

## Typical transaction structures for a minority ownership deal

Many companies prefer to undergo a minority ESOP ownership transaction first for a variety of reasons.



**Looking at ESOPs**  
Stephen Magowan

In previous articles for *The Zweig Letter*, I have outlined

some of the basic rules of using employee stock ownership plans (ESOPs) for business succession planning, some of the key financial and estate planning opportunities for business owners considering an ESOP transaction, and the basics of ESOP feasibility studies.

I have also shown why an ESOP could be a viable business ownership succession tool in these challenging economic times. In this issue, I will explore the basics of how a transaction is funded in the case of a transaction where the ESOP is buying less than 50% of the company.

### What is an ESOP?

Let's briefly review what an ESOP is. An ESOP, or "employee stock ownership plan," is a qualified retirement plan under federal law. ESOPs are governed by special rules contained in the Internal Revenue Code and the Employee Retirement Income Security Act.

ESOPs can be used to acquire the business owner's stock in a tax-efficient basis and offer a way for an owner to get liquidity for his or her business ownership. Partially or wholly ESOP-owned businesses that adopt an inclusive culture of teaching employees about the business statistically do better than their counterparts that are not ESOP-owned. ESOPs also enjoy significant tax benefits, among which are that 100% ESOP-owned companies do not pay federal income taxes on their profits.

### Why a minority transaction?

Although we find increasingly that companies will go from 0% ESOP ownership to 100% ESOP ownership in one transaction, many companies prefer to undergo a minority ESOP ownership transaction first. The reasons for doing a minori-

ty transaction could include any or all of the following:

- 1) A desire to maintain majority ownership in non-ESOP shareholders.
- 2) A desire to have the ESOP adopted in stages, so that the transition to 100% ownership can come in phases as all employees get more used to the ESOP structure.
- 3) A need to ease the burden of financing the ESOP transaction so that the company bites off chunks of the deal in small bits.
- 4) A sense that it will be easier to do a small transaction to start the transition before a larger one is undertaken.
- 5) The feasibility study shows that a minority ESOP deal is workable, but a majority or 100% deal is not feasible from a financial point of view for you and your company.

### Basic structure of a minority ESOP transaction

**Bank financing.** In a bank or similar lender-financed transaction, the company will enter into a loan agreement (including potentially just borrowing under an existing line of credit), then loan these bank funds to the ESOP, which will use the funds to purchase the stock from the seller or sellers. For example, let's say the transaction is for \$2 million.

The company will borrow the funds from the bank, lend the \$2 million to the ESOP and then the ESOP will pay the \$2 million to the sellers. The terms of the company to ESOP loan (i.e., interest rate and time of payment) may or may not mirror the bank loan terms. This is something you will figure out as part of your feasibility plan.

**Seller financing with the ESOP is not, in general, favored. This is because restructuring the ESOP seller note can be a challenge under U.S. Department of Labor rules.**

**Seller financing.** Seller financing can be used with or without bank financing. Seller financing can come from the company or the ESOP. If the seller sells to the company for a note, the company in turn will sell the stock to the ESOP for a note. Seller financing with the ESOP is not, in general, favored. This is because restructuring the ESOP seller note can be a challenge under U.S. Department of Labor rules. Company debt restructuring is much more feasible.

### Amount to be sold

Except as required under Code Section 1042, there is no minimum amount you have to sell to the ESOP. If your company is a Subchapter C corporation and you wish to defer paying taxes on the sale, then your ESOP must own at least 30% of the company after the transaction. We will discuss Section 1042 in greater depth in a column later this year.

This is just a brief overview. In a future issue of *The Zweig Letter*, I will describe a typical transaction where the ESOP goes to 100%, while enabling the company and the ESOP to enjoy significant tax benefits. ■

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