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Nuts and Bolts of Leveraged ESOP Finance

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The Leveraged ESOP

What is an ESOP?

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- An Employee Stock Ownership Plan (“ESOP”) (like a 401K) is a qualified retirement plan which is allowed to purchase equity securities of the plan sponsor. Tax advantages include deductible contributions, tax exempt earnings, and deferred taxation until distributions are paid to participants.
- Privately-held companies use ESOPs to allow for a continuation of the business in lieu of a conventional sale and to provide a vehicle for employees to become owners of their employer.

What is an ESOP? (cont.)

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- ESOP transactions provide unique tax benefits to the seller(s). Selling shareholders can re-invest sales proceeds in qualified replacement securities (also known as a IRC § 1042 rollover) and defer capital gains tax.
- ESOP legislation permits insider transactions between the ESOP and the sponsoring corporation and its shareholders to be exempt from tax penalties and fiduciary prohibitions.

The Basic Leveraged ESOP Transaction

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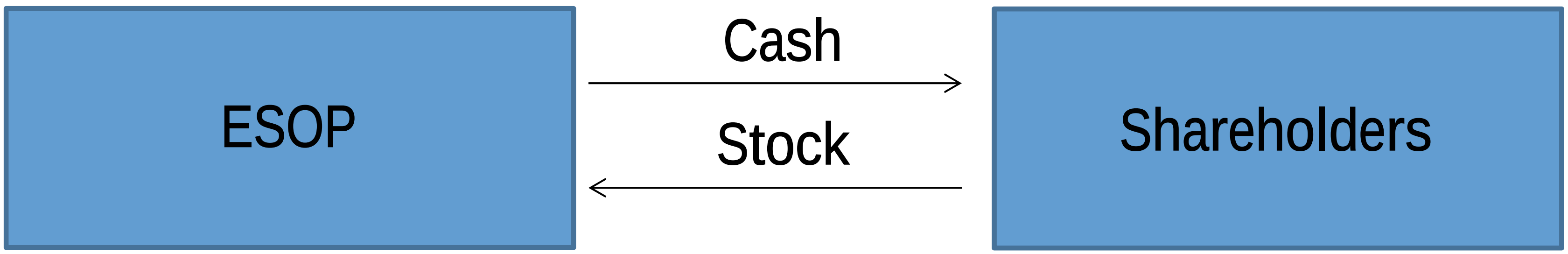
The ESOP sponsor will establish a Trust pursuant to the ESOP to purchase the stock of the Company from the shareholders. The stock purchase agreement will be similar to such agreements with third parties although security provisions for payment of obligations will differ.

The trustee of the Trust can be an individual or an institution.



The Basic Leveraged ESOP Transaction (cont.)

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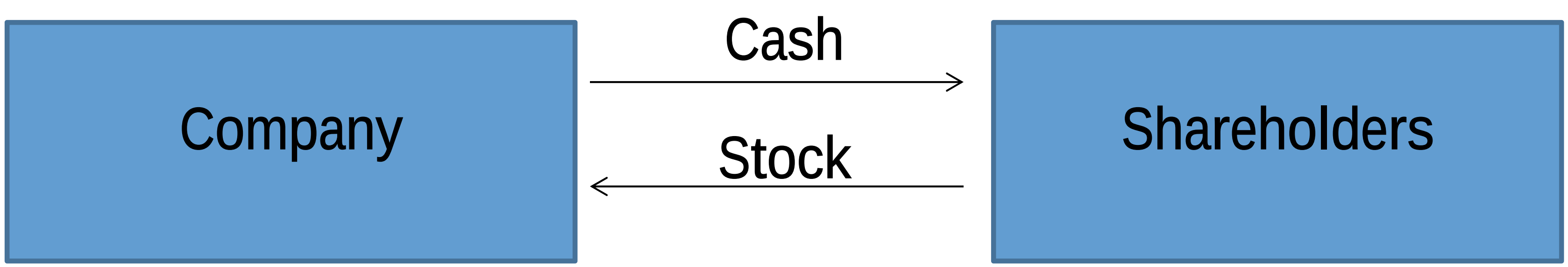
Like a conventional stock purchase transaction, an ESOP transaction can be for all or part of the outstanding stock of the company. For the selling shareholders to receive tax advantages, the ESOP must obtain 30% or more of Company stock and the sponsoring Company must be a C corporation.

An ESOP transaction is an alternative to a stock redemption or third party sale.



The Basic Leveraged ESOP Transaction (cont.)

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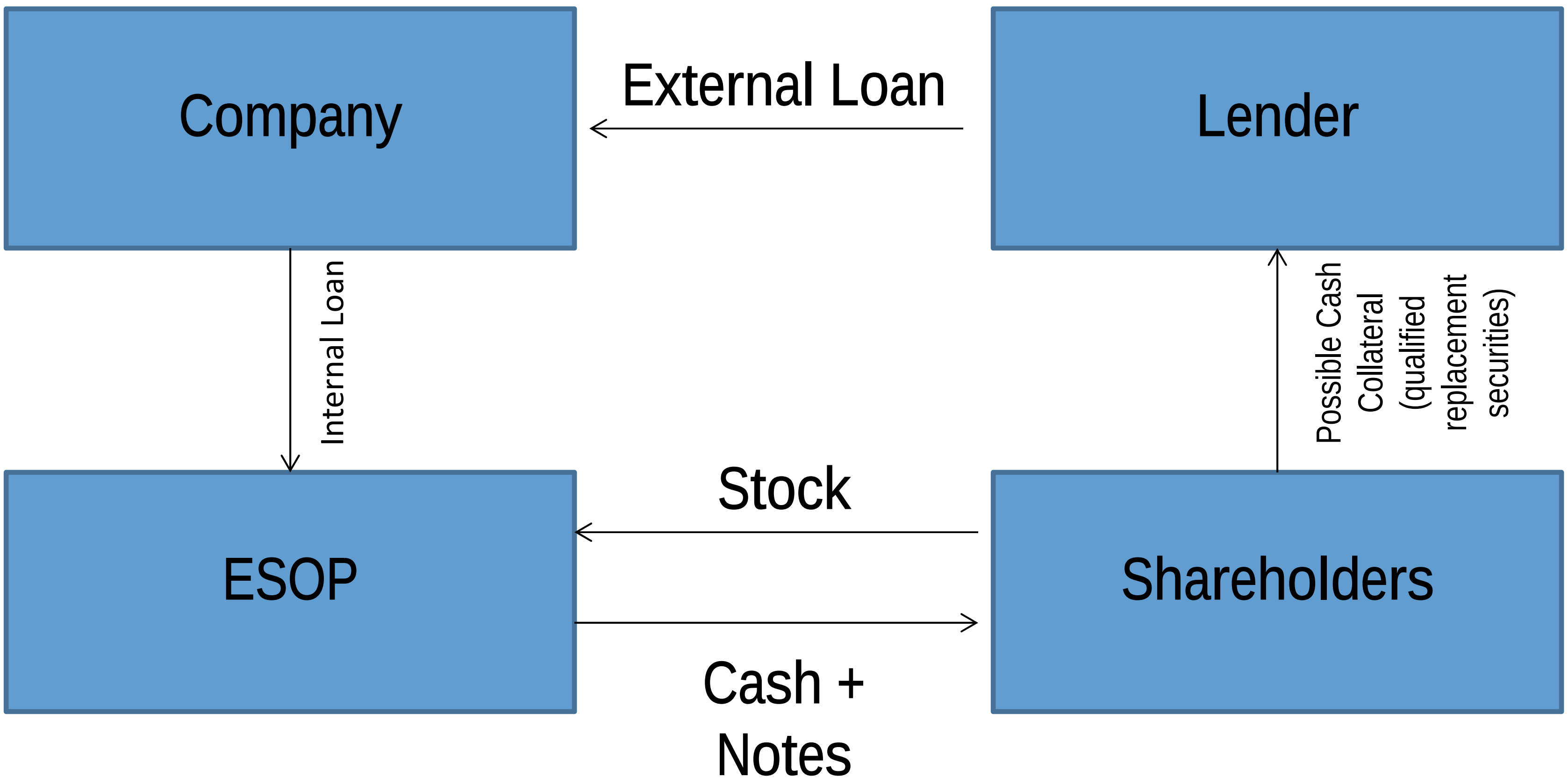
Purchase of Existing Shares



The Basic Leveraged ESOP Transaction (cont.)

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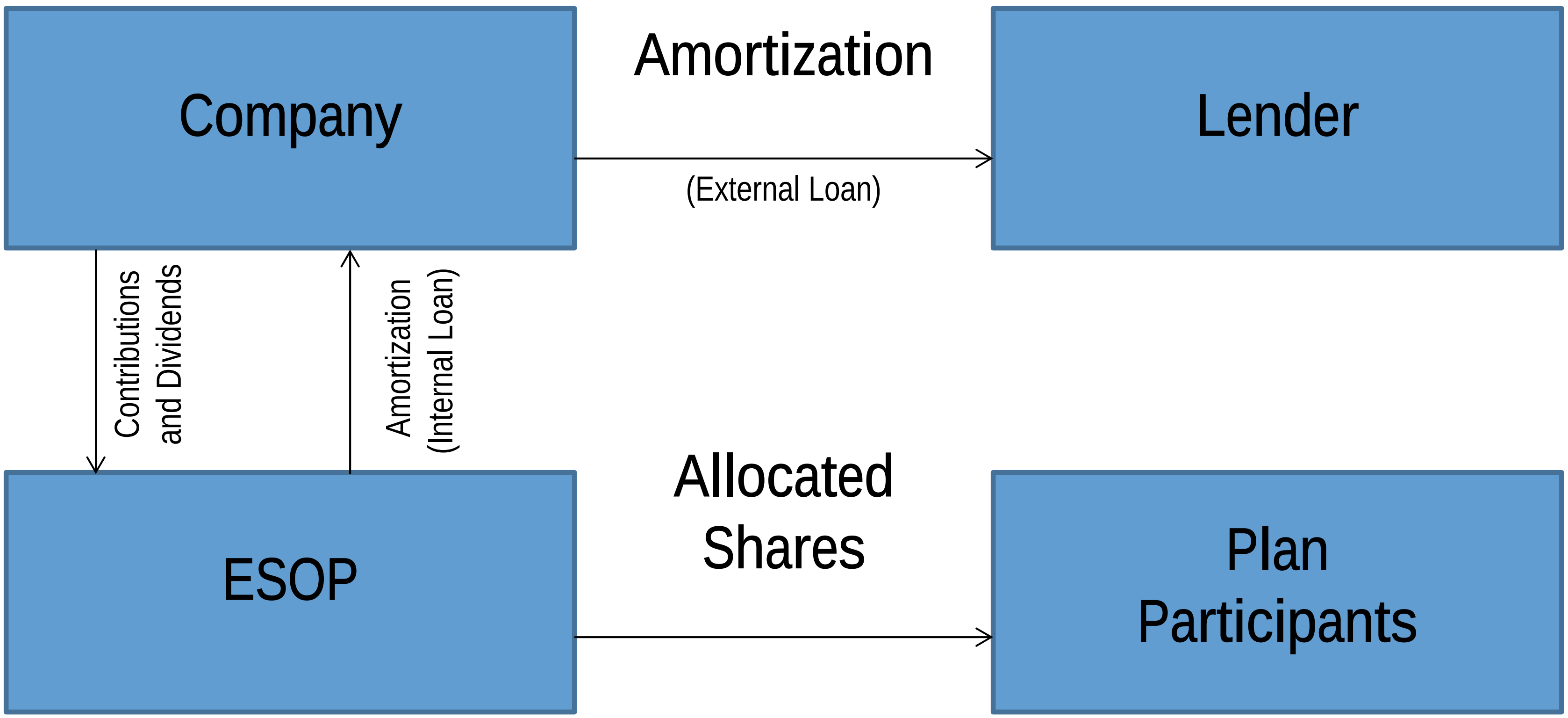
Amortization of the Loans – external and internal loans may amortize differently.



Requirements

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- Purchase Price for the stock must not exceed the fair market value for the stock (no less favorable to the ESOP than "adequate consideration")
- Valuation opinion delivered by qualified independent appraiser, who meets the requirements of IRC § 170(a)(1)
  - Usually the Trustee engages a valuation expert who applies good faith procedures to determine fair market value.
  - Valuation must value stock at date of the transaction and be reflected in a written report. Report must describe financial valuation methodology used.
  - Independence required except ESOP sponsor can be responsible for payment of appraiser's fee, but appraiser reports only to Trustee.

Requirements (cont.)

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- The Trustee must determine that the purchase of the stock by the Trust is in the best interests of the ESOP participants - will rely on a “fairness” opinion from an ESOP valuation expert
- IRS Determination Letter
  - Confirms that the ESOP is qualified plan and document satisfies specific ESOP requirements
  - Often not issued prior to closing (particularly if ESOP is new)
- ESOP documents must include numerous operational requirements, including
  - Mandatory Distributions
  - Put Options
  - Diversification
  - Prohibited Allocations
- Operational requirements result in need for Company liquidity

Financing the ESOP Transaction

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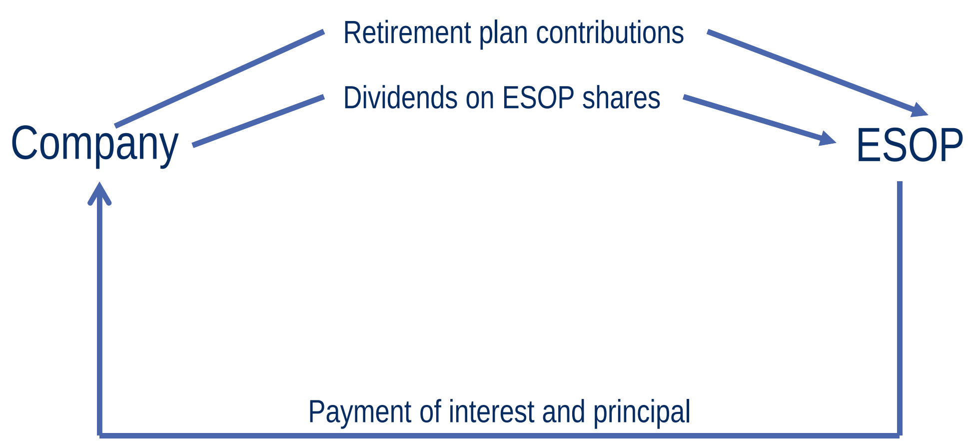
- Financing comes from the external loan
- The internal loan is designed to be repaid through annual deductible contributions to ESOP and dividends paid on stock purchased by ESOP
- Effect is tax deduction for funds used by ESOP to repay internal loan
- The repayment schedules on the internal and external loan need not be the same
- The participants get allocated shares annually as the internal loan is repaid

REPAYMENT OF INTERNAL LOAN



Debt Capacity Analysis

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- In order to determine how much can be borrowed to finance an ESOP, the lender must assess the excess debt capacity of the Company
- Debt capacity is generally determined by a company's EBITDA, market debt multiples and collateral
- Excess debt capacity equals total debt capacity minus total existing debt
- Excess debt capacity must be compared to the proposed purchase price to determine the amount that can be financed
- Lenders require adequate collateral as secondary source of repayment

Debt Capacity Analysis: Example (cont.)

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• EBITDA	$5,000,000
• Debt Multiple	3x
• Debt Capacity	$15,000,000
• Existing Debt	($3,000,000)
• Incremental Debt Capacity	$12,000,000

Debt Capacity Analysis (cont.)

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- The financing analysis must always provide a cushion of extra financing to provide for contingencies
- The quality of EBITDA must be considered

The Seller Financed ESOP: “Day Loan”

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Often used when the company’s incremental debt capacity is not sufficient to cover the purchase price for the stock

Example:

- $20,000,000 purchase price but the company can only obtain term debt of $5,000,000
- Company obtains $5,000,000 term loan from lender
- Company also obtains $15,000,000 “day loan” from lender
  - Generally but not necessarily the same as the term loan lender
- Company uses the $20,000,000 total loan proceeds to make the inside loan to the ESOP, which in turn uses the loan proceeds to acquire the stock from the seller(s)
- Seller uses $5,000,000 to acquire Qualified Replacement Property to comply with Section 1042 of the IRC
- Seller lends $15,000,000 to the company in exchange for a subordinated note and the company uses the $15,000,000 to repay the day loan.
- The day loan is often repaid on the same day it is made, hence the name.
- If the day loan lender is a bank, before the loan is made each of the company, the ESOP, and the seller establish deposit accounts at the bank. The loan proceeds are moved from account to account and then back to the bank to repay the loan. The cash never leaves the bank. The day loan is essentially cash-secured.

The Seller Financed ESOP: “Day Loan” (cont.)

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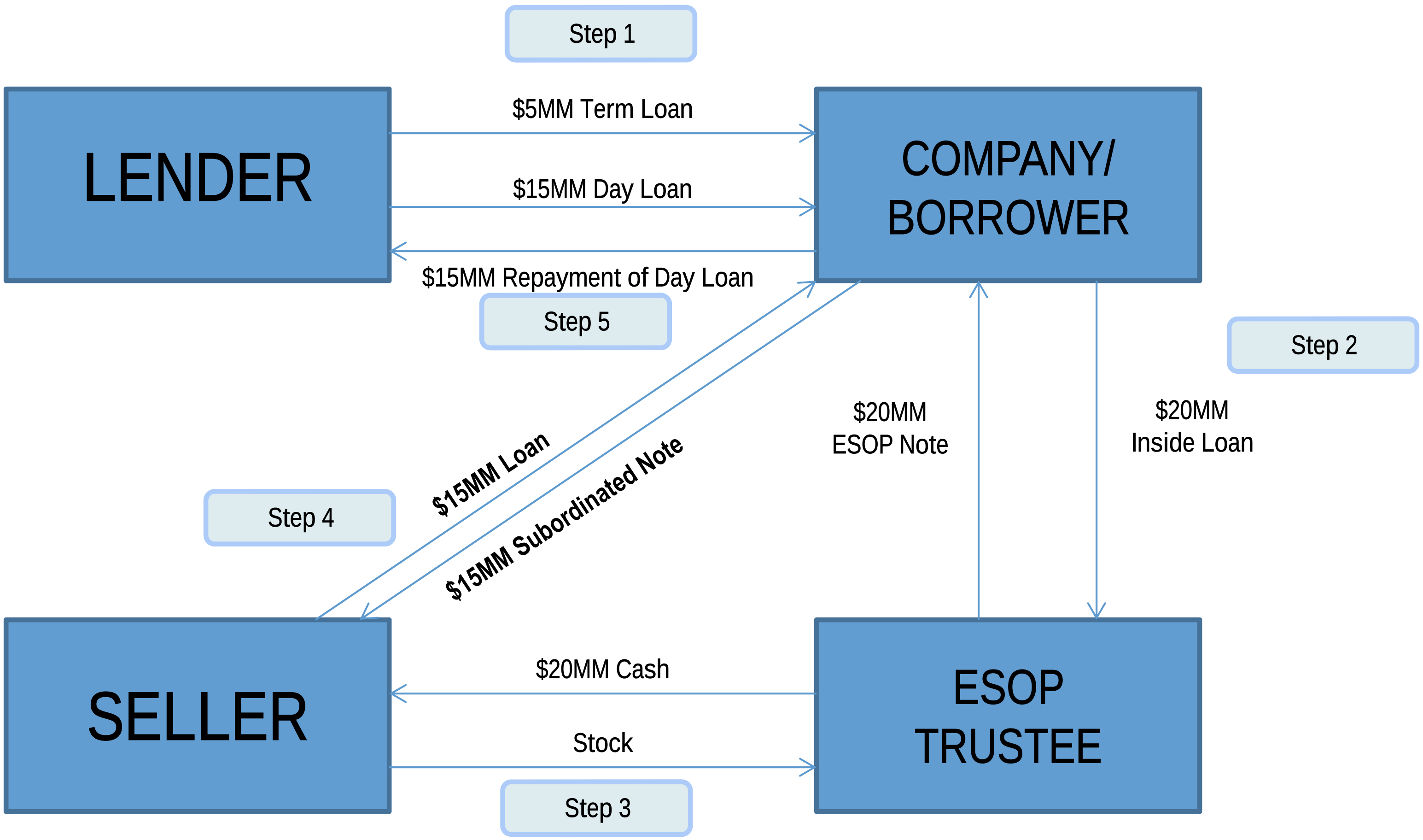
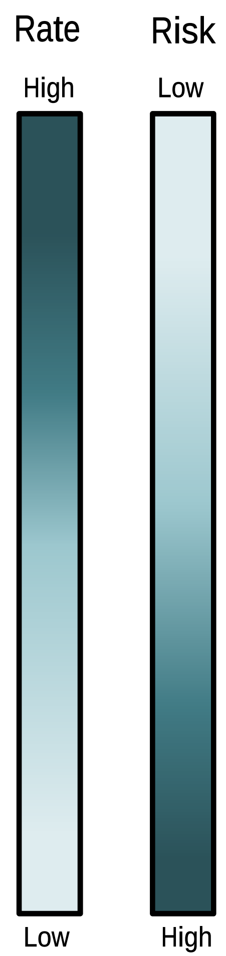


Financing Markets and Terms

Sources of ESOP Financing



Senior	• Senior lenders provide senior debt, on cash flow or asset backed basis, up to a multiple of EBITDA
Mezzanine/ Seller	• Mezzanine lenders can provide second lien and subordinated financing; seller paper is an alternative to mezzanine debt
PE/Seller	• Private equity can provide deeply subordinated equity-like debt financing, typically including a warrant package, or in some more complex structures, preferred stock; seller paper is an alternative to junior sub debt
Existing Qualified Plan	• Assets in an existing qualified plan (401k, overfunded Defined Benefit) can be transferred to the new ESOP by account holders to provide equity capital on a pre-tax basis

Customary Terms

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- Like any other business loan, loans to Companies with ESOPs are generally collateralized by all assets of the Company (there are limits on use of the internal loan as collateral)
- Collateral coverage (excess/shortfall) is determined by traditional asset-based methods
- Some modest collateral shortfalls (stretch piece) may be considered
- In general, major collateral shortfalls must be supported in some way
  - Pledge of 1042 rollover securities (the lender generally agrees to release the collateral from the pledge dollar for dollar as the term loan amortizes).
  - Personal guarantees of Seller(s)
- Pricing is deal specific

The Lender’s Perspective

The Lender’s Perspective

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- A loan used to fund an ESOP purchase of stock is a type of leveraged buy-out.
- A leveraged buy-out often renders the Company balance sheet insolvent.
- Transactions in which the borrower is rendered insolvent are open to challenge as a fraudulent transfer.
- The fraudulent transfer risk must be analyzed and quantified.
- ESOP accounting treats the leveraged ESOP loan as a “contra-equity” account often creating negative tangible net worth. The Lender needs to understand this and set financial covenants accordingly.
- ESOP requirements mandate a liquidity analysis of the Company’s repurchase obligation to its participants.

The Lender's Perspective (cont.)

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Underwriting should include analysis of:

- Strength and depth of management
- The long term ability of the business to generate cash flow and the existing and future claims on that cash flow. This includes an analysis of the following:
  - The stability of the income stream
  - The existing debt and required debt service
  - The future needs to fund capital investment and working capital
- Asset coverage and other credit support
- Solvency issues: Does the Company have sufficient capital to meet its obligations and run the business?

The Lender's Perspective (cont.)

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Important Lender Questions

- Identify total Company financing needs (including excess availability)
- Examine the impact on customers and current trade credit
- Examine the level of collateral coverage
- Determine the market for the Company's debt
- Determine the need for side collateral/mezzanine debt, seller paper or guarantees

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The Seller's Perspective – Tax Considerations

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- Tax free rollover of sales proceeds to securities portfolio – IRC § 1042 rollovers
  - Company must be C corporation (not S corporation)
  - If seller invests proceeds from sale to ESOP in qualified replacement property, gain not recognized
  - Qualified replacement property (QRP): stock and debt instruments (excludes obligations of government entities and certificates of deposit)
    - issued by domestic corporations that are
    - operating businesses (not an investment entity)
    - excludes entities that are related to the Company whose stock was sold to the ESOP
  - ESOP must own at least 30% of stock of the Company-measured by total value or by value of each class
  - QRP must be acquired within 3 months before or 12 months after the sale to ESOP
  - Gain remains deferred if QRP transferred by gift, to charity, in many standard estate planning transfers and may be eliminated at death (basis step up)

The Company's Perspective

The Company's Perspective

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- Company Deductions
  - Retirement plan contribution to ESOP is tax deductible
    - Generally, up to 25% of participant payroll
    - Compensation subject to limitations – $270,000 in 2017
  - Dividends paid by Company are deductible if Company is C corporation and
    - Paid to ESOP and/or through to participants, or
    - Used to repay ESOP (internal) loan, or
    - Used to purchase employer securities if participants are permitted to retain cash

The Company's Perspective (cont.)

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- Company Liquidity Requirements
  - Mandatory Distribution Requirements
    - ➢ Must offer cash to participant when making distributions or, if distributing stock must give participant right to put stock to Company (not ESOP)
    - ➢ ESOP can permit distributions to be deferred over 5 years
    - ➢ Exceptions for unallocated loan shares—release from suspense account as internal loan is repaid using either principal and interest method or principal only method (10 year cap on principal only)

The Company's Perspective (cont.)

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- Put Option
  - Employee must have right to put distributed shares to Company (not ESOP)
  - ESOP design allows shares to be distributed over up to 5 years
- Diversification Requirement
  - ESOP must permit participants to diversify accounts during a 6 year period
  - Applies to participants age 55 or older with 10 years of ESOP participation
  - Applies to 25% of participant's account (50% in the last year of the 6 year period)

- Repurchase obligation studies facilitate understanding of the Company's liquidity needs

The Company's Perspective (cont.)

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- Limits on Allocations to Insiders
  - Shares acquired by the ESOP in a transaction in which the Seller makes a qualified rollover can not be allocated to the selling shareholder, family members, or 25% shareholders of the ESOP company during the non-allocation period (generally 10 years from the rollover sale or while an ESOP loan is outstanding). Offsetting allocations can't be made to non-allocation persons.
    - Company is liable for a 50% penalty tax on the amount of the prohibited allocation
    - Participant will be treated as having received a taxable distribution of the allocated shares
    - ESOP will not be treated as a qualified ESOP

The Company's Perspective – S Corporations

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- S corporations
  - C corporation rules don't apply
    - Deductible dividend rules don't apply
    - Rollover of gain rules don't apply
  - 100% ESOP owned S corporation pays no federal income tax. Analysis of state tax required: California imposes 1.5% tax.
    - Tax liability will arise when ESOP participant receives distributions/payment for shares
    - Corporation charter or bylaws can prohibit participant from retention of shares and mandate buy-sell arrangement
    - S corporation ESOPs are subject to (under IRC § 409(p)) 50% excise tax if allocate employer securities to disqualified persons—10% shareholders, members of a 20% shareholder family group.
    - Similar rules subject S corporations to excise tax where ESOP allocations are made to synthetic equity holders

The Company's Perspective – LLC's

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- ESOPs not permitted for LLC's unless check-the-box or single-member LLC

The Company's Perspective
– ERISA (Fiduciary) Advantages

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- Avoids prohibitions on ERISA fiduciary permitting Plan to borrow or lend to related party, like the Company
- Avoids prohibitions on ERISA fiduciary permitting Plan to sell or exchange or extend/accept credit to/from related party, like Company, founder (shareholder) or officers or directors

Role of Bank Counsel

Role of Bank Counsel

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- Prepare Due Diligence Letter, Perfection Certificate and form of Landlord Waiver, and forward all to the Company or its counsel.
- Review and analyze the due diligence responses provided to the foregoing, including a review of:
  - the ESOP plan documents to determine whether the ESOP has received an IRS determination letter and, if not, whether the strategy anticipated to be employed by the Company to receive a favorable determination from the IRS based on the ESOP plan documents is likely to be successful
  - the stock purchase agreement and related documents between the ESOT and the selling shareholder(s)
  - the inside loan documents and pledge agreements between the Company and the ESOT
  - the independent valuation of the stock of the Company to be acquired by the ESOT
  - the contracts between the trustee of the ESOP and the Company
  - the projections prepared by the company to determine whether the Company will be able to contribute to the ESOT sufficient funds to allow the inside loan between the Company and the ESOT to be repaid.

Role of Bank Counsel (cont.)

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- Order UCC searches against the Company, any other parties providing collateral for the loan, and the seller of the ESOP shares, and prepare a summary of the UCC search results for lender review.
- Prepare and file a UCC-1 financing statement against the Company and any other party providing collateral for the loan.
- Prepare all loan documents that conform to the credit approval and any term sheet provided to the company, which loan documents will also contain representations, warranties, covenants and events of default that are usual and customary in leveraged ESOP loan transactions, including:
  - Representations regarding the legal status of the ESOT and the ESOP.
  - Representations regarding compliance with ERISA.
  - Representations that the ESOP is a qualified plan.
  - Representations regarding the authority of the ESOP trustee to execute the ESOP documents.
  - Representations regarding securities compliance.
  - Covenants regarding making contributions and/or distributions sufficient to amortize the inside loan.
  - Covenants to obtain an IRS determination letter if one has not already been issued.
  - Prohibitions on amending or terminating any of the ESOP documents.
  - Event of default if IRS determines that the ESOP is not a qualified plan or not an employee stock ownership plan within the meaning of ERISA.
- Advise the lender with respect to any comments or negotiations received from the other parties on the draft loan documents, and revise the loan documents as required.

Role of Bank Counsel (cont.)

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- Identify legal issues as they arise during the transaction and find practical solutions that work for all parties.
- Prepare a Closing Checklist.
- Coordinate the closing.
- Prepare Closing Binders and distribute to the parties.

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About Buchalter

Buchalter is a full-service business law firm that has been teaming with clients for over eight decades, providing legal counsel at all stages of their growth and evolution, and helping them meet the many legal challenges and decisions they face. Our clients are engaged in a diverse global economy governed by complex laws and regulations, and they trust us as advisers and business partners because we are involved in their world. They rely on our forward-thinking to help them resolve problems before they arise.

Our founding principle—providing our clients with the best business solutions—continues to lead us. We value each client relationship, recognizing that their success is our success. Our overarching goal—getting the best results for the client in a timely manner with sensitivity to cost—has engendered client loyalty, and the firm has grown from that loyalty.

About Ambrose Advisors

Ambrose Advisors, LLC (“Ambrose”), with offices in Newport Beach, CA; Riverside, CA; San Diego, CA; Dallas, TX; and Washington, DC, provides advisory services in the areas of mergers & acquisitions, ESOP buyouts, capital raising, valuation, strategic/financial consulting and ESOP legal services to a wide variety of private companies. Ambrose offers a multi-disciplinary professional team that is capable of providing a one-stop solution for entrepreneurs, shareholders and corporate boards of privately-held companies that are seeking liquidity using complex leveraged ESOP solutions. The principals of Ambrose have collectively completed more than 500 corporate finance transactions over their careers.

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- Capital Raising (Debt & Equity)
- Sales & Divestitures
- Acquisitions
- Management Buyouts

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- ESOP Third Party Administration
- Valuation & Fairness Opinion
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- Trustee Legal Counsel
- On-Going ERISA Counsel
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- Diversified Manufacturing
- Test & Measurement
- Oil & Gas Equipment
- Chemicals

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- Distribution
- Engineering
- Construction
- Business Services
- IT Services
- Professional Services

About Presenters

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Robert A. Willner is a Shareholder in the firm's Bank and Finance Practice Group in Los Angeles. His clients include international, national, regional and community banks, commercial finance companies, equipment leasing companies, factors, and other financial institutions. Mr. Willner specializes in asset-based lending, cash flow lending, acquisition financing (both stock and asset), debtor-in-possession financing, leveraged ESOP finance, equipment leasing, aircraft leasing, trade finance, factoring, problem loan workouts and restructurings, liquidations and foreclosures.

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Phillip is a managing director at Ambrose Advisors. He has nearly 15 years of relevant experience in investment banking and corporate strategy/development. He has advised clients across a wide spectrum of industries in the structuring and execution of ESOP buyouts, mergers & acquisitions, capital raising and valuation projects. Phillip oversees capital raising engagements and executes corporate finance transactions for Ambrose Advisors' investment banking division.