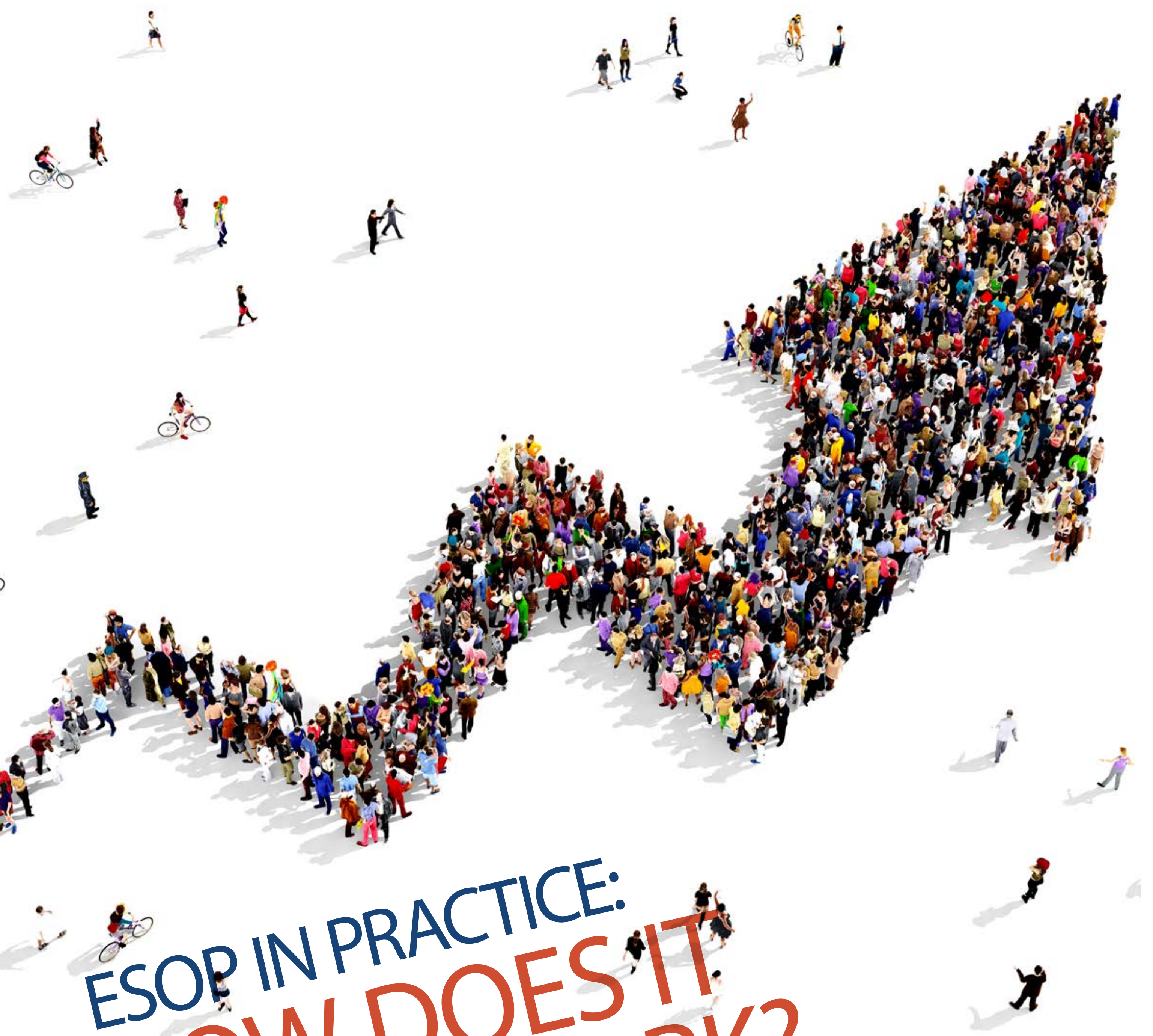

ESOP IN PRACTICE: HOW DOES IT REALLY WORK?

BY CHRISTOPHER A. KRAMER

If you didn't read my last article, you may want to check the September/October issue of *BoxScore* to get the background on the pros and cons of establishing an employee stock ownership plan (ESOP). If you did, you have a good sense for the concepts but are probably a little fuzzy on how it actually works. The goal of this article is to give you a sense of what is involved in actually putting an ESOP into place.

A good way to think about an ESOP is using a red light/green light analogy. You've thought about it, are open to the concept, and now you want to take the next step (the lights are still green). What should you do next?

The best way to proceed is to engage with a sell-side ESOP adviser. This person will perform what is known as a feasibility analysis, which will take into account valuation, cash flows, debt repayment, compensation levels, and other factors to see if a deal even makes sense. This feasibility analysis will help you as a seller understand what you will get from the sale of your stock, as well as the impact on the company and the employees. Assuming that the lights are still green, this preliminary study will roll into plan design, transaction structure, and implementation.

Plan design will involve your goals and objectives with respect to such things as benefit levels, vesting, eligibility, whether credit for prior service will be given, and other factors. It will also consider other benefit plans that might exist, what will happen to those plans, and whether there are any other administrative or regulatory issues to consider. While the plan can be amended at a later date, some of the decisions that are made in the design phase can have a significant impact on the transaction structure, as well as the implications of the post-transaction implementation.

Transaction structure will involve such things as the proposed sale price to the ESOP, the amount of bank financing that will be sought, the terms of any seller financing, and other factors. This stage also involves modeling of the expected benefit levels of the ESOP based on the contributions to be made post- (and sometimes pre-) transaction. Your sell-side adviser will generally model all of these factors into a proposed structure, and assuming the overall proposal meets with your approval, you can move to the implementation phase.

Making the Transaction

Mechanically, an ESOP transaction is like any other sale transaction, in that there is an offer, an acceptance, a due diligence period, and the execution of transaction documents. These documents often consist of a stock purchase agreement, employment agreements, seller notes, and the like. The primary difference between an ESOP transaction and a non-ESOP transaction is that an ESOP deal involves the sale of stock to a trust. Therefore, in order to proceed with a sale of stock to an ESOP, a trust must be formed and a trustee appointed. The trustee can be anyone who is independent of the transaction. Most sellers opt to hire a third-party transactional trustee for the sole purpose of representing the interests of the ESOP in the transaction. That trustee will then retain the services of a financial adviser to perform an appraisal of the company and report a range of value to the trustee.

Once the trust is formed and the trustee is retained, an offer to sell the stock is tendered to the trustee. The trustee, in consultation with his financial adviser, will respond to the offer, and a negotiation will occur. When both parties are satisfied with the material terms of the transaction, a letter of intent will be signed, and the transaction will move to the due diligence phase.

Due Diligence

During due diligence, the trustee team will request a significant number of corporate documents to facilitate legal, accounting, and operational due

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diligence. While this due diligence will generally be less onerous than it would be with a public company or private equity buyer, response to due diligence requires patience and thought. During this process, transaction documents are drafted, bank financing is coordinated, and final negotiations and transaction structuring occur. At closing, signed documents are exchanged, monies are transferred, and the ESOP officially becomes a shareholder of the company.

Post-closing, the company will make debt service payments to the bank and the selling shareholder. Typically, if there is bank financing involved, the bank will allow for interest-only payments on the seller notes until the term debt to the bank is repaid. Following this repayment, the seller notes can begin to be amortized. After the seller notes have been repaid, the company will typically cash out any warrants that have been issued as a yield enhancement to the seller notes.

Time for Growth

From the ESOP's perspective, it will begin to repay its obligations through contributions made by the company. When this occurs, shares are released to the participants, and their account balances grow. The concept is similar to how equity grows in your home as you make your mortgage payments and a portion is used to repay the principal. The participants get an allocation based on their W-2 and subject to vesting and eligibility requirements.

For example, a person who makes $100,000 per year receives twice as much of an allocation as a person who earns $50,000. Thus, the participants' accounts grow in the following two ways: 1) by allocation of shares as the debt is repaid, and 2) by the increase in the value of the stock. These contributions are tax-deductible to the corporation, and it is through these contributions that the repayment of debt ends up happening on a pretax basis.

The debt to the bank and the shareholders will generally be repaid over the shortest possible period of time without putting an undue burden on the company. The allocation of shares to the participants, on the other hand, will generally be over a longer period than the repayment of the bank debt or seller note. There are three primary reasons for this: 1) As the ESOP is a retirement plan, the goal is typically to provide a long-term benefit to the employees, not a short-term benefit; 2) the longer allocation period encourages longevity and tenure of the workforce (i.e., they have to be there longer to get more); and 3) a longer allocation ensures that shares will be available for allocation to new employees in the future. Furthermore, this enhances the ability to sell the ESOP as an additional employee benefit when recruiting.

Enhanced Performance

While the tax benefits to both the sellers and the company can be substantial, what really makes an ESOP work to maximum effect is the enhanced performance that often occurs when the employees have a vested interest in the company's performance. Numerous studies have confirmed that companies in which ownership is shared with the employees outperform those that do not. Many ESOP companies end up branding themselves as employee-owned, and they effectively communicate the benefits of employee ownership to all of their stakeholders. This has resulted in numerous examples of companies where performance has improved and the workforce has ended up with a far greater economic benefit than they would have achieved elsewhere.

Other than an ESOP, no transition vehicle or strategy currently available affords the combination of flexibility, tax benefits, employee engagement, and preservation of corporate culture. From the seller's perspective, the taxes on the sale of stock can be deferred or avoided altogether. In exchange for financing the transaction over time, the seller can receive a substantial rate of return on this financing, often in excess of the expected rate of return were cash proceeds to be invested in a bond or stock portfolio. From the company's perspective, the transaction can be paid for with pretax dollars, and if the ESOP ends up owning 100 percent of the stock, the company will never again have to pay corporate tax or make a tax distribution.

From the employee's perspective, they receive a meaningful financial incentive to help the company grow and prosper in the future, and they get to work for a company whose culture is intact. With more than 7,000 ESOP-owned companies in existence in the United States today, it is a strategy that should be considered by most closely held companies seeking an ownership transition. ■

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