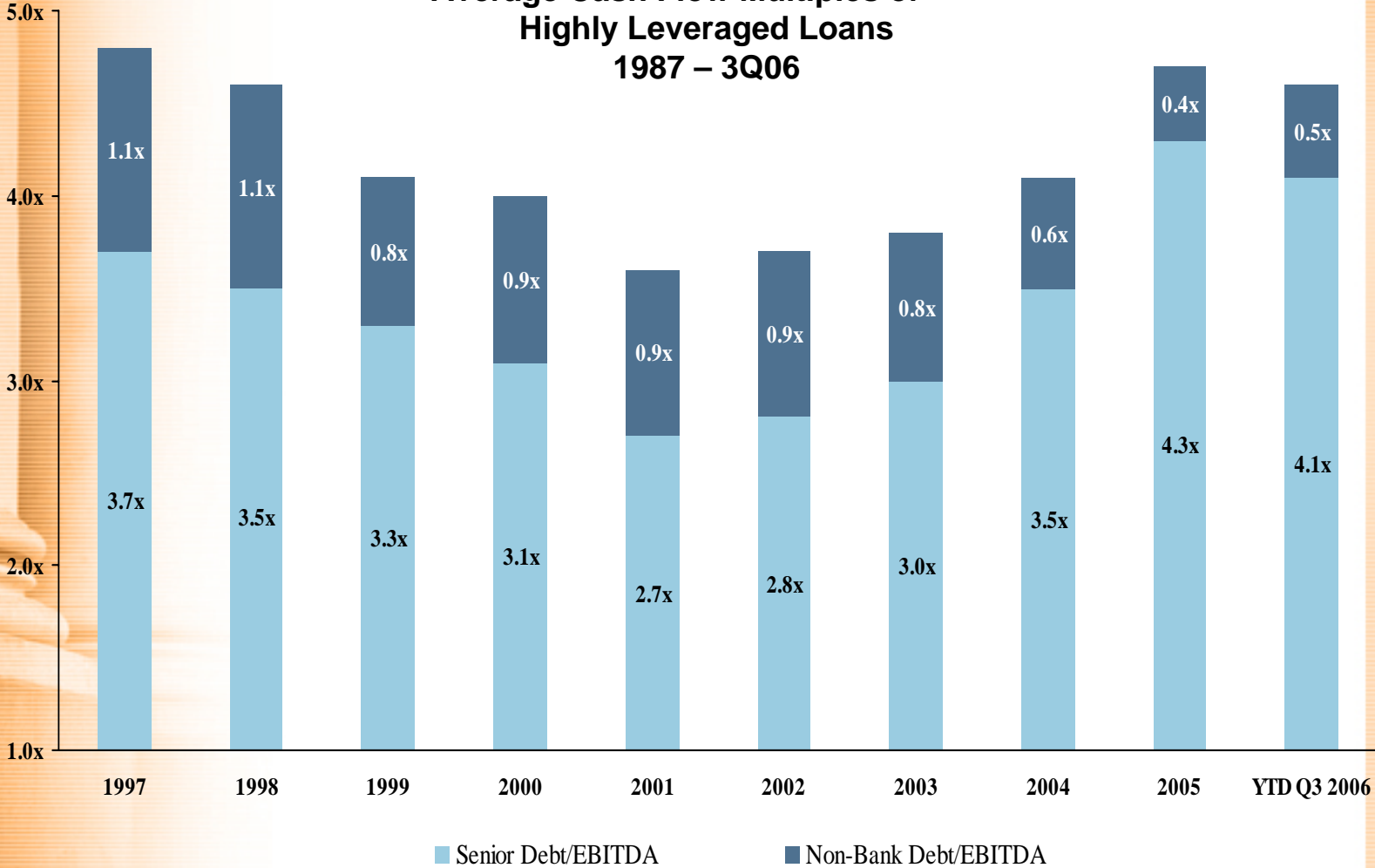
# How Financing Works



1. If fully leveraged, lender(s) lend \$4.75mm to Company which, in turn, lends same to ESOP Trust (there may be some amount of seller financing here).
2. The ESOP trust uses the loaned funds to buy the stock from company or (2a) from the shareholders.
3. Company makes annual tax deductible contributions and dividend payments to ESOP Trust
4. ESOP Trust repays Company which, in turn, repays Bank
5. Employees collect stock or cash when they retire or leave Company

# Typical Amount of Financing

Average Cash Flow Multiples of Highly Leveraged Loans 1987 – 3Q06



## Tax Benefits

Assuming the seller shareholder decides to sell 100% of the company to the ESOP, the tax benefits to the shareholder and the company are as follows:

1. Owner receives sale price tax-free  $\$4.75\text{mm} \times \left[ \begin{array}{l} \text{Capital Gains Rate} \\ \text{Est. Fed } 15\% \\ \text{GA } 6\% \end{array} \right] = \$997,500 \text{ savings}$
2. Company receives tax deductions (over time) = to purchase price + interest  $\$4.75\text{mm} \times \left[ \begin{array}{l} \text{Corporate Tax Rate} \\ \text{Est. } 40\% \end{array} \right] > \$1.9 \text{ million savings}$

### Additional Tax Benefits

- Valuation will include a multiple of the add back of shareholder compensation. As a result, the shareholder is accelerating this compensation from the company and, due to the effect of Section 1042, not paying the ordinary income tax rates (i.e., savings of 44%) on such compensation.
- Unlike other forms of financing, both the interest and principal of ESOP loan are tax deductible to the Company.

# Control

- Even assuming a 100% sale, the ESOP gives the seller control over who will run the company post-closing. The ESOP trustee will have no desire to insert itself into the management process. The board of directors of the company will be able to determine the identity of the trustee (which could even be the seller).
- The employees only get a direct right to vote in extraordinary circumstances (e.g., sale of the company, recap, sale of assets). In all other cases where a shareholder vote is required, the trustee of the plan will vote the shares on behalf of the employees.
- The employees will have no right to company information. They will only receive a statement showing their account balance (similar to other retirement plans).

## Additional ESOP Considerations

EPSTEIN BECKER & GREEN P.C.

- Due diligence process is less disruptive to business
- Transaction is typically handled much more quickly than sale to third party
- Holdbacks, earn outs and indemnification claims common in third-party sales are much less likely in ESOP transactions
- Confidentiality of business operations and trade secrets can be maintained (i.e., no competitors looking at sensitive company information)

## Conclusions as to Small Business Application

EPSTEIN BECKER & GREEN P.C.

- Post-closing, assuming a \$4.75mm sale price and a 100% sale, the shareholder will save just under \$1 million in taxes (assuming IRC 1042 tax treatment is elected). Therefore, a strategic buyer would have to make an offer of \$5.75mm to be competitive with the ESOP as to price.
- The shareholder will receive most of the sale price in cash at closing (i.e., less transaction costs, any seller financing will be paid back over time, IRC 1042 will require 5-10% of sale price to be invested in long-term notes (i.e., 5-10% is invested in qualified replacement property; remainder may be used without any limitation).
- Selling shareholder is still in control of the management of the Company.
- Due diligence wasn't disruptive and competitors did not see trade secrets of company.
- Company will received almost \$2 million in tax deductions during the term of the ESOP loan.
- Those employees who decide to stay with the company long-term will receive a retirement benefit windfall and may defer taxes until later in life.

## How to Proceed with Potential Clients

EPSTEIN BECKER & GREEN P.C.

- The cost to find out if an ESOP transaction is minimal. Essentially any company with ebitda of at least \$1 million and employees will be a viable ESOP candidate. The ESOP valuation will cost approximately \$7,500 and take only a couple of weeks to complete.
- Even if your client has interested third party buyers it should consider an ESOP as well. An ESOP transaction can proceed simultaneously with your marketing efforts to third parties. Minimal cost is required to determine the benefits of an ESOP transaction. The mere potential of an ESOP transaction can keep third party bidders for the company from obtaining too much power in negotiations.
- An ESOP trust is an “unrelated party” and therefore your current engagement letters should be sufficient to protect your broker fee.
- If you have multiple clients in the same type of business an ESOP can be a terrific roll-up vehicle (each entity involved in roll-up could be smaller than \$1 million ebitda).
- If you have a client interested in acquiring businesses an ESOP can be used to acquire them in a manner that requires very little cash from the acquirer (e.g., Tribune transaction).

## Contact Information

EPSTEIN BECKER & GREEN P.C.

Please contact me if I can provide further information to you or your clients.

J. Todd Butler

Epstein Becker & Green P.C.

945 East Paces Ferry Rd, Ste 2700

Atlanta, GA 30326

404 – 869 - 5332 (direct)

404 – 435 - 6324 (mobile)

[tbutler@ebglaw.com](mailto:tbutler@ebglaw.com)