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Advantages of Using ESOPs To Structure Acquisitions and Divestitures In Uncertain Economy

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M&A advisors are becoming increasingly familiar with leveraged ESOP transactions and are routinely considering the ESOP platform in structuring acquisitions and divestitures. The first part of this article references the ways in which leveraged ESOPs have historically been used to provide a tax-advantaged exit strategy for privately held business owners. The article then discusses the advantages the leveraged ESOP structure can bring to M&A advisors and private equity groups charged with structuring acquisitions and divestitures during a down economy.

I. Introduction

For years, employee stock ownership plans (ESOPs) have provided both a ready exit strategy for privately held business owners and a platform for management buy-outs. More recently, M&A advisors have used leveraged ESOPs to accomplish both conventional stock and asset acquisitions *and* divestitures (including spin-offs of divisions or companies (*e.g.,* failed "roll-up" companies). They have also been used by venture capital and private equity firms (collectively, "private equity groups") as investment platforms and in planning investment exit strategies.

In the current economic environment leveraged ESOPs can continue to be used for *all* of these purposes. They can also provide real advantages not available in traditional

M&A transactions. With company owners postponing sales in the face of lower values and inferior offers, ESOPs allow for partial sales, maximize after-tax sales proceeds and provide sources of financing which are both tax-advantaged and flexible. The leveraged ESOP structure also provides an increase to company cash flow, and, on a go-forward basis, a more stable company structure with improved performance. Seller financing may also be measurably more attractive in an ESOP purchase scenario than under traditional M&A models.

II. Advantages Available in ESOP Structure

a) ESOP as A Qualified Retirement Plan that Can Borrow Funds to Create A Market and Make an "Internal" Purchase of Shares

An ESOP is no more than a defined contribution plan (like a profit sharing or 401(k) plan). It is designed to invest most of its assets in the stock of the sponsoring corporation (the "Company").

Unlike other qualified plans, an ESOP can use both borrowed money and funds rolled over tax-free from other qualified retirement plans and/or certain IRAs to purchase the stock of the sponsoring corporation. Armed with this ability, in uncertain economic times ESOPs can create a market for closely held shares that might not otherwise exist. Shares can be purchased from one or more individual(s) or entity(ies) looking for shareholder liquidity ("Sellers") or from the Company itself.

Because an ESOP purchase can be structured internally (*i.e.,* without "taking the Company to market"), the transaction can be more easily closed within a specific time frame that meets buyer and/or seller objectives. If desired, an ESOP purchase offer can alternatively be timed to occur concurrently with additional M&A offers (with the ESOP serving as a "stalking horse" to potentially increase third party M&A offers).

b) Possibility of Partial and/or Tax-Deferred Sale Makes ESOP Purchase Transaction Attractive to Seller

(1) Partial Purchase Capability

An ESOP can purchase part or all of a company's shares and it need not purchase the shares in a single transaction. For a business owner seeking partial liquidity, an ESOP may be extremely attractive as compared to traditional M&A transactions in which buyers are rarely willing to purchase a minority interest.

(2) Possible Tax-Deferred or Tax-Free Sale

Moreover, as long as (1) the ESOP purchases at least 30 percent of the Company's shares and (2) the Company was (a) privately held (or an OTCBB company) for at least one year prior to the ESOP's stock purchase, (b) not a member of a corporate controlled group that included a public company (other than an OTCBB company) during such period, and (c) a C corporation at the time of the ESOP's stock purchase, then a selling shareholder (a "Seller") that (i) is an individual, trust, partnership or S corporation and (ii) has held its shares for at least three years prior to the sale closing date is able to make a tax-deferral election with respect to the sale under Section 1042 of the Internal Revenue Code.

Such an election will allow the Seller to sell his/her/its shares on a tax-deferred (or, in the case of *individual* Sellers) tax-free basis. Tax-*deferred* sale treatment is generally available if the Seller reinvests the Seller's sale proceeds in domestic stocks and bonds ("replacement securities") within 12 months of the transaction closing date. *Tax-free* sale treatment is generally available to the extent that an individual Seller acquires replacement securities in an amount equal to the ESOP purchase price and then holds them until his/her death. (The IRS makes it quite easy to hold replacement securities until death, since neither (i) gifting or making charitable contributions of the securities, nor (ii) borrowing against them (*e.g.,* through margin loans) constitutes a disposition of the securities for purposes of the applicable IRS rules.)

(3) Even if Sale is Not Tax-Deferred or Tax-Free, It Will Result in Capital Gains

In the event that an ESOP purchases a Seller's shares and the Seller chooses not to make (or fails to qualify for the making of) a tax-deferred election under Section 1042, the sale will result in capital gains (currently subject to a 15 percentpercent federal income tax rate). Given that (i) many buyers in a traditional M&A transaction want to purchase *assets*, (ii) private equity and strategic buyers will generally pay a lower purchase price for stock than for assets and (iii) an asset sale typically results in a blended capital gains/ordinary income tax rate and sometimes a double tax if the corporation then liquidates, a Seller's ability to make a tax-deferred or capital gain *stock* sale to an ESOP is a real advantage. In a challenging economic environment it may be the principal factor or, perhaps, the *only* factor that encourages an owner to sell now rather than later. Putting more after-tax dollars into an Seller's pocket can also bring about "meeting of the minds" in terms of the transaction purchase price. It can further provide a competitive advantage to a purchaser that is offering the same price as competing buyers.

One of the great "ESOP fables" is that an ESOP won't pay as high a purchase price as an outside third party might. While it's true that an ESOP can't pay a true "strategic" purchase price, it can pay a price equaling a Company's full economic fair market value. As credit markets have contracted, so too have the pricing multiples paid by strategic buyers, with ESOP offers in the current economic climate sometimes even exceeding strategic offers when viewed on an after-tax basis.

c) ESOP Financing Which is Tax-Advantaged and More Flexible

(1) Structure of ESOP Loan (with Possible Reduction of Transaction Debt)

A corporation wishing to engage in a leveraged ESOP stock purchase transaction (the "Company") adopts an ESOP and the ESOP typically borrows its share purchase money from the Company and/or the Seller(s) (with the Company portion of the funds so borrowed by the ESOP sometimes having been sourced by the Company from one or more senior lenders). The amount borrowed is reduced to the extent employees are given, and take advantage of, an opportunity to transfer some or all of their

401(k), profit sharing and/or IRA account balances to the ESOP for investment in Company shares (with dollars coming into the ESOP (i) reducing the amount of both ESOP debt and Company debt and (ii) being viewed as transaction equity by senior lenders).

(2) Repayment of Both Interest and Principal With Deductible Dollars

The ESOP loan (whether from a bank, the Company which borrowed the funds from a bank and/or the Seller(s)) is repaid with (1) contributions made by the Company to the ESOP plan and/or (2) C corporation dividends or S corporation distributions paid on the ESOP's Company shares (the "ESOP shares"). In the aggregate, the contributions and dividend/distributions generally equal the transaction's debt service. Because an ESOP is a qualified plan, an ESOP sponsor receives a deduction for the contribution the sponsor makes to the ESOP. If a sponsor is a C corporation, it will also be able to deduct reasonable dividends paid on ESOP shares which are used to retire the ESOP loan.

Contributions and/or distributions received by the ESOP are used by it to repay its debt service to the Company, with the Company then using the monies it receives to repay its debt service to the bank or the Seller. Since the aggregate amount of deductible contributions and dividends is generally enough to service, first, the ESOP's indebtedness to the Company and, second, the Company's indebtedness to the bank, the Company is effectively able to deduct both the interest and the *principal* on its bank loan.

(3) Resulting Increased Cash Flow (Which May Last Beyond Loan Term with S Corporation Election)

Because the Company is essentially able to repay its indebtedness on a pre-tax basis, the Company's cash flow is increased. Moreover, if the Company is an S corporation or a C corporation as to which a post-transaction S corporation election will be made, the enhancement to the Company's cash flow need not be limited to the term of the transaction-related deductions. The reason is than an S corporation is a pass-through entity and an ESOP is a tax-exempt entity. If the Company remains or becomes an S corporation, there will be no federal income tax (and, perhaps, no *state* income taxes) to the extent of the ESOP's Company ownership percentage. If the ESOP winds up owning 100percent of the Company's outstanding shares (albeit that options, warrants or other forms of synthetic equity may, for example, be held by the Company's management team and/or private equity investors), the Company can operate on a go-forward basis as an entity exempt from federal (and, in many cases, state) income taxes.

(4) Benefits of Increased Cash Flow

The increased cash flow of the Company related to ESOP-generated deductions in a C corporation context or the ESOP's ownership percentage in an S corporation context can be used to make scheduled or accelerated transaction-related debt service payments. It can also be used for other acceptable corporate purposes (*e.g.,* capital expenditures), which may provide the Company with continued growth and a significantly higher internal rate of return. In addition to increasing the Company's financial strength, the Company's enhanced cash flow will enhance its creditworthiness. Not only will senior and mezzanine transaction lenders be encouraged to loan more into the transaction, private equity group(s) may be encouraged to provide transaction financing (even, *e.g.,* where the transaction is being structured to take out an existing private equity investor).

(5) Seller Financing is More Attractive in ESOP Structure

Another significant financing advantage of the ESOP structure is that seller financing is generally more attractive in an ESOP purchase transaction than in a traditional M&A acquisition. First, the fact that the Company's enhanced cash flow will permit its senior indebtedness to be repaid at an accelerated pace means that subordinated seller financing can be repaid more rapidly. Second, if a Seller who provides a portion of the transaction's financing has made a Section 1042 election, the transaction can be structured so that the Seller receives a higher subordinated return and principal payments which are received on a tax-free basis (as opposed to traditional M&A installment payments for which only a portion of each installment constitutes a return to basis). Finally, because an ESOP company's management team generally remains in place to continue running the entity's day-to-day operations, Sellers may feel more comfortable providing financing than they would in a traditional third-party purchaser M&A transaction.

(6) ESOP Structure Provides Greater Financial Flexibility

The fact that ESOP purchase transactions can often be closed with a much greater percentage of Seller financing (which can, of course, be taken out in the future when credit conditions have improved) makes ESOP purchase financing definitely more flexible than traditional M&A financing in a down economy. This flexibility is accentuated when the transaction can be structured to roll monies into the ESOP from other retirement plans and/or IRAs. The fact that an ESOP transaction structure creates an inherent source of funding which can be used to repay transaction indebtedness (as described below) is yet another advantage of its financial flexibility.

d) Inherent Sources of the Funds Which Can Be Used to Repay Transaction Debt

The Company can, of course, take from its cash flow the dollars it will need to make the contributions or pay the dividends/distributions which will enable the ESOP to repay its loan. Other sources inherent in the transaction structure can include:

- the annual use of dollars previously contributed as a matching contribution to the Company's 401(k) plan (with the Company continuing the "match," if desired, within the ESOP in the form of Company shares);

and/or

- the use of the tax dollars saved by the Company due to either ESOP-generated deductions in a C corporation context or the ESOP's ownership percentage in an

S corporation context.

e) Stable Company with Improved Performance

(1) Although Company Is Leveraged, Its Management Team Will Likely Remain in Place and Enhancements to Cash Flow Can Provide Continued Growth

Like any other leveraged transaction, a leveraged ESOP purchase transaction puts a large amount of debt on the Company's books. However, unlike traditional M&A transactions, the Company's management team will in all likelihood remain in place to run the Company's day-to-day operations. Moreover, because transaction indebtedness is essentially paid with pre-tax dollars, the Company's cash flow is increased in a way that can provide the Company with continued growth and a sufficiently higher internal rate of return. In the event that the Company operates on a post-transaction basis as an S corporation, the Company's increased cash flow related to the ESOP's ownership percentage can continue well beyond the life of the transaction's term debt.

(2) ESOP Provides Employees With a Beneficial Interest In the Company Which May Increase Production and Increase Company's Chances of Survival

The fact that the ESOP will provide employees with a beneficial interest in the Company will also incentivize employees financially, providing the Company with positive effects in terms of attracting, retaining and motivating employees to increase the Company's productivity. Data referenced by the National Center for Employee Ownership (NCEO) also decisively shows that companies which share ownership broadly with employees are less likely to go out of business, that they generate more jobs and they create an average of three times the retirement benefits as comparable non-employee ownership companies. Tony Matthews, director of employee ownership at the Beyster Institute, has also said that "In tough times like these, giving employees a stake in the outcome inspires people to put in the extra effort required to insure the survival of a company."

III. Summary

With both M&A advisors and private equity groups needing to find new ways to compete in tighter credit markets, using an ESOP as a stalking horse and/or an acquisition tool may provide a competitive edge. The parties to a leveraged ESOP transaction can readily control its timing and 100 percentpercent of a company's equity need not be purchased in a single transaction.

The ESOP purchase structure is also advantageous in that an ESOP can purchase shares with pre-tax dollars and it can access other qualified plan and IRA monies to both (i) reduce the amount of acquisition indebtedness and (ii) provide a partial funding source for periodic loan payments. The factors that make *seller financing* so attractive under an ESOP purchase structure also provide the structure with a competitive advantage in a down economy in which it is difficult to fund 100percent of a purchase with external financing. The fact that an ESOP purchase can close without going to market and pay up to a full economic fair market value provide additional advantages which greatly minimize the risk that a purchase agreement may never be executed.

Finally, the fact that ESOP financing can enhance cash flow which can be used for both debt reduction and periodic growth makes the ESOP structure worth considering not only as a down economy alternative to a traditional M&A transaction, but also as a go-forward investment and/or acquisition platform.

There are, of course, considerations to the ESOP transaction structure which must be explored and quantified (*e.g.,* the requirement that a privately held company must repurchase shares distributed to departing employees at fair market value). With proper planning these considerations need not, however, become structural drawbacks. In a down economy in which M&A advisors and private equity groups are looking for flexible structures which can take an acquisition to completion, the leveraged ESOP purchase structure presents a compelling alternative.