ROUNDTABLE DISCUSSION

EMPLOYEE STOCK OWNERSHIP PLANS

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Explore whether this succession strategy is right for your company

Baby boomers own nearly half of all privately held businesses with employees in the U.S. As such, the business landscape is poised for a dramatic shift as this generation of business owners retires. The trend highlights just one reason ESOPs, or Employee Stock Ownership Plans, are a popular and attractive business succession tool. Designated as a qualified retirement plan, an ESOP offers some unique advantages over a third-party sale since it is structured as a liquidity event that still enables the owner to retain some control and perpetuate his or her legacy, while also offering employees an ownership stake. *Crain Content Studio–Cleveland* turns to four industry professionals who offer additional perspective on exploring the benefits and other considerations associated with ESOPs.

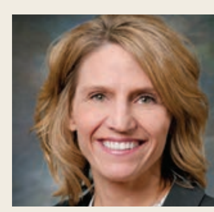
THE PANEL

TED LAPE
Partner
Lazear Capital Partners

Ted Lape is a partner with Lazear Capital Partners, a boutique investment bank with a focus on ESOPs, M&A and capital formation. Ted has 25-plus years of experience advising companies and business owners. He joined Lazear in 2009 after serving as a partner in the private equity firm Talisman Capital Partners and as a senior vice president at LaSalle Bank. Ted concentrated on helping clients transition ownership through an ESOP at both firms. He is a highly rated national speaker on ESOPs. Ted received a Bachelor of Science from Northwestern University and a Master of Business Administration from the University of Chicago, Booth School of Business. Ted is a member of the Washington, D.C.-based ESOP Association and the National Center for Employee Ownership. He also serves on the board of Association for Corporate Growth, Columbus.

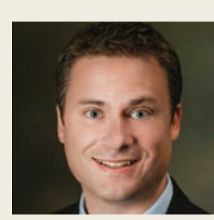
SHAYLOR R. STEELE
Partner
Executive Compensation & Employee Benefits Practice Group at Benesch

Shaylor R. Steele is a partner in Benesch's Executive Compensation & Employee Benefits Practice Group. Shaylor has extensive experience with structuring dozens of buy-side and sell-side ESOP transactions for privately held companies. In addition, Shaylor brings value to his ESOP clients because of his ESOP dispute resolution experience. He has successfully represented multiple clients through U.S. Department of Labor investigations focusing on the value of the company stock. The Ohio Employee Ownership Center awarded the 2018 ESOP Impact Award to a recent ESOP transaction in which Shaylor represented the seller. Shaylor also is a nationally recognized attorney in 401(k) plan fiduciary and operational compliance. He helps clients provide fully compliant, affordable and attractive benefit programs and 401(k) plans for their employees.



JULIE A. WILLIAMS
Managing Director, National ESOP Team Lead
PNC Financial Services Co.

Julie A. Williams has 15-plus years of experience advising companies and business owners on various aspects of ESOP transactions. As PNC's managing director and national lead for ESOP Solutions, Julie helps PNC clients and prospects navigate the benefits and considerations of using an ESOP as an ownership transition and liquidity solution. Julie also serves as a resource for PNC clients as they execute their corporate strategy with the added complexity of ESOP ownership. She joined PNC in 2015 after serving as a senior vice president in JPMorgan Chase's ESOP Advisory Group. She previously held senior positions with Duff & Phelps and Cognient Group in Chicago, where she served as a financial adviser for companies, an institutional ESOP trustees, and selling shareholders engaged in ESOP transactions. She also served as an institutional ESOP trustee at GreatBanc Trust Co., where she led negotiations for ESOP transactions involving the purchase or sale of stock or assets. Julie received a Bachelor of Business Administration from the University of Michigan and an MBA from the University of Chicago, Booth School of Business. She is licensed by FINRA with a Series 79 and Series 63. Julie is a member of the ESOP Association and serves on its Valuation Advisory Committee. She is also an active member of the National Center for Employee Ownership, Association for Corporate Growth and Economics Club of West Michigan.



JOSEPH P. YONADI JR.
Partner
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As a partner in Benesch's Executive Compensation & Employee Benefits Practice Group, Joe Yonadi counsels for-profit and nonprofit clients on a variety of employee benefit matters. Joe provides a unique perspective and counsel to his ESOP-owned company clients because of his former experience as in-house benefits counsel at a *Fortune* 500 public company that maintained a leveraged ESOP-component to its 401(k) plan. Joe has built on that experience to advise ESOP trustees, lenders and sellers on their ongoing ESOP compliance and fiduciary governance matters. In addition, he assists business owners with assessing the benefits of utilizing an ESOP as a succession planning tool. His benefits practice also includes providing counsel on the Affordable Care Act and health and welfare compliance considerations. Joe maintains a robust executive compensation practice that includes assisting employers with designing and implementing various nonqualified deferred compensation plans and short-term and long-term incentive plans.

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Q&A

What is an Employee Stock Ownership Plan (ESOP)?

SHAYLOR STEELE: First and foremost, an ESOP is a qualified retirement plan governed by the Employee Retirement Income Security Act. However, unlike most qualified retirement plans, an ESOP is designed by law to be invested primarily in the employer's stock. So essentially, an ESOP provides a company's employees with the opportunity to have an ownership stake by having their retirement contributions invested in employer stock.

ESOPs really took off in the early 1980s with Tax Reform Acts of 1984 and 1986, which created significant tax advantages and planning opportunities. Then, in 1996, the Small Business Protection Act was passed, which provided a window of opportunity for shareholders of S corporations to utilize the benefits of an ESOP.

Why are ESOPs so popular now?

TED LAPE: There are a few key reasons owners sell to an ESOP. They want to maintain operational control, and often they want to maintain a tenant for the real estate they own. The process is easier, more certain and more confidential. Owners receive a competitive purchase price plus additional proceeds. The company usually becomes tax free, and the owners can potentially sell it tax free. The employees are much better off, and the key employees are even better off.

JOE YONADI: With the influx of baby boomers retiring today, we are seeing many business owners coming to us and asking for our advice on using an ESOP as a form of succession planning. Generally, business owners have a few different options with respect to how they will proceed with selling their business: (1) They can sell to a strategic buyer — a buyer who is in the same industry or a buyer looking to diversify their business. (2) They can sell to a financial buyer — a private equity company that is looking to add the business to its applicable investment portfolio. (3) They can sell into an ESOP.

ESOPs are generally chosen over the other two options because the owner wants to sell the company to its employees and maintain some type of control moving forward. With the other two succession planning options, the owner generally will lose control of his or her business at the time the sale closes. Essentially, an ESOP is a trifecta for all parties involved: The transaction provides a business owner with a liquidity event, employees are provided with an ownership opportunity, and the business owner can maintain his or her legacy because there is no third-party sale.

How are ESOPs generally established?

SHAYLOR STEELE: There are many parties involved in setting up an ESOP, including attorneys, accountants, trustees, investment bankers, lenders and consultants. ESOPs are first established by drafting a retirement plan document setting forth the tax code's qualification requirements for the plan and identifying the plan administrator, fiduciary, contribution, distribution and overall governance requirements. The company's board of directors will appoint an ESOP trustee, who will be responsible for hiring an independent appraisal to annually monitor the stock valuation. In addition to the annual appraisal, there are ongoing audit and tax reporting requirements with which an ESOP must comply.

If the ESOP is leveraged, the company will retain a lending institution, which must become comfortable with the ESOP transaction and the company financials.

TED LAPE: Usually a seller will start by wanting to understand how an ESOP works. The seller will want to know what the economics look like for himself or herself, the company, and the employees, especially the key employees. An ESOP investment banker can answer all of those questions. In our case, we can show them a presentation with the economics from a similar company. We can also examine the company's financials, and ask a lot of questions, to provide a full feasibility analysis showing a proposed structure and all of the economics for their company. We then work with the company to customize the design to fit what they are looking for. If they decide to move forward, a team is established, including the attorney, accountant and other professionals to execute the transaction and make sure it works within all applicable guidelines.

What are the benefits of an ESOP to the selling shareholder? To employees?

JULIE WILLIAMS: ESOPs are often described and explored by business owners. They address ownership transition goals, provide flexibility and offer attractive tax benefits for both the selling shareholder and the company. They also appeal to an owner's desire to protect and provide opportunities for employees to participate in the financial rewards of ownership. The benefits to owners and to employees are often inextricably linked.

For example, an ESOP structure allows the company to continue to operate the business independently consistent with the current strategy. This is a benefit to both the owner, who wants to perpetuate legacy and culture, but also to the employees whose jobs depend on it. And ultimately, the company and future shareholders benefit from this very decision because employee ownership can yield positive outcomes for the company and benefits that employees can readily recognize. ESOPs often perform better in economic downturns and frequently experience less turnover and fewer layoffs.

SHAYLOR STEELE: A selling shareholder benefits by selling his or her company into an ESOP and maintaining the company's legacy without selling and losing such legacy to a third-party buyer. In addition, the selling shareholder will still be able to have a liquidity event and gain some additional upside compensation through the receipt of warrants or stock appreciation rights. Most selling shareholders receive a position on the board of directors and will maintain some control over the sold company.

Employees receive an ownership stake in the company and in turn become vested in the company's performance. Statistics have shown that ESOP-owned companies outperform non-ESOP companies because of the commitment shown by ESOP employees. In addition, the ownership stake represents the employees' retirement account, which creates a more secure path to retirement for all of the ESOP employees.

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> **— JOE YONADI,** *Partner,* Executive Compensation & Employee Benefits Practice Group at Benesch

Are there any associated tax advantages if you sell to an ESOP, and if so, what are they?

JOE YONADI: As with all qualified retirement plans, contributions to ESOPs are tax-deductible to the company. However, if an ESOP is structured in which it takes out a loan from a lender and pays the company in exchange for employer securities, it is referred to as a "leveraged" ESOP. This type of ESOP is very tax-efficient. The company can deduct any contributions made to the ESOP, plus any principal and interest on the loan. There is a contribution limit on the deductibility of up to 25% of payroll.

One of the biggest tax benefits is where a selling shareholder of a subchapter C corporation sells stock to the ESOP. In this scenario, such shareholder may be in line to defer all federal income tax on the gain of the sale under Code Section 1042. This rule applies if the ESOP owns at least 30% of the corporation's stock after the sale, and the ESOP doesn't sell the stock acquired for three years.

It is also important to note that if a 100%-owned ESOP company is structured as an S corporation, then it effectively becomes a tax-free company because an S corporation is not taxed at the entity level, and the ESOP is a tax-exempt entity.

What are the compliance considerations for establishing an ESOP?

SHAYLOR STEELE: There are a whole host of compliance considerations with forming an ESOP that we could dedicate an entire roundtable to discussing. For now though, the key compliance consideration is that the ESOP-owned company board of directors must appoint a trustee to act as the ESOP's fiduciary and to protect

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employees. This is compliance burden unlike any other in the corporate context. A trustee is required to check in at least once a year to assess the value of the company ESOP-owned stock and may weigh-in on other business transactions. So, dealing with an additional governance body is something to think about when contemplating an ESOP.

A second compliance consideration is that an ESOP is a qualified defined contribution retirement plan that is designed to invest primarily in employer securities. Because of the retirement plan aspect, it must have a plan document and comply with a multitude of plan qualification requirements under Internal Revenue Code Section 401(a). This includes filing a Form 5500 and performing discrimination testing to ensure highly compensated employees are not benefiting any more than a non-highly compensated employee.

The final major compliance hurdle is that once employees vest in their employer securities, they have a right to require the employer to repurchase their securities. This obligation requires employers to monitor their repurchase obligation, particularly when the ESOP begins to mature, to ensure they are able to pay for such obligations.

Where does the money come from that the ESOP uses to pay for the stock, and what sources of capital are available to finance an ESOP transaction?

JULIE WILLIAMS: The money needed to facilitate an ESOP transaction may come from numerous sources, including third-party debt or private equity. Because senior bank financing is the least expensive and most accessible form of capital, it is commonly the primary ESOP funding source.

While senior debt capital comes with a lower cost, senior lenders will require more restrictive loan covenants and conditions compared to junior/subordinated debt or equity. Once the company has maximized the amount of senior debt it can, it could potentially utilize other sources of capital, including junior subordinated debt, loans from non-traditional institutional lenders or private equity. A company's size and credit profile will be a significant factor in determining how much and which type of capital are appropriate for a given ESOP transaction.

When third-party capital is not enough to cover the purchase price, seller financing is commonly used to bridge the shortfall. Sellers can obtain a return for this investment that is similar to the return a third-party investor would require of the same investment. Because the seller is below the senior lender in priority and in security, this rate of return is often similar to that of a junior lender.

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How does the sale price for an ESOP compare to selling to a strategic buyer?

TED LAPE: Historically, we have seen values that are very close to what a company would receive in a third-party sale. The exception is companies like contractors that typically sell for low multiples and high-tech growth companies that sell for high multiples in third-party sales. We generally see contractors go for a higher multiple and high-tech growth companies a lower multiple to ESOPs. However, the recent federal tax law change had a big effect on ESOP valuations. Without going into the details, all existing and future ESOPs increased about 15% in value. In addition to the sale price, sellers also receive additional proceeds that can often make total proceeds to the seller more attractive than a third-party sale.

What factors are important in determining how much a company can borrow to facilitate an ESOP transaction?

JULIE WILLIAMS: The amount of funds that a company can borrow for an ESOP transaction is directly linked to the overall condition and creditworthiness of the business as well as the amount of debt already on the company's balance sheet. An ESOP loan will be incremental debt of the company — over and above the current debt outstanding. So to the extent a company already has debt, its ability to borrow additional money for an ESOP may be constrained. The determination of debt capacity is dynamic and can vary widely from one company to the next.

Collateral and cash flows available to repay debt are primary drivers. Depending on the nature and the size of the business, senior lenders may require loans to be substantially secured. Non-senior lenders will often require less collateral, but in return will need a much higher rate of return for their investment. Companies with a strong credit profile are characterized by a nice history of stable and growing profits and a strong management team.

Other important considerations in determining debt capacity include the condition of the industry and the company's competitive position, ongoing capital spending requirements of the business and customer or vendor concentrations.

The ESOP's tax benefits can have a positive impact on debt capacity since these benefits can meaningfully impact the cash flow available to repay debt. While ESOPs do offer an attractive financing structure, it is important to make sure that the ultimate debt structure considers your company's strategic goals, allowing for flexibility to invest in growth initiatives.

What governing bodies manage an ESOP-owned company?

JOE YONADI: An ESOP-owned company is governed by a board of directors, similar to that of a publicly or privately owned company. For privately held companies that are ESOPs, the board is composed of a mix of owners and independent directors. The trend is to have the board's majority composed of independent directors, or members who have a certain type of business expertise and who have no connection to the business.

The trustee's role is a unique aspect of an ESOP. Because an ESOP is a qualified retirement plan, a trustee is appointed and becomes the shareholder of record for the company stock held in trust by the ESOP. The board-appointed trustee is a fiduciary with the responsibility to safeguard the trust's assets for the employee-beneficiaries. The trustee also plays the role of the buyer in an ESOP transaction to negotiate the stock price in good faith and for adequate consideration. Lastly, the trustee has annual responsibilities to appraise the corporate stock each year and does so by engaging an independent third-party appraiser.

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>
> **— JULIE A. WILLIAMS,** *Managing Director,* National ESOP Team Lead, PNC Financial Services Co.

What are the disadvantages or risks associated with establishing an ESOP?

TED LAPE: The primary disadvantage of selling to an ESOP versus a third-party sale is that the seller receives less cash at close. They receive the rest of the proceeds over four to six years. The seller finances a portion of the transaction. In exchange, the seller will receive interest of approximately 12% of the amount they finance.

The other disadvantage applies to situations in which the sellers do not want to stay and run the company post-closing or are not committed to bringing in new management. ESOPs are designed to last, and you need good management to last. Other objections relating to the deal's complexity, corporate governance, economics and cash flow tend to result from people not truly understanding ESOPs.

SHAYLOR STEELE: ESOPs are heavily regulated because by operation of law they exist as a qualified retirement plan. As such, they are subject to ERISA's fiduciary protections because company stock is going into employee-beneficiaries' retirement accounts. They are also regulated because of Internal Revenue Code provisions that relate to favorable tax deductions to the company and possibly the selling shareholder.

Hiring a good ESOP adviser with the relevant experience can mitigate most regulatory risk associated with designing and planning for an ESOP. The outlying risk that sometimes can't be mitigated nor predicted is to what degree the U.S. Department of Labor will scrutinize the transaction. Over the past decade, the DOL has audited hundreds of ESOP transactions to enforce whether the stock price negotiated was an adequately considered purchase. As a result of these audits, a few large trustees, including GreatBanc, have been required to enter into DOL Process Agreements that are binding on the applicable trustee and serve as required guidelines for the trustee to follow on all future transactions.

JULIE WILLIAMS: It's really important to keep in mind that ESOPs are not appropriate nor attractive for every situation. Understanding risks while evaluating an ESOP transaction will help an owner avoid negative outcomes years later.

ESOPs are often, but not always, a leveraging event for the business. They are best suited for businesses with consistent and predictable earnings so they are well-positioned to service the transaction debt, even in the event of an unforeseen business disruption. Further, if the company's operations require significant growth capital or have other demands on capital, a leveraging event for an ESOP may not be in the best interest of the company.

In the long term, ESOP companies are required to repurchase the ESOP shares when participants become eligible for a distribution of their account. The cash that leaves the company for share repurchases can become a meaningful use of cash that would otherwise be available to invest in the business.

ESOPs can pay no more than fair-market value for the stock, and fair-market value may not be the highest value you can achieve with alternative buyers. When selling to an ESOP, the cash proceeds available to the selling shareholder at closing are limited by the company's debt capacity or capital provided from all third-party sources. This means that a meaningful portion of the total sale proceeds may be deferred and paid to the seller over a period of time.

A lifetime is a long investment horizon. How do you select companies to invest in given that challenge?

JOE YONADI: That's true. If you look at the history of the Dow Jones Index, for example, many of the companies that were part of it 30 years ago are no longer in business. In addition to the investment horizon issue, purchasing Qualified Replacement Property presents a liquidity challenge. Most business owners have plans for the liquidity they gain from selling their business and that generally doesn't include buying stocks and bonds and holding them for the rest of their life.

The solution that was developed to mitigate these challenges, and the most commonly employed QRP strategy is to purchase a type of bond called a floating rate note. FRNs are 40- to 60-year non-callable bonds with a floating interest rate tied to a common interest benchmark such as LIBOR. Unlike fixed bonds, which decrease in market value as interest rates rise, FRNs pay interest that adjusts with prevailing interest rates. That means the value of the bonds stay at or near par in rising and falling interest rate environments. Due to the stability in the value of FRNs, they are viewed as ideal collateral for margin loans.

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