



**MENKE & ASSOCIATES, INC.**  
ESOP ADVISORS AND INVESTMENT BANKERS

## **Options and Alternatives for Structuring ESOP Transactions**

**Web Seminar  
October 12, 2011**

Should you have any questions prior to the event,  
please contact Jeanie Kluga at 800-347-8357

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## **Meeting Logistics**

### ▶ **Audio**

- Broadcast mode
- Speakers will answers questions at end of the presentation

### ▶ **Web Conference**

- Main window to view slides
- To ask a question, type in your query in Chat

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## Today's Presenters



**Victor Alam**  
Senior Corporate Counsel



**Chuck Bachman**  
Senior Corporate Counsel

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## Today's Agenda

- ▶ Valuation Considerations
  - Sell now or sell later?
- ▶ Tax Considerations
  - Pay Uncle Sam now or pay Uncle Sam later?
  - To participate in ESOP or not to participate?
- ▶ Financing Considerations
  - To borrow or not to borrow?
  - To lend or not to lend?
- ▶ Fiduciary Considerations
  - To serve as an internal fiduciary?
  - Appointing an independent fiduciary

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## Today's Agenda

- ▶ Control Considerations
  - Whether or not to sell a controlling interest?
- ▶ Incentive Plans for Key Employees
  - To motivate or not to motivate?
- ▶ Illustrative Case Histories
- ▶ Q&A

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## Valuation Considerations

- ▶ Sell now or sell later?
  - Sell now
    - Assumptions:
      - Pre-tax earnings of \$1.67 million
      - Valuation multiple of 6x = \$10 million
      - Basis of zero
      - Tax rate of 20% (federal plus state)
      - 100% sale to ESOP
  - Net proceeds: \$8 million

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## Valuation Considerations

- ▶ Sell later – higher tax rate
  - Assumptions:
    - Same pre-tax earnings of \$1.67 million
    - Same valuation multiple of 6X = \$10 million
    - Tax rate of 25% (federal plus state)
  - Net proceed: \$7.5 million

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## Valuation Considerations

- ▶ Sell later – higher tax rate but lower value
  - Assumptions:
    - Pre-tax earnings of \$1.4 million
    - Valuation multiple of 5X = \$7 million
    - Tax rate of 25% (federal plus state)
  - Net proceeds: \$5.25 million

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## Valuation Considerations

### Second Stage Transaction

- ▶ Sell now
  - Lower tax rate
  - But lower value if prior debt is still outstanding
  - Impact of new debt on value of participants' existing shares
  - Cash flow impact of new debt
  - Impact on contribution limits
  - Is a repurchase liability study needed
- ▶ Sell later
  - Higher tax rate
  - Higher value if prior debt is fully repaid
  - Less cash flow impact
  - Less impact on contribution limits
  - Is a repurchase liability study needed

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## Tax Considerations

- ▶ C corporation strategies
  - C corp remains as C corp
    - Taxable sale now
      - 15% federal capital gains tax
      - Seller participates in ESOP

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## Tax Considerations

- ▶ C corporation strategies
  - C corp remains as C corp
    - Tax-free rollover sale
      - No current tax
      - If QRP sold later capital gains tax may be higher
      - If QRP never sold, estate gets a step-up in basis
      - Seller (and seller's family) and 25% shareholders (and their families) are excluded from ESOP

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## Tax Considerations

- ▶ C corporation strategies
  - C corp remains as a C corp
    - Taxable sale versus tax-free sale
      - Small transaction/small family
      - Small transaction/large family
      - Large transaction/large family

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## Tax Considerations

### ▶ C corporation strategies

- Small transaction / small family % / small contribution rate
  - Assumptions:
    - Company value of \$10 million
    - 30% tax-free rollover sale = \$3 million
    - Capital gains rate (federal plus state) of 20%
    - Payroll of \$6 million
    - Payroll of seller and his family = \$1 million
    - Annual (10 year) contribution of principal = \$300,000
    - Contribution rate = 5% of payroll
  - Capital gains savings = \$600,000
  - Loss of ESOP participation:
    - \$50,000/year X 10 years = \$500,000

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## Tax Considerations

### ▶ C corporation strategies

- Small transaction / large family % / large contribution rate
  - Assumptions
    - Company value of \$10 million
    - 30% tax-free rollover sale = \$3 million
    - Payroll of \$2 million
    - Payroll of seller and his family = \$1 million
    - Annual (6 year) contribution of principal = \$500,000
    - Contribution rate = 25% of payroll
  - Capital gains savings = \$600,000
  - Loss of ESOP participation:
    - \$250,000 X 6 years = \$1,500,000

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## Tax Considerations

### ▶ C corporation strategies

- Large transaction / large family % / large contribution rate
  - Assumptions
    - Company value of \$10 million
    - 100% tax-free rollover sale = \$10 million
    - Payroll of \$2 million
    - Payroll of seller and his family = \$1 million
    - Annual (20 years) contribution of principal = \$500,000
    - Contribution rate = 25% of payroll
  - Capital gains savings = \$2 million
  - Loss of ESOP participation:
    - \$250,000 X 20 years = \$5 million

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## Tax Considerations

### ▶ C corporation strategies

- C corp switches to S status
- Advantages
  - ESOP tax shield
    - Bank and/or seller note can be paid back faster
  - S corp distributions can be used to pay bank debt and/or seller note
    - Avoids contribution limits
    - Avoids allocation limits
    - Avoids limits on deductible dividends

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## Tax Considerations

- C corp switches to S status
- Disadvantages
  - Must adopt calendar year
  - Short period accounting statements
  - Short period tax returns
  - Built-in-gains tax
  - One class of stock
  - Switch from LIFO to FIFO
  - LIFO recapture
  - Taxation of fringe benefits to 2% shareholders
  - Loss of NOL carryovers
  - Anti-abuse provisions- §409(p)

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## Tax Considerations

### Second Stage Transactions

- ▶ If ESOP acquires less than 100%
  - Advantage of remaining a C corp
    - Continued availability of §1042
  - Advantage of switching to S status
    - ESOP tax shield
    - S corp distributions can be used to pay bank debt and/or seller note
- ▶ If ESOP acquires 100%
  - No advantage in remaining a C corp

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## Tax Considerations

### ▶ S corp strategies

- S corp remains as an S corp
  - Advantages
    - Lock in 2011 capital gains rate
    - Tax rate is low if basis is high
    - Sellers and their family members participate in allocations
    - S corp distributions can be used to repay ESOP loan
    - ESOP tax shield on S corp distributions enables faster pay down of ESOP loan
  - Disadvantages
    - 1042 election not available

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## Tax Considerations

### ▶ S corp strategies

- S corp switches to C corp before year end
  - Advantages
    - Sellers can elect 1042
  - Disadvantages
    - Short period accounting statements
    - Short period tax returns
    - Sellers and family members cannot participate in ESOP
    - Corporation will be subject to income taxation
    - 5 year wait to switch back to S corp
    - ESOP will not have access to S corp distributions to help repay loan amount
    - Corporation must use accrual method of accounting
    - Corporation may be liable for income tax on accounts receivables

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## Financing Considerations

- ▶ To borrow or not to borrow?
  - Borrow if:
    - Want to lock in capital gains rate
    - Want to lock in current value
    - Seller plans to elect 1042 and need to purchase QRP
  - Do not borrow if:
    - Company is in a cyclical industry
    - Borrowing will use up company's line of credit
    - Borrowing will otherwise jeopardize company's financial security
    - Personal guarantees are a concern

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## Financing Considerations

- ▶ To lend or not to lend?
  - Advantages of using seller notes:
    - Seller can lock in current valuation
    - Seller can be more flexible than a bank
    - Seller can still lock in capital gains rate, provided that seller elects out of installment sale treatment

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## Financing Considerations

- ▶ To lend or not to lend?
  - Advantages of using seller notes:
    - Seller can still qualify for 1042 treatment by buying Floating Rate Notes (“FRNs”)
      - FRNs are issued by Fortune 500 companies
      - Interest rate floats with T-bill rate
      - Market value does not fluctuate
      - Thus, FRNs can be purchased on margin with as little as 10% or 15% down

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## Financing Considerations

- ▶ To lend or not to lend?
  - Advantages:
    - Seller can earn interest at the same rate that a bank would charge
    - Seller may charge a mezzanine rate of interest in certain cases
    - Seller may receive warrants in certain cases
      - May or may not be worth more than deferred interest
      - But warrants may qualify for capital gains treatment

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## Fiduciary Considerations

### Second Stage Transactions

- ▶ If there is a prior bank loan, seller note will be subordinate to bank loan
- ▶ C corp dividends and S corp distributions on both allocated shares and unallocated shares can be used to repay an ESOP loan
- ▶ But dividends and distributions paid on a prior block of stock cannot be used to make loan payments on a loan used to acquire a second block of stock

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## Fiduciary Considerations

- ▶ To serve as an internal fiduciary
  - Wearing two (2) hats
    - Seller is not prohibited from serving as trustee/fiduciary
    - Insider's knowledge of the company may be beneficial
    - Transaction costs & efficiencies

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## Fiduciary Considerations

- ▶ To serve as an internal fiduciary
  - ERISA provisions:
    - But seller has a conflict of interest
    - And fiduciaries have personal liability for:
      - Prohibited transactions
      - Breaches of fiduciary responsibility
    - Fiduciary must obtain independent appraisal
    - But fiduciary is still responsible for determining
      - Reasonableness of assumptions
      - Correctness of valuation methodology
      - Correctness of conclusion

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## Fiduciary Considerations

- ▶ To serve as an internal fiduciary
  - ERISA provisions:
    - 406(a) of ERISA sets forth a list of prohibited transactions
    - Any purchase of stock by a qualified plan from a party in interest is a prohibited transaction
    - But 408(e) of ERISA creates an exception for ESOPs if certain conditions are met
    - Case law provides for a presumption of good faith in the case of an independent fiduciary
    - If the fiduciary is conflicted, however, there is no presumption of good faith and the seller has the burden of proof

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## Fiduciary Considerations

- ▶ To serve as an internal fiduciary
  - Consequences of fiduciary breach:
    - Fiduciary is personally liable to participants for all damages
    - Seller must repay the overpayment, plus 15% penalty tax per annum until corrected
    - Seller may incur thousands of dollars in legal expenses
    - Removal as plan fiduciary
    - Fiduciary liability insurance

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## Fiduciary Considerations

- ▶ Appointing an independent fiduciary
  - Possible solutions: retain an independent fiduciary (“I.F.”) to represent the ESOP
  - Steps in the process
    - I.F. is retained on behalf of the ESOP
      - Engagement is usually only for purposes of the current transaction
      - But I.F. can also be engaged to serve on an ongoing basis as a trustee
    - I.F. assumes liability for the investment and control of trust assets relating to the transaction
    - I.F. hires the independent appraiser and reviews the appraisal analysis prepared by the independent appraiser
    - I.F. retains independent counsel to conduct necessary legal due diligence and to review all transaction documents

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## Fiduciary Considerations

- ▶ Appointing an independent fiduciary
  - Steps in the process
    - I.F. obtains a Fairness Opinion from the independent appraiser regarding the terms of the transaction
      - Term of seller note
      - Interest rate on seller note
      - Fairness of any covenant not to compete
      - Fairness of employment agreements
      - Fairness of other consideration paid to seller

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## Fiduciary Considerations

- ▶ Appointing an independent fiduciary
  - Advantages of retaining I.F.
    - Avoids liability for serving as a conflicted internal fiduciary
    - Promotes transparency to the employees
    - This is a relatively cheap form of insurance
  - Disadvantages of retaining I.F.
    - Additional time to close (60-75 days)
    - Additional costs
      - Independent fiduciary \$25,000 - \$35,000
      - Independent counsel \$15,000 - \$25,000
      - Fairness Opinion \$10,000 - \$20,000
      - Total \$50,000 \$80,000

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## Fiduciary Considerations

### Second Stage Transactions

- ▶ Risk of overleveraging
  - If company is overleveraged, can seller note be refinanced or extended
  - DOL position – Field Assistance Bulletin 2002-1
- ▶ Risk of reducing the value of existing participants' company stock accounts
  - Possible solutions
    - Valuation protocol
    - Deferred distributions

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## Control Considerations

- ▶ Whether or not to sell a controlling interest?
  - What is control?
    - Control of Board of Directors
    - Control of Plan Committee
  - When is it necessary for seller to keep control?
    - When selling a minority interest
    - When selling a majority interest in exchange for a seller note
    - When selling a majority interest for cash, but lending bank still requires seller's guarantee

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## Control Considerations

- ▶ Advantage of retaining control
  - Assures that seller note and/or bank loan will be repaid
  - Assures that company will continue to be properly managed
  - Provide time to properly train successor management
- ▶ Disadvantage
  - Seller will not get control premium price
  - Seller must continue managing the business

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## Control Considerations

- ▶ Advantage of giving up control
  - Seller will get control premium price
  - Seller can retire from active management
  - Accomplish the transition to new management
- ▶ Disadvantages
  - Seller will no longer be able to control operations and or feel involved
  - Seller note, if any, may be less secure

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## Control Considerations

- ▶ Alternatives to giving up control
  - Give up control, but retain input and influence by staying on the Board of Directors and on the Plan Committee
  - Give up control but retain loan covenants that prohibit certain corporate actions
  - Give up control, but retain right to regain control in the event of a payment default on the seller's note

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## Corporate Governance

- ▶ If seller keeps control
  - Seller must be mindful of fiduciary obligation to manage the ESOP in the best interests of the participants
- ▶ If seller transfers control to others after completing a second or third stage transaction
  - Seller may be liable for fiduciary breach if his successor is not properly qualified

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## Incentive Plans for Key Employees

- ▶ To motivate or not to motivate?
  - Why an incentive plan for key employees is needed
    - Key employees receive a relatively small percentage of the ESOP shares
    - Banks and some large suppliers may require that key employees have skin in the game
  - Available tools
    - Deferred Compensation
    - Phantom Stock Plans
    - Stock Appreciation Rights (SARs)
    - Stock Options
    - Stock Purchase Plans
    - Management Stock Bonus Plans

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## Incentive Plans for Key Employees

- ▶ To motivate or not to motivate?
  - Deferred Compensation
    - Advantage
      - Simple and easy to administer
    - Disadvantage
      - No equity potential
  - Phantom Stock Plan
    - Advantage
      - Has equity potential
    - Disadvantage
      - Not actual stock
  - Stock Appreciation Rights
    - Advantage
      - Has equity potential
    - Disadvantage
      - Has value only if stock appreciates
      - Not actual stock

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## Incentive Plans for Key Employees

- ▶ To motivate or not to motivate?
  - Stock Option Plan
    - Advantages
      - Has equity potential
      - Is actual stock
    - Disadvantages
      - Has value only if stock appreciates
      - Employee has to pay the exercise price
  - Stock Purchase Plan
    - Structure
      - Employee buys newly-issued stock from the company, or
      - Employee buys outstanding stock from existing shareholders

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## Incentive Plans for Key Employees

- ▶ To motivate or not to motivate?
  - Stock Purchase Plans
    - Is actual stock
    - Company and/or selling shareholders receive cash for shares sold
    - Direct purchase from a selling shareholder is especially feasible in the case of S corps. Key employees can purchase shares from existing shareholders in exchange for promissory notes that can be paid off with future funds that such employees receive as their share S corp distributions
  - Disadvantage
    - In the case of C corps, key employees are seldom able to finance the direct purchase of company stock

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## Incentive Plans for Key Employees

- ▶ To motivate or not to motivate?
  - Management Stock Bonus Plans (MSBPs)
    - Structure
      - Company grants newly-issued shares to key employees on a year-by-year basis based upon the attainment of performance goals, such as exceeding a base level of projected profits
      - These shares are forfeitable and non-transferable until the employee retires, dies or becomes disabled
      - The employees is not taxable on these shares until the forfeiture restrictions are removed
    - Advantages
      - Is actual stock
      - Employee does not have to pay money out of pocket
    - Disadvantages
      - Can be dilutive unless strictly based upon performance

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## Incentive Plans for Key Employees

- ▶ To motivate or not to motivate?
  - Legal and financial issues
    - Incentive plans are treated as a current expense for financial statement purposes. Thus, the company must be careful not to overly dilute its pre-tax earnings by issuing too much incentive compensation in any given year
    - Management Stock Bonus Plans and Stock Option Plans result in the issuance of new shares of company stock. Thus, the company must be careful to not overly dilute its shareholder equity by issuing too many shares of company stock in a given year

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## Options and Alternatives for Structuring ESOP Transactions

# Illustrative Case Histories

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## Alternative Structures

### ▶ Sale to ESOP with seller note from the company

- Objective
  - Wind up with a seller note from the company rather than from the ESOP
    - Company note is more secure
    - If cash flow declines, company note can be extended; ESOP note cannot be extended without risk of fiduciary liability
- Applications
  - Can be used either by C corps or by S corps
  - Can be used either in taxable transactions or 1042 transactions

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## Alternative Structures

- ▶ Sale to ESOP with seller note from the company
  - Steps in the transaction
    - This example assumes a 1042 C-corp transaction
    - Company obtains a one-day bank loan for, say, \$2.7 million to purchase 30% under 1042.
    - Company lends \$3 million, including \$300,000 of company cash, to the ESOP in exchange for a \$3 million promissory note payable over 10 years

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## Alternative Structures

- ▶ Sale to ESOP with seller note from the company
  - ESOP purchases \$3 million of company stock in exchange for cash
  - Seller purchases \$3.0 million of QRP on margin for \$300,000 and elects 1042 treatment
  - Seller lends \$2.7 million back to the company in exchange for a promissory note payable over 6 years. Company pledges back company assets to secure this note
  - Company repays the \$2.7 bank loan

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## Alternative Structures

### ▶ Simultaneous ESOP purchase and stock redemption

- Objectives
  - Minimize any potential liability for selling company stock to the ESOP at more than fair market value
  - If part of the proceeds is a seller note, give the seller a direct company note rather than a note from the ESOP
  - If part of the proceeds is an unsecured seller note, give the seller a mezzanine rate of return
    - Deferred interest (taxable as ordinary income)
    - Stock warrants (taxable for the most part as capital gains)
- Applications
  - Can be used either by a C corp or by an S corp
  - Cannot be used in a 1042 transaction. A tax-free rollover election requires that the stock be sold directly to the ESOP

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## Alternative Structures

### ▶ Simultaneous ESOP purchase and stock redemption

- Steps in the transaction
  - ESOP purchases 1% of the company stock in exchange for a promissory note payable over 10 years (or 15 years in the case of a very large transaction)
    - ESOP may purchase newly issued shares from the company,
    - or
    - ESOP may purchase outstanding shares from existing shareholders.

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## Alternative Structures

### ▶ Simultaneous ESOP purchase and stock redemption

- Steps in the transaction
  - Company redeems the remaining shares that are available for sale in exchange for seller notes
    - Under current law (EGTRRA,) stock redemptions, whether they be partial stock redemptions or total stock redemptions, qualify for capital gains treatment
- Legal issues
  - State law may prohibit a stock redemption if this causes the company to have a negative net worth
  - The fiduciary issues under this type of transaction may the use of an independent fiduciary and the procurement of a fairness opinion from the independent appraiser

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## Alternative Structures

### Second Stage Transactions

### ▶ Simultaneous ESOP purchase and stock redemption

- Where prior ESOP loan is outstanding this structure helps to avoid exceeding the IRS limits on deductible contributions and annual additions
- Because fewer shares are outstanding after the redemption, the negative valuation impact of the new debt is offset by an increase in the total value per share of outstanding shares

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## Alternative Structures

- ▶ Asset purchase by ESOP-owned company
  - Objective
    - Due to pending liabilities, ESOP wants to purchase assets rather than stock, or
    - Seller wants to sell assets in exchange for cash, a seller note, and an earn-out provision
  - Applications
    - Can be used either by a C corp or an S corp
    - Cannot be used in a 1042 transaction

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## Alternative Structures

- ▶ Asset purchase by ESOP-owned company
  - Steps in the transaction
    - Management forms a Newco with paid-in capital of \$10,000
    - Newco Establishes an ESOP
    - ESOP purchases all of the outstanding stock of Newco in exchange for a promissory note in the amount of \$10,000 payable over a term of 10 or 15 years.

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## Alternative Structures

- ▶ Asset purchase by ESOP-owned firm
  - Steps in the transaction
    - Newco borrows say, \$10 million from a bank, secured by the assets to be purchased
    - Newco purchases the assets from company X in exchange for \$10 million of cash, a promissory note of, say, \$5 million, and an earn-out of up to \$5 million if earnings over the next 5 years exceeds projections

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## Alternative Structures

- ▶ Asset purchase by ESOP-owned firm
  - Legal issues
    - The sale of Newco stock will not qualify for capital gains treatment, but the taxable amount is very small
    - The fiduciary issues under this type of transaction may the use of an independent fiduciary and the procurement of a fairness opinion from the independent appraiser

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## Options and Alternatives for Structuring ESOP Transactions

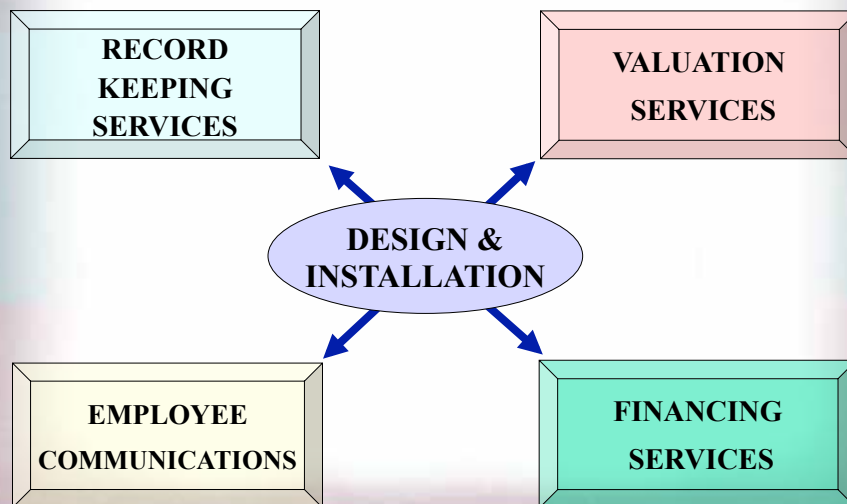
# Questions and Answers

A copy of this web seminar will be available on our website within 24 hours.

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## Menke & Associates Total ESOP Servicing



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# The End

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