

ESOP: The Basics

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Overview



- ◆ ESOP Basics
- ◆ Mechanics of an ESOP
- ◆ ESOP Tax Incentives
- ◆ ESOP Valuation
- ◆ Additional Facts



What is an ESOP?

ESOP

- ◆ An Employee Stock Ownership Plan (“ESOP”) is a “qualified employee retirement plan that is designed to invest primarily in stock of the sponsoring company.
- ◆ The federal tax laws promote the use of ESOPs both as an employee benefit and as a technique of corporate finance.

ESOP (cont)

- ◆ Because an ESOP is a “qualified” plan, it must satisfy the discrimination, participation, vesting, distribution and other requirements of the Internal Revenue Code of 1986 (“IRC”) and the Employee Retirement Income Security Act of 1974 (“ERISA”)

Employer Security

- ◆ Basically, an “employer security” is common stock of the sponsoring company that
 - Has a combination of voting power and dividend rights at least equal to any other securities of the sponsoring company.

Components of an ESOP

- ◆ An ESOP has two components
 - The plan document itself, which sets forth in writing the terms of the ESOP
 - The trust agreement, which sets forth in writing the powers, duties and other rights and responsibilities of the trustee.

Trustee of an ESOP

- ◆ Corporate officers of the sponsoring company often serve as the trustees.
- ◆ The sponsoring company may, however, appoint a corporate trustee.
- ◆ Trustee votes the ESOP shares except major decisions (sale, liquidation, mergers, recapitalization)

Leveraged ESOPs

- ◆ A leveraged ESOP borrows funds to purchase employer securities.
- ◆ The loan to the ESOP can be made by the sponsoring company, or it can be made by a bank or financial institution and guaranteed by the company.

Leveraged ESOPs (cont)

- ◆ The stock purchased with the loan proceeds is held in trust by the ESOP trustee in a separate “suspense” account, as collateral for the loans.
- ◆ As the loan is repaid, the trustee allocates stock from the suspense account to separate accounts established for each employee participating in the ESOP.



Allocations

- ◆ The amounts allocated to each participant's account remain in trust.

Contributions

- ◆ The employer makes contributions to the leveraged ESOP that are then used to repay the principal of the ESOP loan.
- ◆ These contributions are deductible to the employer in an amount up to 25% of the aggregate compensation of all ESOP participants.

When an Employee Leaves the Company

- ◆ If an employee retires or, in most cases, if he dies or is disabled, he will be 100% vested in all of the cash and employer securities in his account.
- ◆ Each employee who participates in the ESOP may designate a beneficiary who will be entitled to the participant's vested interest on the participant's death.
- ◆ A participant may receive his ESOP benefit in a lump sum distribution during a single taxable year or in several annual installments.

Put Rights

- ◆ Participants receiving employer securities of a private company as a distribution have a right to “put” those securities to the employer during certain specified time periods.



How Does an ESOP Work?



Loan Directly to the ESOP

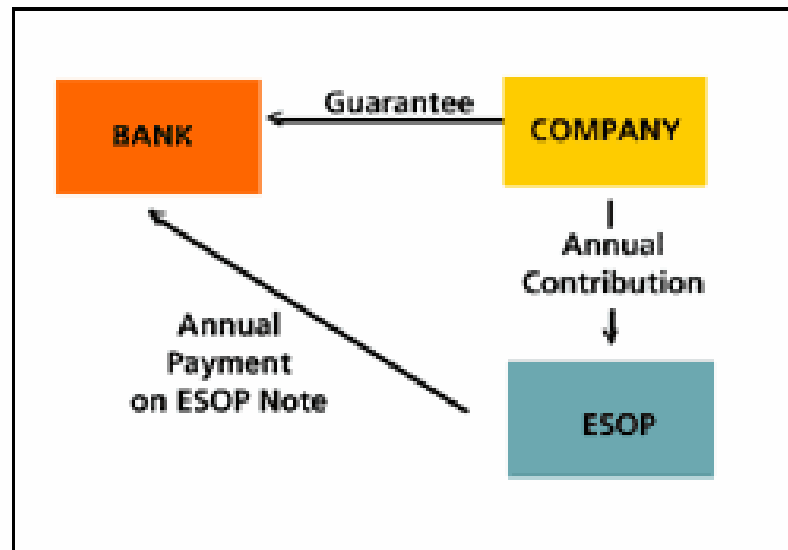
- ◆ The ESOP may borrow directly from a bank, with a guarantee from the sponsoring company.

Transaction Structure

- ◆ The company establishes an ESOP
- ◆ The ESOP enters into a contract to purchase a specified number of shares of employer securities from the existing shareholders or the company for a specified price.

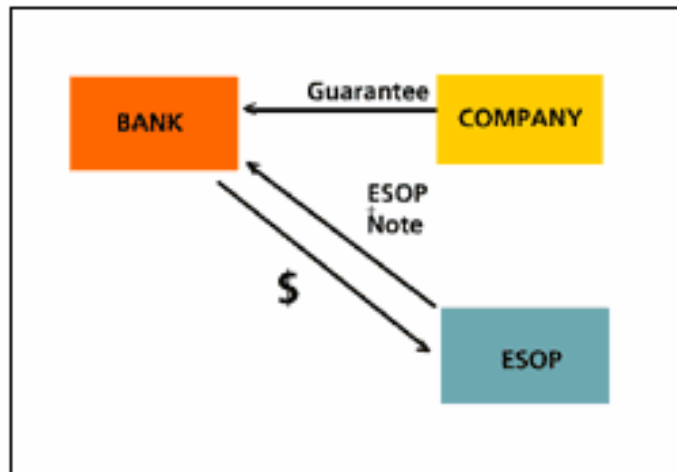
Transaction Structure (cont)

- ◆ The ESOP borrows the purchase price of the employer securities from a bank.



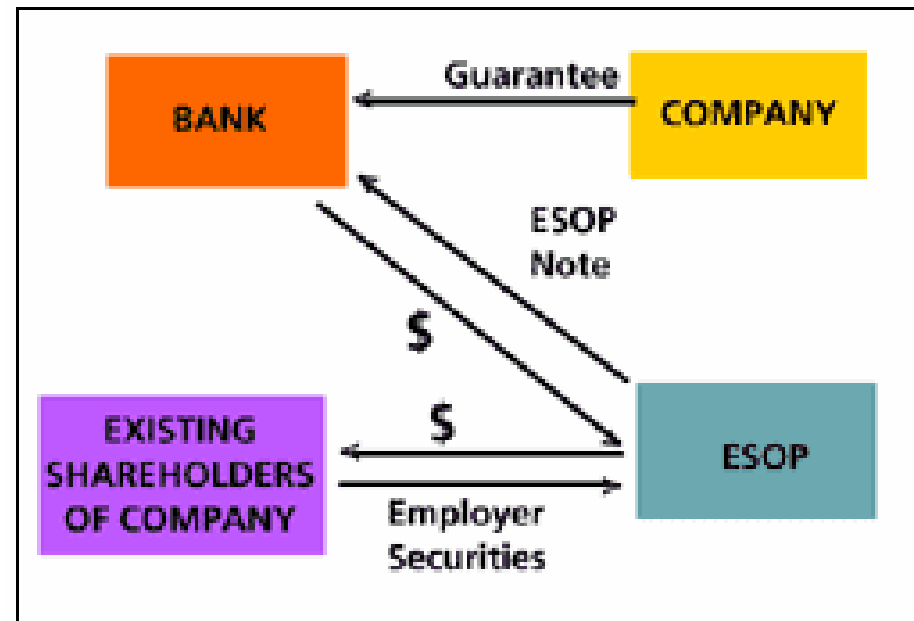
Transaction Structure (cont)

- ◆ The ESOP then uses the proceeds of the ESOP loan to purchase the stock from the existing shareholders or the company.



Transaction Structure (cont)

- ◆ Each year, the company makes a tax deductible contribution to the ESOP, sufficient to enable the ESOP to make its annual debt repayment on the ESOP Note to the bank.





Tax Incentives

Selected ESOP Tax Incentives

- ◆ Deduction of Principal
- ◆ Non recognition of Gain on Sale of Employer Securities to an ESOP (1042 “tax free rollover”)
- ◆ Employee participants are not taxed on stock allocated to their accounts until they receive distributions.
- ◆ ESOP ownership in S corporation receives distributions with no federal tax liability thereon.



ESOP Valuation



Valuation

- ◆ All assets held by an ESOP, including employer securities, must be valued at least once a year on a specified date, generally the last day of the plan year.
- ◆ If any assets in the ESOP are employer securities that are not publicly traded, the annual valuation of such securities must be done by an independent appraiser.



Additional Facts

How is an ESOP transaction similar to all transactions?

- Same in all material respects
- Same financial statement analysis
- Same methodology
- Same documents requested by buyer
- Financing - banks are sometimes more willing to lend to an ESOP
- ESOP is no different than any other buyer or seller assuming the terms of the transaction make sense

Advantages related to ESOPs that facilitate getting deals done

- Flexibility in ownership interest acquired (less than 100%)
- Willing buyer
- Set up fees typically lower than investment bank/broker fees



Disadvantages

- ◆ Annual Administrative Fees
- ◆ Fair Market Value vs. Strategic Value
- ◆ Repurchase Obligation

Establishing the ESOP

- ◆ Normally requires feasibility study
- ◆ Requires ESOP attorney to draft plan documents
- ◆ Requires an independent valuation
- ◆ Requires a knowledgeable ESOP lender
- ◆ In some case, may require a fairness opinion
- ◆ Trustee: Independent? Institutional? Both?

Transaction Matrix

	ESOP	Traditional Sale	MBO
Value	Negotiated, similar to private market	Private market based	May depend largely on financing
Tax Consequences	Capital gains tax can be deferred indefinitely	Proceeds subject to capital gains tax	Proceeds subject to capital gains tax
Debt Amortization	ESOP debt principal payments are tax deductible	Conventional debt principal payments are not deductible	Conventional debt principal payments are not deductible
Liquidity	30% to 100% sale at owners' discretion	Usually 100%, smaller deals more difficult to achieve	100%
Feasibility	Company must be able to assume leverage	Typically needs strong growth prospects	Management needs capital or enough growth potential to attract a sponsor
Timing	Relatively quick since buyer already in place; 60 to 120 days	Typically 4 to 12 months	Typically 5 to 12 months
Legal & Regulatory Issues	ERISA, corporate, labor, securities and tax law	Corporate law	Corporate law
Management Continuity	Can sell control and still manage, or leave business entity	Management involvement may end	Management involvement usually ends with ownership less than 10%
Market Conditions	Debt market tight now but specialized ESOP lenders available	M&A market has slowed	Usually requires deep pocket equity sponsor

National Center for Employee Ownership

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