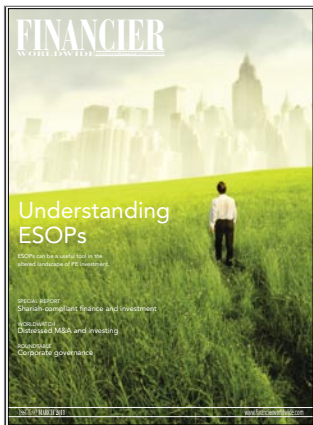


COVER STORY

UNDERSTANDING ESOPS



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Understanding ESOPs

BY MATT ATKINS

Incorporating Employee Stock Ownership Plans (ESOPs) into a leveraged buyout structure can bring many advantages. ESOPs may be used to fill a gap in the capital structure, derive additional tax benefits, increase cash flow and offset the target's other retirement benefit costs. They can also boost productivity and motivation. However, such deals also bring complex corporate governance issues and regulatory requirements, and there are many considerations when determining whether or not a company should consider an ESOP.

Historically, private equity firms have not often employed ESOPs in buyout situations, usually because in the past PE firms could easily raise capital. This situation has now altered, and PE firms may find the utilisation of ESOPs a more attractive option if financing challenges persist and corporate tax rates and rules continue to change.

Tax benefits

A number of benefits make ESOPs a compelling choice when structuring a leveraged buyout. Those benefits cited most often by financial advisers are the tax advantages that the plan allows, which serve to increase cash flow. "ESOPs are attractive in leverage buyouts because of the ability of the corporation to repay acquisition debt from pre-tax company profits," says Jim Steiker, chairman and CEO of SES Advisors Inc. "This works particularly well where there is both a high degree of anticipated profitability and a high degree of leverage."

If an ESOP is used to finance a buyout, not only will interest on the loan be deductible but so will principal repayments, explains David Ackerman, a partner at Morgan, Lewis & Bockius LLP. "This substantially reduces the cost of ESOP financing as compared to other available types of financing. In addition, if an ESOP is used, and if the company makes the S election under US federal income tax laws, the company's income will be shielded from tax on that percentage of its income equal to the ESOP's stock ownership percentage." Furthermore, ESOP companies where the ESOP owns 100 percent of the stock of an S corporation avoid all current Federal income tax at both a corporate and shareholder level.

Those companies that do not meet the requirements of an S corporation still benefit, says J. Michael Keeling, president of The ESOP Association. "In a C corporation, dividends used to pay ESOP debt are tax deductible, and if the leveraged buyout involved a privately held company, sellers may be able to defer capital gains taxes. But setting aside these tax advantages, the evidence is overwhelming that a well-managed ESOP company is a very profitable business," he adds.

Employee performance

Including employees in the ownership structure has positive implications for increased performance and profitability. The ESOP model can help to boost productivity across a company's workforce, the ethos being that employees with a vested interest in their employer, beyond an annual salary, will be more enthusiastic and dedicated. The structure gives employees a greater sense of solidarity and reinforces the feeling that employer and employee are 'in it together'. Evidence for the trend has been found in numerous studies on the subject. A recent ESCA study of S Corporation Resilience indicates that ESOPs have survived the recession better than non-ESOP companies. "The data is overwhelming, showing that ESOP companies that combine ownership and participation outperform their non-ESOP counterparts as measured both by profitability and productivity and controlled for size and industry," says Mr Steiker. "The National Center for Employee Ownership (NCEO) has compiled numerous independent academic studies to this effect. ESOPs don't turn a sow's ear into a silk purse but do make good companies better."

Improved productivity is not guaranteed, however. Education and encouragement from managers is a must if employees are to fully understand and embrace the new business structure. Some company's do not get this right and the interests of the workforce and the PE firm are consequently misaligned. "Those managers that make a sustained concerted effort to educate and communicate key performance drivers to their employees see a demonstrable improvement in productivity and profits," says Kenneth E. Serwinski, a senior managing director at Prarie Capital Advisors Inc. "Research has consistently found that if employees understand what drives their business, understand cash flows, and understand its link to their personal wealth, productivity can increase from 8 to 11 percent. It would seem that the effort of communication pays off."

In addition to the potential boost in productivity, ESOPs can help firms hold onto valuable staff members. ESOPs can attract and retain key management and employees, which is particularly important in knowledge and service driven companies, where people are a primary asset. The ESOP can serve in place of, or alongside, other deferred compensation or equity compensation structures that may be stipulated.

Retirement provisions

Employee performance can be further improved by the potential retirement perks that an ESOP model can provide. The enhanced cash flow that results from the structure of the buyout means that very often there is more cash available to enhance retirement packages and other employee reward packages. ESOP companies typically provide a higher level of wages and retirement benefits, on average, than their non-ESOP counterparts. A comprehensive study, concentrating on ESOP firms in the US State of Washington, found that retirement assets were roughly three times as great as in comparable non-ESOP companies. Higher up the chain, many ESOP companies also offer phantom stock, stock appreciation rights and other types of incentives for executives, often as a means of guaranteeing their service after the transaction is completed.

ESOPs can offer all the benefits of a retirement plan, according to Robert Brown, founding partner and CEO of Boylan, Brown, Code, Vigdor & Wilson. "An ESOP is a qualified retirement plan which invests primarily in employer securities. Employees, as participants in the ESOP, have a beneficial interest in the stock of a company. Each participant has an individual account, the value of which is generally distributable following death, disability, retirement or separation from service. As the company does well and its stock appreciates in value, the account balances of the participants will likewise increase in value," he explains.

But employees who base their retirement exclusively on the stock value of their own company may not be making the wisest choice. The risk remains that em- ►►

In tandem with the advantages that an ESOP brings come a great deal of corporate governance considerations and regulatory requirements.

employees who count on employer stock can see their retirement plans turn to dust if the business fails, or at least see a substantial decline in what they expected. For this reason, many employee ownership companies try to get the message across to their employees that their stock ownership is an important investment, but not a retirement plan in itself.

A survey of ESOP Association members revealed that approximately 90 percent offer retirement savings plans in addition to the ESOP. In the US, ESOP plans are often paired with a 401k plan, allowing employees to accumulate savings along with their ESOP accumulations. These plans often include a contributory component of 2 to 5 percent. Though not all companies match the contribution, employer matches are often necessary to attract enough participation in the 401k plan by lower-paid employees and avoid violating anti-discrimination rules.

Corporate governance

In tandem with the advantages that an ESOP brings come a great deal of corporate governance considerations and regulatory requirements, one of which is related to employee performance. Following the creation of an ESOP, the board and management must implement communication and participation plans in order to educate employees about the risks and rewards of the plan. More significantly, corporate governance issues in an ESOP company generally include the size and composition of the board of directors, and the inclusion of independent outsiders. The legal framework surrounding ESOP companies often permits flexibility in their design with respect to the level of participation of ESOP trustees and participants

in the governance of a corporation. This range of participation may extend from a very limited impact on governance in some companies to situations in which ESOP participants vote on all issues put before shareholders.

ESOP companies generally do not differ too much in structure from their non-ESOP counterparts. As Mr Steiker points out, they generally follow a traditional corporate governance model where the board of directors is elected by the shareholders and the board appoints executive officers to run the company. "ESOP companies commonly have some outside independent directors nominated by a board-nominating committee. They differ from conventional companies more commonly in management practices, such as open book management and employee participation programs employed by some ESOP companies, rather than in governance," he adds.

In this sense, corporate governance issues do not differ significantly from any company attempting to create a sustainable business structure: the implementation of 'best practices' remains a central focus. One distinguishing point of an ESOP, however, is in the common practice of appointing an institutional trustee for the ESOP. "The principal difference lies in the requirement that the board seek an institutional trustee to represent the ESOP trust," Mr Serwinski explains. "The trustee has the responsibility to act in the best interest of the plan participants. The trustee is also responsible for approving the initial transaction and, on an ongoing basis, the administration of the plan as well as its requirement to have the company valued a minimum of once per year. Though trustees seldom seek board representation, they are engaged and often attend at least one board meeting per year. The trustee is appointed by the board and serves at its pleasure."

The trustee is the legal shareholder of stock held by the company's employees and is the only party who can attend shareholder meetings and vote on company stock held by the ESOP. The primary responsibility of the trustee is to protect the basic interests of the ESOP shareholders.

It should be made clear that the trustee's role is that of shareholder rather than a board member. The trustee does not oversee or govern the business operations of the company. That function is held by the board. The relationship between the ESOP trustee and the company's board of directors can be set up in two ways: either an 'independent' trustee makes decisions independently of the board on those things for which the trustee is required to vote, or a 'directed' trustee is directed by the board in how to vote and must follow such direction unless doing so would be contrary to the trustee's fiduciary duty.

Trustees are not obliged to answer to company management or its board of directors if their directives will place ESOP participants in jeopardy. In fact, ESOP trustees are required by law to act solely in the best interests of the employee shareholders. "The trustee of an ESOP company initially has a duty to assure that the ESOP does not pay too much for its shares and that the transaction is fair to the ESOP. Thereafter, the trustee must monitor the board of directors and management to assure that they are serving the best interests of the ESOP shareholder by maximising long term shareholder value," says ►►

Gregory Brown, a partner at Katten Muchin Rosenman LLP.

The US Employee Retirement Income Security Act (ERISA) requires that ESOP participants can instruct the trustee on voting of stock when major issues such as mergers, dissolution and recapitalisation arise, and, as important as acting in the best interest of ESOP participants, the trustee is required to uphold ERISA. ERISA lays out all the specific ways in which trustees must behave in accordance with the best interests of shareholders. Even if an ESOP trustee is ordered by the company ESOP Administration Committee (EAC) to act in a manner inconsistent with ERISA, the ESOP trustee must ignore the order.

In instances where an ESOP owns 100 percent of the company, the trustee, as the sole shareholder, will have the ability to appoint the board of directors. In turn, the board of directors has the ability to retain or fire the trustee. Mr R. Brown explains how this situation gives rise to additional corporate governance issues. "This type of circularity in corporate governance can at times create problems for the selling shareholder who may have a vested interest in remaining on the board. One method of resolving such a matter is for the selling shareholder to become a member, or sole member, of a nominating committee. The nominating committee is tasked with the job of nominating individuals who are eligible to sit on the board of directors. The ESOP, in turn, will have the authority to approve or disapprove those individuals nominated for election," he adds. As such, the selling shareholder will have power over who will ultimately comprise the board of directors and thereby avoid circularity of governance issues.

Regulation

Buyouts that make use of ESOPs face additional regulatory requirements. Two key obligations are that the ESOP has its own financial adviser and its own legal counsel, notes Mr G. Brown. "While an independent trustee is not required, it is advisable to have one to reduce regulatory scrutiny. The trustee team must work at all details to assure fair treatment of the ESOP including, but not limited to, executive stock based compensation and other deferred compensation. "Regulators are challenging employers' provision of indemnity to trustees, so getting fiduciary insurance is advisable," he suggests.

ERISA provides much of the regulatory requirements in the US, with specific rules that govern participation, vesting, distributions and other aspects of ESOP ownership. In the leveraged buyout environment, the primary rules that affect ESOP transactions are the 409(p) restrictions on issuance of synthetic equity. These rules limit the underlying equity claims of PE firms or other investors to 49 percent, although the PE investor may retain substantive control of corporate governance. There are also limits to the benefits that can be received by participants in any one year and, as a result, employee benefit consultants are often sought in advance of the year's close.

Evaluate a potential deal

PE firms attracted to incorporating an ESOP into a private equity deal structure would be wise to consider a number of factors before pressing ahead. First, the firm must decide why it

is entering into the deal. If a firm is intent on a very short-term investment and return, with a quick exit, then an ESOP-structure is not the best strategy. However, firms looking to create long-term value and align the needs of a business and its staff may find incorporating an ESOP highly valuable.

Second, there are a number of aspects to mull over when identifying ESOP candidates. The candidate should be financially successful with a track record of reasonably predictable profitability and cash flow. Stable and well-established firms are a plus since their track record will help service acquisition-related obligations and secure the support of lending institutions. "Incorporating an ESOP into a private equity deal requires careful understanding of cash flow needs of all parties, corporate governance and the ultimate exit strategy," advises Mr G. Brown. "This will involve delicate balancing of PE investor expectations and ESOP participant retirement needs and meeting regulatory scrutiny. While this can all be quite challenging, it has been done and will continue to be done."

The maturity, morale and cohesion of a company are important issues to take into account. ESOPs are often not suitable for start-up organisations, failing industries or companies with a history of exceedingly volatile earnings. A capable successor management team is also important as it will be required to facilitate the repayment of the debt. Where communication is poor between management and employees, an ESOP will not achieve its full potential. Companies that communicate well with their employees are excellent candidates because rapport and trust is already established. "Employee involvement needs to be matched to employee sophistication, and employee communication needs to be forthright and open on those subjects that enhance the feeling of employee ownership," says Mr R. Brown. Likewise, the sophistication of the ESOP as a shareholder must not be underestimated, he explains. "If the ESOP is treated as a 'real' shareholder in the transaction, it is very likely that shareholder value will be enhanced across the board. If the ESOP is used only for its tax and financial benefits, the other benefits of effective employee participation will likely not be realised."

Finally, ESOPs can provide a way out for PE firms, if economic conditions deteriorate. Having an ESOP as part of the initial deal allows them to utilise that ESOP if and when an outside buyer fails to materialise, explains Mr Serwinski. "The ESOP can function as your best chance to realise liquidity when either the markets are not in your favour or you just need the liquidity to satisfy your investor group. The ESOP transaction can be a 'friendly' transaction for the PE group as it controls its implementation. This tax advantaged recapitalisation tool can be leveraged quickly and deals struck to create a success for all parties."

Private equity firms that fully understand ESOPs can benefit from their potential for tax-free earnings and improved employee performance. They must however be fully aware of the complex rules and regulations which surround the buyout structure if they are to maximise the rewards and avoid the potential pitfalls. Firms with a good understanding of the issues may well find ESOPs a useful tool in the altered landscape of PE investment, especially in years to come. ■

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