

Using Convertible Preferred Stock in ESOP Transactions

Robert E. Massengill

Owners thinking about implementing a C corporation ESOP should consider the use of convertible preferred stock to enhance the value for the ESOP and the seller(s). This article introduces the basic mechanics and considerations for using this technique, as well as an example for valuing and structuring a transaction using convertible preferred stock.

A corporation is typically capitalized with cash and/or property in return for an ownership interest. This ownership interest takes the form of shares of stock. In addition to representing an ownership claim, shares of stock create a voting mechanism and a ready means of exchanging value in the enterprise.

All corporations have *at least* one class of voting common stock. The number of shares created can be somewhat arbitrary and can be as few as one share. The total value of the equity of the corporation divided by the number of shares outstanding gives the price per share. The more shares outstanding, the lower the price per share for a given value, and vice versa. In addition to the voting common *class* of stock, shareholders may approve the creation of other classes of stock. Other classes of stock include, for example, non-voting common, preferred stock and convertible preferred stock. It is important to point out that only C corporations may have multiple classes of stock, although S corporations may have non-voting common stock.

A new class of stock is typically created in conjunction with a special corporate event, need, or transaction, such as raising additional equity capital or completing a leveraged ESOP transaction. This article discusses the reasons for using convertible preferred stock in ESOP transactions as well as the structuring, mechanics, issues, and considerations involved in completing such transactions.

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Convertible Preferred Stock

Preferred stock is a distinct *class* of capital stock that has characteristics of both common stock and debt. Preferred stock provides (1) a stated dividend that is paid before common shareholders receive dividends and (2) a priority claim over common stock in the event of a sale or liquidation of the corporation. Like common stock, preferred stock represents ownership of a corporation, although it may carry voting rights different from those associated with common stock (e.g., more or less than one vote per share). The main benefit to a holder of preferred stock is a higher priority of payment than that held by a common shareholder. Although preferred shareholders will typically be paid (in a liquidation, for example) after payment of any outstanding corporate debt, preferred shareholders receive dividends before common shareholders. In addition, in the event of a corporate bankruptcy, preferred shareholders are paid prior to common shareholders.

Convertible *preferred* stock is an equity that is senior to other classes and that allows the holder to convert the security into another designated class of stock. If an ESOP holds convertible preferred stock, the law requires two additional characteristics of the convertible preferred stock. First, the shares must be convertible into *common stock*, which provides the shareholder with greater upside potential than the preferred issues. Second, the convertible preferred stock must have *voting rights* or be readily *convertible* into a class of common stock that *has voting rights*. Voting rights give the ESOP trustee more ability to manage the corporation.¹

In ESOP transactions, the primary use of convertible preferred stock is to redistribute value among the existing shareholders where value is shifted from the common stock to the convertible preferred. The value attributed to the convertible preferred is primarily a function of the dividend characteristics but also the seniority it has relative to the other equity classes. It is important to understand the mere creation of a convertible preferred class does not by itself, create any value.

Dividing Total Equity

The total equity of a corporation is the aggregate value owned by its shareholders, regardless of the number of owners or classes of stock.

In a sale transaction, shareholders sell their shares of stock for cash, with holders of different classes sometimes being treated differently depending on the terms of the sale. Sales events can take the form of a private transaction (among existing shareholders, managers, and/or investors), an IPO, a sale of the entire business to a third party, or a sale to an ESOP.

One effect of the issuance of additional shares (whether of an existing class of stock or of a new class) is dilution to the existing shareholders. However, it may also be true that the value created from the issuance of the shares (whether in the form of cash received in an IPO, the value enhancement from an acquisition, or from productivity gains from creating broad-based ownership) could have a corresponding *value benefit* such that the value of each share outstanding is higher than before the dilutive event.

Imagine a corporation worth \$8.5 million with two shareholders each owning 50% of the only outstanding class of common stock. One would say the total equity value is \$8.5 million. If the corporation also had \$1 million of debt, one would say the “enterprise value” or “total invested capital” was \$9.5 million, comprised of \$1 million of debt capital and \$8.5 million of total equity capital (figure 1).

If the same corporation had multiple classes of capital stock, to determine the relative value attributable to each class of stock, one would simply divide the total equity value among the classes. In figure 2, \$2 million of equity value is attributed to the holders of the convertible preferred stock, leaving the remaining value to the holders of common stock. The total equity value is still \$8.5 million, though now it is divided between two classes.

The value attributed to the convertible preferred stock is determined by setting the amount of dividends payable, the value of the option to convert into common stock, and the underlying common stock value itself. Regardless of how much of the enterprise value is attributed to the convertible preferred stock, the mere creation of this new class (all other things being equal) does not itself create value but requires a new allocation of existing value between the classes of outstanding capital stock. For example, if the corporation is required to pay dividends on the convertible preferred stock and to convert it to common stock, the equity value of the corporation is “used up” by these obligations, leaving less equity value remaining for the other class(es) of stock.

Figure 1
Enterprise Value, \$9.5 million
One Class of Equity and One Tranche of Debt Capital

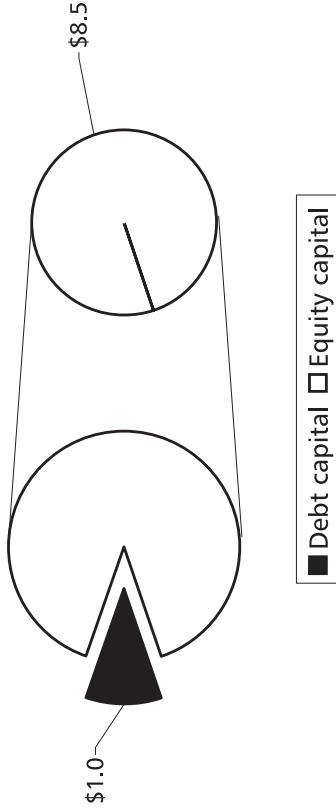
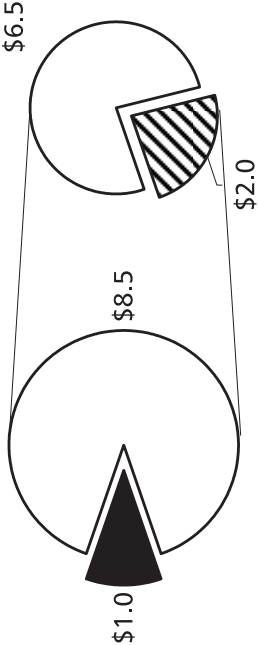


Figure 2
Enterprise Value, \$9.5 million
Two Classes of Equity and One Tranche of Debt Capital



■ Debt capital □ Common stock ▨ Convertible preferred stock

In figure 3, the convertible preferred stock is shown to represent \$4 million of the total equity pool. In this illustration, the convertible preferred stock is worth more than shown in figure 2, presumably as a result, for example, of the amount of the dividends payable and/or the conversion ratio upon conversion to common stock. Again, the total equity value remains \$8.5 million, but has been allocated differently.

ESOP Transaction Alternatives

Going back to the above example of a corporation whose only outstanding class of stock (common) is owned 50% by each of two owners, now suppose the owners have decided to sell a portion of their stock to an ESOP and want to receive \$2 million each. Given an \$8.5 million total equity value² and a \$4 million sale, the owners should be willing to part with 47%³ of their common stock, assuming the following:

Total Equity Value	
(minority interest, non-marketable)	\$8,500,000
Desired Sale Proceeds	\$4,000,000
Percentage of Total Equity Value to Be Sold	47%

In the traditional leveraged ESOP transaction, this result would be accomplished as follows:

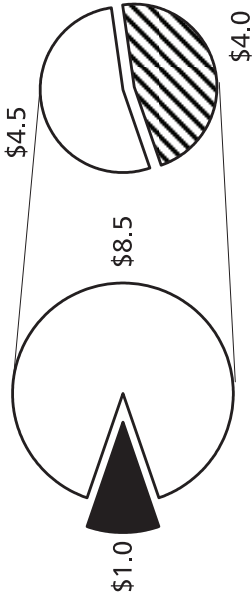
Stock Transaction

1. Corporation borrows \$4 million from a bank
2. Corporation lends ESOP \$4 million
3. ESOP purchases 47% of owners' stock

Debt Repayment

1. Corporation makes annual contributions to the ESOP
2. ESOP uses the contributions to repay the loan from the corporation
3. Corporation uses the tax-sheltered payments to repay the bank

Figure 3
Enterprise Value, \$9.5 million
Two Classes of Equity and One Tranche of Debt Capital



■ Debt capital □ Common stock ▨ Convertible preferred stock

The end result is the same \$9.5 million corporation (ignoring adjustments for post-transaction debt) with \$4 million of new debt and a new shareholder, the ESOP, owning 47% of the outstanding stock. The existing owners have \$4 million in cash and, together, own the remaining 53% of the outstanding stock.

An alternative way for the owners to realize \$2 million each would be to recapitalize the corporation and create a class of convertible preferred stock. In the recapitalization, the corporation attributes \$4 million of equity value to the new class of stock, and the ESOP purchases the new convertible preferred stock instead of common stock. By structuring the convertible preferred stock within various tax and ERISA constraints, the owners retain more of their common ownership by using the convertible preferred than they would have if they had sold only common, since the value of the dividend stream replaced the value of common shares that otherwise would have been tendered.

The examples below illustrate the mechanics of this value substitution or replacement between shares and dividends. Structured properly and used in the right circumstances, this transaction structure should be mutually beneficial for both the buyer and the seller.

Mechanics of the Convertible Preferred ESOP Transaction

Since the example corporation has only one class of stock before the recapitalization, the shareholders will vote to authorize the issuance of a new class of dividend-paying convertible preferred stock. The shareholders will exchange the portion of their common stock for a number of shares of convertible preferred stock (based on the valuation and the rights and preferences of the convertible preferred stock) that gives them the desired sale price and post-transaction percentage of common stock. The following sections describe the steps of creating, valuing, and issuing the new class of convertible preferred stock. Care needs to be taken to assure the recapitalization does not create a taxable event, so one should consult a qualified tax advisor early in the evaluation process.

Structuring the Value of the Convertible Preferred Stock

Since the total equity of the corporation will be allocated between the classes of convertible preferred and common stock, we will need to determine the value of the convertible preferred stock. This value will be a combination of the underlying common stock value into which the convertible preferred stock may be converted and the dividend stream. The more value attributed to the dividend, the less common stock will be needed to make up the dollar value of the convertible preferred stock, and vice versa. There are, however, various tax and ERISA rules that constrain an unbridled allocation of dividends to the convertible preferred stock.

This example assumes the value of the convertible preferred stock is the sum of the value of the underlying common stock (\$3,040,000) and the value of the future dividend stream (\$960,000), or \$4 million.

In most ESOP transactions, subject to negotiation with the ESOP trustee, the value of the convertible preferred stock is structured to equal either the proceeds that the owners want to realize from the sale or the ownership percentage they want to sell to the ESOP. Once that number has been determined, the price of the convertible preferred stock can be determined by using the following steps.

Step 1: Value the Dividend Stream

The terms of the convertible preferred security will state the dividend terms in dollars per share.⁴ Typically, the stock is non-callable by the corporation for a period of time, although as long as the ESOP owns the shares the dividends are paid. If the shares are called by the company, the ESOP must have the right to convert its shares to common stock.⁵ The ESOP trustee can therefore be sure the ESOP will receive *at least* a minimum dollar value from the dividends. It is the responsibility of the ESOP trustee's financial advisor to establish the value of this dividend stream. There are two principal competing viewpoints about how long the dividends are likely to be paid and, consequently, the value of the convertible preferred stock.

The first of these two viewpoints is that the dividend should be valued only for the non-call period. This view is based on the as-

sumption that the corporation will redeem the ESOP's shares as soon as the non-call period ends.

This makes some sense because a company would presumably want to terminate its dividend obligation as soon as it can. However, if the shares become redeemable at a time when the convertible preferred stock price is less than the redemption price, it is not likely the corporation will redeem the ESOP shares. If shares were called in that situation, the ESOP trustee might decide it best not to convert the shares but to sell them at the redemption price and maximize its value. That, in turn, would force the company to finance a buyback of all the shares, where in different circumstances (e.g., when the redemption price is less than the value of redemption) the ESOP would likely opt to convert to common and therefore eliminate any financing event by the company. More likely, a company would not call the convertible preferred shares and continue to pay the dividend until it could be sure the ESOP would convert rather than sell.

This is why other appraisers take the second viewpoint, which is that the dividend stream should be valued in perpetuity. There is no way of telling, as of the initial valuation date, how long the dividend will be paid, or if or when it will cease. Further, this group believes the ESOP would never voluntarily exercise its right to convert the convertible preferred stock into common stock (and terminate the dividend) because the shares of convertible preferred stock will normally trade at a higher price than the common shares due to the dividend value.

Table 1 summarizes the present valuation of the dividend stream using the two viewpoints of a fixed known period and a value in perpetuity, discounted at 25%.

Table 1. Present Valuation of Dividend Stream

Desired Sale Proceeds	\$4,000,000
Contractual Preferred Dividend Yield	6%
Contractual Annual Dividend	\$ 40,000
Non-Callable Period (in years)	6
NPV Discount Rate Applied to Dividends	25%
NPV of Dividend (valued in perpetuity)	\$ 960,000
NPV of Dividend (valued for non-call period only)	\$ 708,342

Given these facts, the present value of the dividend stream of \$240,000 for the non-callable period only (\$4 million \times 6% for 6 years) would be \$708,342, and \$906,000 if valued in perpetuity. The following examples assume the dividend is valued in perpetuity and use \$906,000 as the value of the dividend stream.

Step 2: Solve for the Unknown

A simplified equation for valuing the convertible preferred stock is:

$$V_{cp} = V_{div} + V_c$$

Where: V_{div} = present value of the dividend stream

V_{cp} = value of the convertible preferred stock

V_c = value of the underlying common stock

Thus, if we know the value of the dividend *and* the net value of the conversion right *and either* the proceeds that the seller wants from selling the convertible preferred stock *or* the amount of common stock the ESOP will own, we can solve for the other variables and finish the equation.

$$V_{cp} = V_{div} + V_c$$

$$\$4,000,000 = \$960,000 + V_c$$

Solve for V_c ,

$$V_c = \$3,040,000$$

The equity value for the entire corporation, before creating the dividend stream for the convertible preferred stock, is \$8.5 million (V_e). The value of the dividend stream reduces the value available to the common shareholders, so the new total equity value for the common equivalent becomes \$7,540,000, or $V_{e'}$.

Where: $V_{e'}$ is the value of equity after the dividend costs.

$$V_{e'} = V_e - V_{div}$$

$$V_{e'} = \$8,500,000 - \$960,000$$

$$V_{e'} = \$7,540,000$$

To determine the percentage of common stock that will be needed to make up the \$3,040,000 (i.e., the value of the convertible preferred stock not represented by the dividend stream), we divide \$3,040,000 by the total value of the equity after the dividend costs.

$$V_c = \$3,040,000$$

$$V_{e'} = \$7,540,000$$

$$\% \text{ Common Exchanged} = V_c \div V_{e'}$$

$$\% \text{ Common Exchanged} = 40.3\%$$

The end result is the shareholders exchange approximately 40.3% of their common stock for convertible preferred stock and then sell the convertible preferred stock to the ESOP for \$4 million.

Pricing the Convertible Preferred Stock

The price per share of the convertible preferred stock can be an arbitrary number and can be determined by setting either the number of shares to be issued or the price per share. In this example, the target value for the convertible preferred stock is \$4 million. If the price is set at \$100 per share, then 40,000 shares will be issued. It is also possible to set a number of shares to be issued that would result in a different price per share, but shares are not customarily priced in this manner.

Pricing the Common Stock

The price per share of the common stock is determined by attributing the remaining equity value of the corporation and the percentage of the common stock not represented by the value of the convertible preferred stock, or \$4.5 million and 59.7% respectively.

In this example, the number of shares of convertible preferred stock (40,000) is divided by the percentage of the total equity represented by the convertible preferred shares (40.32%) to get the total number of shares outstanding, or 99,211. By subtracting the number of convertible preferred shares from the total shares outstanding, we are left with the number of common shares, or 59,211. To calculate the price per share of the common stock, the remaining value of equity is divided by the number of shares of common stock.

Thus, \$4.5 million is divided by 59,211 to get a common price per share of \$76.00. We can cross-check by multiplying the two to verify it totals \$4.5 million.

Table 2 illustrates the new capital structure of our example corporation with convertible preferred stock and common stock outstanding, still worth \$8.5 million.

Table 2. New Capital Structure

Equity Class	Shares	Price	Value
Convertible Preferred	40,000	\$100.00	\$4,000,000
Common Stock	59,211	\$76.00	<u>4,500,000</u>
			\$8,500,000

Recapitalization and the Share Exchange

In this example, after the exchange of some of the owners' common stock for convertible preferred stock, there will be a total of 40,000 shares of convertible preferred stock and 59,211 shares of common stock outstanding. To effect the recapitalization, each owner will exchange his or her "old common" for 20,000 shares of convertible preferred and 29,605 shares of common stock. Handled properly and under the right circumstances, this will be treated as a tax-free exchange without a tax event. The shareholders are now prepared to sell their convertible preferred stock to the ESOP and retain the remaining common stock.

By converting some of the owners' common stock to convertible preferred stock, they are left with more common stock after the transaction for the same proceeds.

Dividends and Stock Price Performance

Stock price performance will influence how long dividends are paid on the convertible preferred stock. Generally speaking, the sooner the equity value appreciates, the sooner the corporation will redeem the convertible preferred stock that terminates the dividends. When the corporation offers to redeem the convertible preferred stock, the ESOP trustee will have the choice of receiving cash equal to the redemption price or converting the convertible preferred stock to

common stock. In either case, the dividend ceases. Figures 4 and 5 illustrate the value of the ESOP's convertible preferred stock upon redemption or conversion, using different equity growth rates.

In a "slow growth" environment, there is a prolonged period during which the value of redemption (a known price) remains higher than the conversion or common stock price. In such a situation, the corporation is not likely to redeem the convertible preferred stock because the ESOP trustee would be likely to elect redemption over conversion. In this event, the corporation would have to pay about \$4 million for the redemption price. Alternatively, if the convertible preferred stock is not called, then the \$240,000 dividend payment continues until it is called and converted by the ESOP. This would likely happen when the price of the common stock rises above the redemption price.

Figure 4 illustrates such a "slow growth" scenario in which the convertible preferred stock price does not exceed the redemption price until the 10th year (several years after the typical non-call period). This is the first year when corporation might reasonably expect the ESOP trustee to convert its shares into common stock rather than permit the redemption, since the aggregate value of the common stock upon conversion is higher than the redemption proceeds.

If the total equity value appreciates more rapidly, then the common stock price may exceed the redemption price earlier than expected. In this event, the corporation could offer to redeem the convertible preferred stock as soon as the non-call period is over. At this time, the value of the ESOP's equity would be higher after converting the convertible preferred stock to common stock, and it would be likely the ESOP trustee would convert to common stock rather than accept cash in a redemption transaction. The corporation would then not be forced to finance the redemption, and the dividend payments would cease.

In comparison, in the "rapid growth" environment of figure 5, the value of the convertible preferred stock exceeded the conversion or common stock value in year four. Since the corporation is restricted from redeeming these shares until the sixth year (because of the no-call restriction), it must continue paying the dividend. When the convertible preferred stock becomes redeemable in year six, it is likely the company will call the stock and the ESOP trustee will convert the convertible preferred shares into common stock.

Figure 4
Equity Values: Slow-Growth Scenario

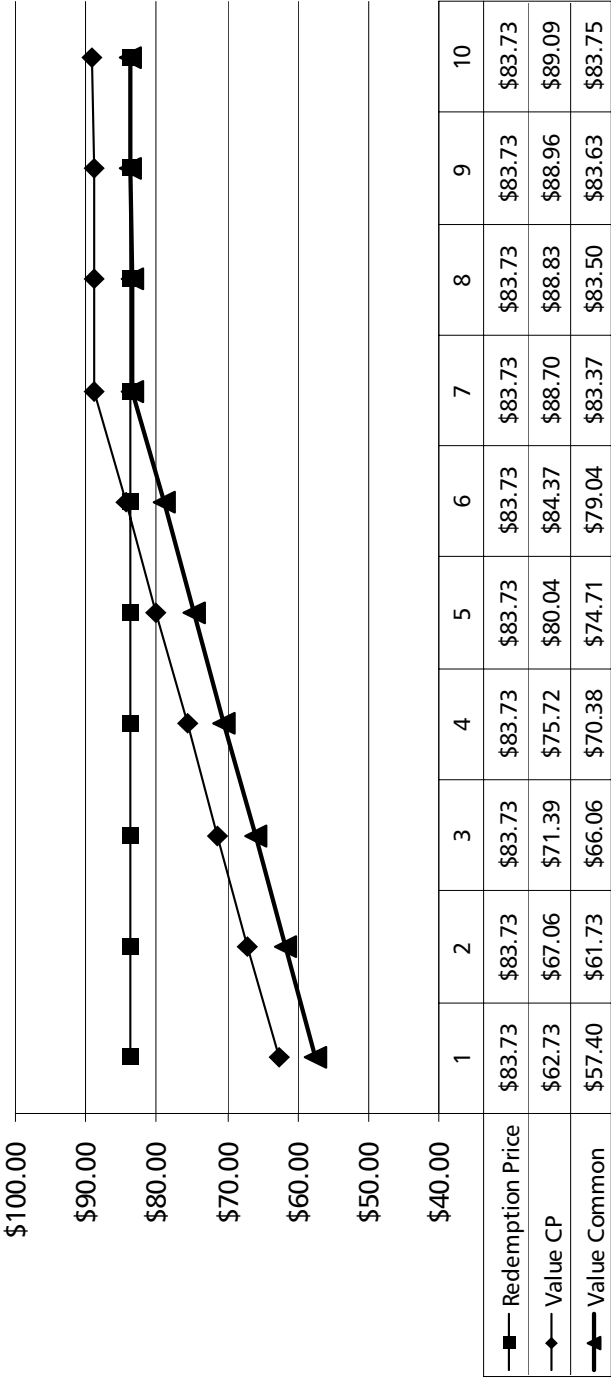
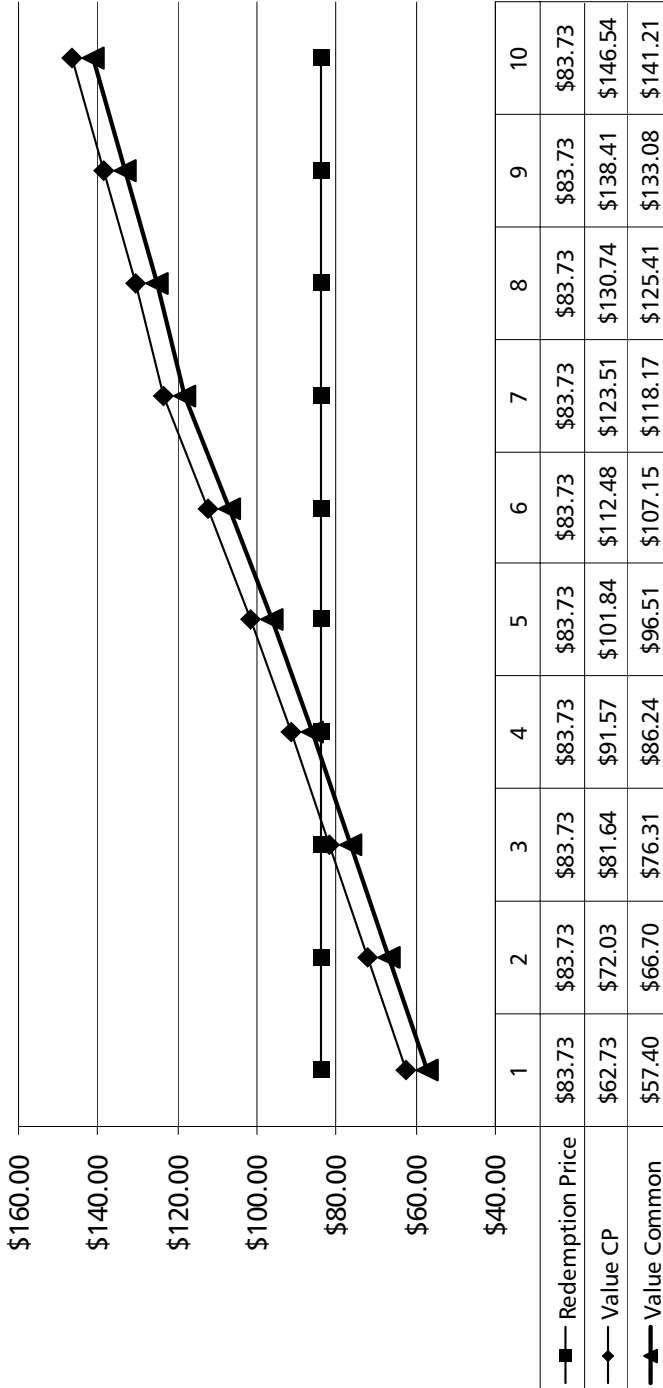


Figure 5
Equity Values: Rapid-Growth Scenario



A Good Deal?

The use of convertible preferred stock must be viewed from various perspectives to make sure there are mutual advantages for the ESOP, the corporation, and the existing/remaining shareholders.

The ESOP

It is appropriate for the ESOP to pay a higher price (that is, get less underlying common stock) for the convertible preferred stock since the convertible preferred shares come with a minimum dividend payment stream and an option to convert into common stock. As a result of the ESOP's increased cash flow (which includes both dividends and ordinary contributions), the ESOP will be able to repay its inside loan to the corporation faster. The faster the ESOP pays its debt, the faster it releases suspense account shares, which means the faster the employees get more shares into their individual accounts. Receiving the shares sooner rather than later is the primary ESOP benefit for owning the convertible preferred shares.

The Corporation

Assuming the outside loan used to finance the ESOP transaction is structured to accommodate the various cash flow needs of the corporation (e.g., business cycle downturns, capital projects, or funding growth), a corporation should be at least indifferent to the payment of dividends during the non-call period. During this period, all dividends paid to the ESOP are tax-deductible, within limits. Furthermore, any cash "paid" to the ESOP as a dividend payment will be returned by the ESOP to the corporation to repay the loan. The corporation will also realize a larger tax deduction because an ESOP dividend used for debt payments is deductible.

On the other hand, the ESOP dividend becomes an after-tax expense if it is not used by the ESOP to repay its debt service or paid out to plan participants. This situation could arise if the price of the convertible preferred stock languishes (thus, there would be no incentive for the corporation to redeem the shares), and the ESOP has paid off its loan to the corporation. In addition, if the corporation makes large dividend payments, it may be subject to alternative minimum tax (AMT) and forego an immediate tax benefit be-

cause dividends are a preference item for AMT purposes, even though dividends are not annual additions subject to Internal Revenue Code Section 404 or 415 limits.

A final consideration is that the corporation cannot rely solely on dividends to meet its obligation to make regular and recurring contributions to the ESOP because a dividend is not considered a contribution.

Existing and Remaining Shareholders

Existing and remaining shareholders may or may not be negatively affected by the creation of a convertible preferred class of stock, depending on when they want to sell their remaining shares and if the convertible preferred stock has been redeemed at the time of their proposed sale. If the dividend payments have ceased, then there is no effect on value, and if the dividend payments are being made, there may or may not be a value discount.

During the ESOP debt repayment period, it is generally accepted that the dividend payments represent “accelerated” contributions. Because ESOP contributions and dividends typically exceed the long-term average retirement benefit cost during this time (and typically decline after the debt is gone), appraisers adjust earnings to exclude the additional/temporary costs. In this event, the existing shareholders’ value is not adversely affected by the dividend payments.

On the other hand, if the stock price does not increase sufficiently and the corporation does not redeem the ESOP shares (or the ESOP trustee does not convert the shares to common), then the dividend payments will continue. If the dividend payments continue, they will be a drag on value, especially to the extent they are paid on an after-tax basis and are not paid out to plan participants.

When evaluating the use of convertible preferred stock in an ESOP transaction, the ESOP advisor should take into consideration when the “second generation” of shareholders will want to exit and structure convertible preferred stock and transaction debt terms to coincide with expected exit periods, so that at those times the corporation is out of debt and the convertible preferred stock has been or will likely be converted into common stock.

Final Thoughts About Using Convertible Preferred Stock

When evaluating the use of this transaction structure, many factors need to be considered, including the corporation's tax status, the design of the convertible preferred stock, the corporate growth rate assumptions, and (in particular) secondary or follow-on transactions, since the existence of a dividend obligation may have an impact on future valuations.

Structured properly, the use of convertible preferred stock in ESOP transactions can be a win-win situation for sellers and ESOP participants. Sellers realize their target proceeds while keeping a larger percentage of their common stock, while ESOP participants get their shares allocated faster and receive the added cash flows from dividends.

Comments on Super-Common Stock

“Super-Common” stock is a security designed in nearly all ways to be identical to convertible preferred stock. The purpose of using this security is the same as that for using the convertible preferred—replacing equity value by using a dividend payment stream. Its primary difference is that it is a common class and has seniority only over other common stock and not over other classes of stock. Often, shares of super-common stock are also convertible into common stock at a specific date or upon the occurrence of certain conditions. Designed properly, super-common stock can be used as a substitute for convertible preferred stock, though fewer issues seem to arise with dividend treatment using convertible preferred stock.

Notes

1. An ESOP must be invested primarily in “employer securities.” See the definition of “employer securities” in Internal Revenue Code Section 409(l).
2. As agreed to by the ESOP trustee with advice from an independent appraiser.
3. \$4 million of the \$8.5 million being sold is 47% of the total equity value. For convenience, this example assumes no minority discount for the sale of a non-controlling interest (i.e., 47%) and no lack-of-marketability discount.

4. The dividend has to be “reasonable” to qualify for tax deductibility.
5. The shares must meet the definition of “employer securities” for the ESOP to purchase them. Shares not meeting this definition would disqualify the entire transaction.