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Structuring M&A and Private Equity Sales Involving Employee Stock Ownership Plans

Evaluating Advantages and Risks, Best Practices for Structuring the Deal

TUESDAY, JUNE 26, 2018

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Structuring M&A and Private Equity Sales Involving ESOPs: Alternative Strategy in a Down Market

Strafford Live Webinar | June 26, 2018 | 1:00 p.m. – 2:30 p.m. EDT

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Presentation Overview

- Alternative Exit Strategies
- Criteria for Evaluating Alternatives
- Introduction to ESOPs
- Profile of an Ideal ESOP Candidate
- ESOP Corporate Governance
- How Does an ESOP Work?
- Plan Design Considerations
- What is a "Repurchase Obligation"?
- Corporate v. ERISA Fiduciary Standards
- General Regulatory Framework
- ESOPs and Other Retirement Plans
- Summary of Pros and Cons of an ESOP

Alternative Exit Strategies

- Sell to a Strategic Buyer
- Sell to a Financial Buyer
- Sell to an ESOP

Alternative Exit Strategies

- Purchase Price
- Tax Considerations
- Form of Consideration
- Diversification and Liquidity Concerns
- Legacy
- Alignment of Initiatives
- Time to Close

Introduction to ESOPs

ARE YOU CONSIDERING SELLING YOUR COMPANY TO AN ESOP?

- ESOPs are powerful, flexible vehicles that can provide closely-held companies and their selling shareholders with tax advantages not found elsewhere
- ESOPs are defined contribution plans (similar to 401(k) plans) that invest primarily in employer securities
- The Employee Retirement Income Security Act of 1974, as amended ("ERISA") and the Internal Revenue Code of 1986, as amended (the "Code"), are the governing laws regulating ESOPs
- Congress' intent was to create ownership and retirement assets for working class Americans
- Congress has passed a number of tax laws to encourage business owners to establish ESOPs

Introduction to ESOPs (Continued)

ARE YOU CONSIDERING SELLING YOUR COMPANY TO AN ESOP?

- ESOPs are designed to invest primarily in employer securities ("Company Stock")
  - Not subject to the 10% limitation on investments in Company Stock that apply to other ERISA plans; however
  - ESOP participants have diversification rights under either Section 401(a)(28) or 401(a)(35) of the Code
- ESOPs are not subject to the minimum funding requirements under Section 412 of the Code
  - Although planning for future payment obligations to terminated employees is highly recommended

Introduction to ESOPs (Continued)

RECENT ESOP TRENDS

- According to the most recent tally of ESOP annual returns (Form 5500*:
  - An average of 229 new ESOPs have been established every year since 2010
  - Companies across a broad range of industries and all across the U.S. have adopted ESOPs
  - As 2015, there were 6,669 ESOPs in existence in the United States, with an aggregate participant count of over 14.4 million individuals and with aggregate plan assets in excess of **$1 trillion**

*Statistics are courtesy of "ESOPs by the Numbers," The National Center for Employee Ownership, available at https://www.nceo.org/articles/esops-by-the-numbers#7 (last updated March 2018).

Introduction to ESOPs (Continued)

RECENT ESOP TRENDS

- Equity transactions involving ESOPs are on the rise:
  - With the increase in corporate tax savings attributable to the Tax Cuts and Jobs Act of 2017 (Pub. L. 115-97), and the generally positive state of the U.S. economy, experts have projected that 2018 will be a boom year for mergers and acquisitions activity as a whole
  - More lenders are becoming familiar with ESOP transactions
    - JPMorgan Chase and Bank of America, to name a few, have dedicated ESOP teams in the commercial banking divisions.
  - More business owners are seeking exit strategies

Introduction to ESOPs (Continued)

GENERAL CIRCUMSTANCES FAVORING ESOP TRANSACTIONS

- One or more shareholders desires liquidity for their equity and the remaining shareholders wish to retain their shares
- No available third-party buyer due to special circumstances or failed attempt to market the business
- Shareholders have a low tax basis in their shares of Company Stock
- Release of confidential information to prospective buyers (and potentially competitors) might have significant adverse impact on the business
- Meaningful debt capacity (current and future ability to de-leverage)
- Significant employee ownership will benefit marketing and business operations
- ESOP as a tax shelter will greatly improve corporate cash flow

Advantages of Selling to an ESOP

SELLING SHAREHOLDER

- Non-recognition of gain on sale for C corporation
  - Subject to certain conditions (described later), selling shareholders of a C corporation may elect to defer capital gains taxes on the sale of Company Stock to an ESOP under Section 1042 of the Code
  - If a 1042 election is made, the ESOP must own at least 30% of Company Stock immediately following the sale to the ESOP
- Facilitate partial or complete ownership transition

Advantages of Selling to an ESOP (Continued)

C CORPORATION

- Tax deductible funds transfers to the ESOP Trust
  - Tax savings can be used productively – debt repayment, capex, acquisitions, etc.
  - Employer Contributions deductible under:
    - Section 404(a)(3) of the Code
      - Up to 25% of the eligible "Compensation"
      - Aggregated with employer contributions to other defined contribution plans
    - Section 404(a)(9) of the Code
      - Up to 25% of the eligible "Compensation"
      - Only if contribution used to make exempt loan payments
      - Interest payments excluded
- Dividends deductible under Section 404(k) of the Code
  - Subject to certain conditions and restrictions

Advantages of Selling to an ESOP (Continued)

S CORPORATION

- Future corporate income is "passed through" to the ESOP Trust (tax-exempt)
- Tax deductible funds transfers to the ESOP Trust
  - Tax savings can be used productively – debt repayment, capex, acquisitions, etc.
  - Only the deduction for employer contributions under Section 404(a)(3) of the Code is available
    - S Corporation distributions may still be declared, and the ESOP Trust may use such proceeds to make exempt loan payments, however, the S distributions are not deductible.

Advantages of Selling to an ESOP (Continued)

EITHER C OR S CORPORATION

- Positive impact on corporate cash flow:
  - Employer Contributions to the ESOP may be made in shares of Company Stock
  - Employer Contributions to the ESOP used to acquire shares of Company Stock (pre-tax dollars) in lieu of stock redemption proceeds (after-tax dollars) may significantly impact the Company's cash flow availability on a post-transaction basis
- Particularly helpful if the Company is trying to maximize tax deductions while complying with any financial covenants with senior lenders.

Advantages of Selling to an ESOP (Continued)

ELIGIBLE EMPLOYEES

- Retirement plan with substantial benefits
  - No deduction from their wages is required or permitted
  - Typically no investment authority (unlike in 401(k) plans), however, potential retirement benefit based upon performance of Company Stock
  - Independent studies have shown that ESOP-owned corporations provide greater compensation and benefits overall to employees

Advantages of Selling to an ESOP (Continued)

ELIGIBLE EMPLOYEES

- Aligns incentives of management and employees through beneficial ownership interest- powerful tool for recruitment and retention
  - Employee-ownership culture
  - Participating employees have opportunity to provide input on certain corporate matters through ESOP pass-through voting rules
  - Open book management (potentially)

Benefits of ESOPs vs. M&A or LBO Strategies

BENEFITS TO MANAGEMENT AND EMPLOYEES

- No operational restructuring implemented by private equity firm or strategic buyer
- Management team and employees remain in place
- Management team can control exit strategy and governance
- Creates new employee benefit to motivate and reward employees
- Synthetic equity plan can be put in place as added incentive for key management

Profile of an Ideal ESOP Candidate

SELLING SHAREHOLDER CHARACTERISTICS

- Desires Fair Market Value
- Seeks personal wealth diversification
- Would like to take some value out of corporation on a tax-deferred basis
- Seeks to preserve corporation and employee legacy
- Wishes to provide employees with economic benefits

Profile of an Ideal ESOP Candidate

SPONSORING CORPORATION AND EMPLOYEE CHARACTERISTICS

- Sufficient balance sheet strength to absorb ESOP acquisition debt (if any anticipated)
- Sufficient cash flow from operations to cover all ESOP acquisition debt and other long-term debt service requirements
- Historical and projected profitable operating performance (i.e., revenue generation and profit margins)

Profile of an Ideal ESOP Candidate

SPONSORING CORPORATION AND EMPLOYEE CHARACTERISTICS

- Sufficient payroll to meet contribution requirements
- 15 to 20 employees or more
- Management depth and established plan for succession
- Participatory management environment
- Effective communications exist between employees and management
- S corporation or C corporation

Other ESOP Considerations

FACTORS FOR THE BOARD OF DIRECTORS TO CONSIDER

- Value to all shareholders
- Interest of creditors
- Continuity of business
- Company culture and independence
- Employees, employment, motivation, productivity

Other ESOP Considerations (Continued)

FACTORS FOR THE BOARD OF DIRECTORS TO CONSIDER

- ESOP plan administration and maintenance expenses (annual following closing)
  - Record keeping, accounting, and filing of annual return for the ESOP
  - Post-transaction, annual stock valuations
  - Required ESOP disclosures to participants
  - Typically higher than for other employee benefit plans due to the need for independent ESOP advisors and independent appraisals of Company Stock
  - Related: Management of future ESOP repurchase obligations

Other ESOP Considerations (Continued)

FACTORS FOR THE BOARD OF DIRECTORS TO CONSIDER

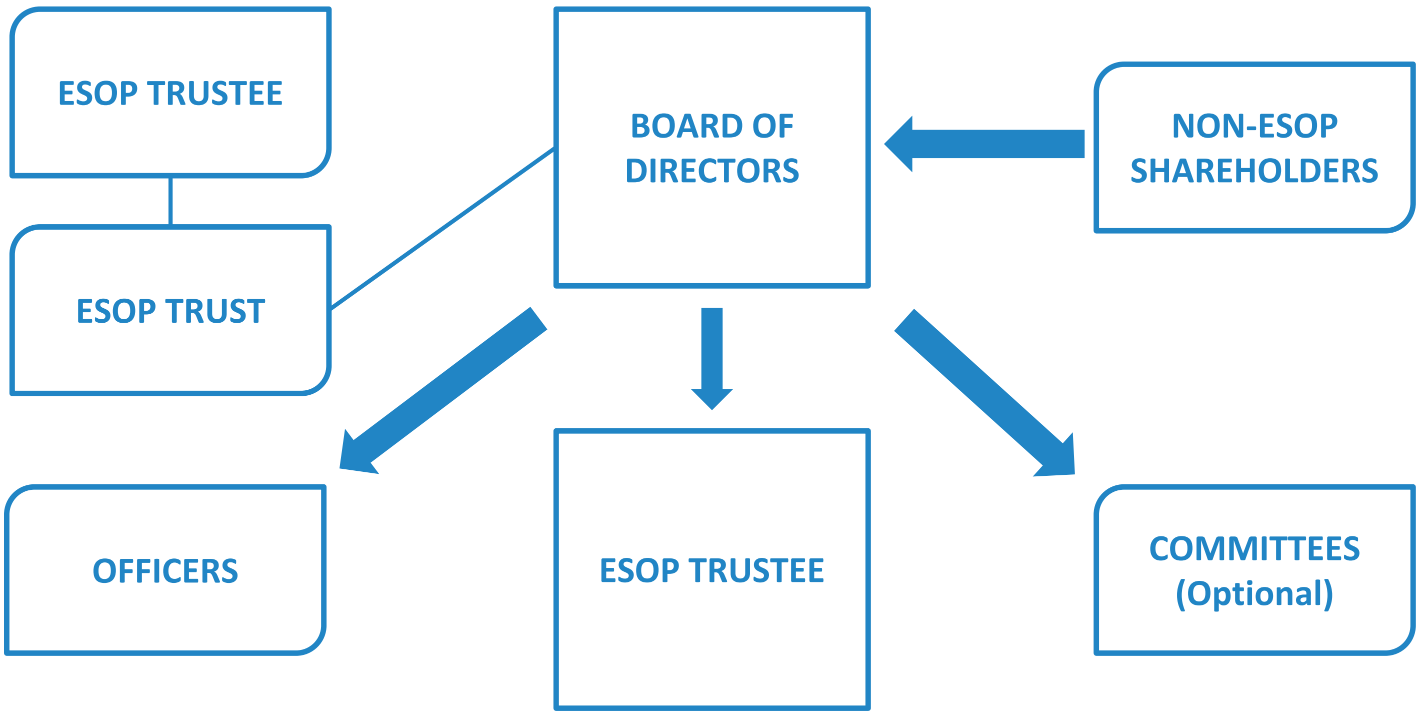
- Balance Sheet Impact
  - Contra-equity account (leveraged ESOPs only)
- Potential Impact of ESOP ownership on:
  - Inter-company transactions with affiliates
  - Relationship with bond issuers
  - Relationship with financial institutions

Other ESOP Considerations (Continued)

FACTORS FOR THE BOARD OF DIRECTORS TO CONSIDER

- Other Transaction Considerations
  - Expenses for advisors in negotiating and drafting financing and transaction documents
  - ESOP requires independent advisors and a separate fairness opinion based upon a separate appraisal as of the closing date
  - U.S. Department of Labor and the Internal Revenue Service maintain regulatory oversight of all ESOPs.
    - Liability may be mitigated or minimized through obtaining ERISA fiduciary liability insurance and implementing best practices for corporate governance and ESOP transaction matters

Corporate Governance in an ESOP Corporation



- Shareholders elect Board of Directors
- Board of Directors appoints officers, ESOP Trustee (or a Board of Trustees), and committee members

Brief Description of Respec30tive Roles

ESOP Trustee

- Elects and Monitors the Board of Directors
- Votes Shares Owned (if necessary)
- Responsible for ESOP Trust Administration
- Establishes Fair Market Value for Company Stock

Board of Directors

- Responsible for Major Corporate Actions
- Strategic Planning
- Appoints Officers and Trustee (and Optionally Committees)

Corporate Officers

- Responsible for Day-to-Day Management of Corporation

Brief Description of Respective Roles (Continued)

Optional Committees of the Board of Directors

- **Nominating Committee** – Evaluating current directors and identifying and vetting potential new directors
- **ERISA Fiduciary Committee** – Selection and monitoring of ERISA fiduciaries of all employee benefit plans that the Company maintains
- **Audit Committee** – Oversight of the annual audit of the Company's financial statements (if applicable)
- **Executive Compensation Committee** – Evaluation of the compensation packages awarded to executives (including the engagement of an independent analyst)
- **ESOP Communications Committee** - Responsible for learning how the ESOP functions and communicating that to the Company's employees

ESOP Corporate Governance

Success in an ESOP-owned corporation encompasses:

- Business survival and growth
- Increase in Company Stock value
- Repurchase of Company Stock from departing employees
- Adequate provision for employee retirement
- Employee fulfillment of operational improvement initiatives to increase, quality, productivity, profitability and value

The ESOP Trust

- The ESOP needs a trust, which is a separate legal entity, to hold title to assets (including shares of Company Stock) and administer plan assets
    - The ESOP Trust will be the legal or record owner of shares of Company Stock
    - Participating employees are beneficial owners of Company Stock and not direct owners
- When the Company establishes an ESOP, the Company must concurrently form a trust and appoint a trustee for the ESOP
- ERISA governs the ESOP Trust
    - The ESOP Trustee is subject to the ERISA prudent person standard, which is the highest standard of care in the country

The ESOP Trustee

Types of ESOP Trustees

- Inside Trustees
  - Directors, officers, or employees of the Company
- Independent Trustee
  - Institutions (banks, trust companies, etc.)
  - Professional individual service providers

Authority of ESOP Trustees

- **Directed Trustee** (inside or independent): Receives and acts under direction from discretionary fiduciaries
- **Discretionary Trustee** (inside or independent): Has full discretion with regard to voting ESOP-owned shares and investment and management of ESOP assets

The ESOP Trustee

ERISA Fiduciary Obligations - Generally

- Exclusive benefit rule
  - A qualified retirement plan is required to be maintained for the exclusive best interests *of the participants and beneficiaries* and payment of reasonable administrative expenses
- Prudence
  - With the care, skill, prudence and diligence under the circumstances then prevailing, that a prudent person, acting in a like capacity and familiar with such matters, would use in the conduct of an enterprise of a like character and with like aims

The ESOP Trustee (Continued)

ERISA Fiduciary Obligations – In ESOP Transactions

- **Adequate Consideration**

  - The ESOP cannot pay more than fair market value for the shares of Company Stock that it is acquiring

- **Fairness**

  - The overall transaction must be fair to the ESOP from a financial point of view

    - This includes any other contemporaneous arrangements between the Company and the selling shareholder(s) and/or between the Company and management (such as management incentive plans)

Parties and Advisors Involved in an ESOP Transaction

<table>
<tr><th><u>The Company</u></th><th><u>The ESOP Trust</u></th><th><u>The Selling Shareholder(s)</u></th></tr>
<tr>
<td>

<u>Accountant and/or Consultant</u>
<u>Financial Advisor</u>
May assist with debt placement
<u>Legal Counsel</u>
Assists with ESOP transaction design
Drafts ESOP plan documents
Drafts ESOP transaction documents

</td>
<td>

<u>ESOP Trustee</u>
<u>ESOP Independent Appraiser and Financial Advisor</u>
Valuation Report and Fairness Opinion Letter
<u>Legal Counsel</u>
The ESOP Trust’s legal advisor (not corporate counsel)

</td>
<td>

<u>Accountant and/or Tax Preparer</u>
<u>Financial Advisor</u>
<u>Separate Legal Counsel</u>
Reviews ESOP transaction documents

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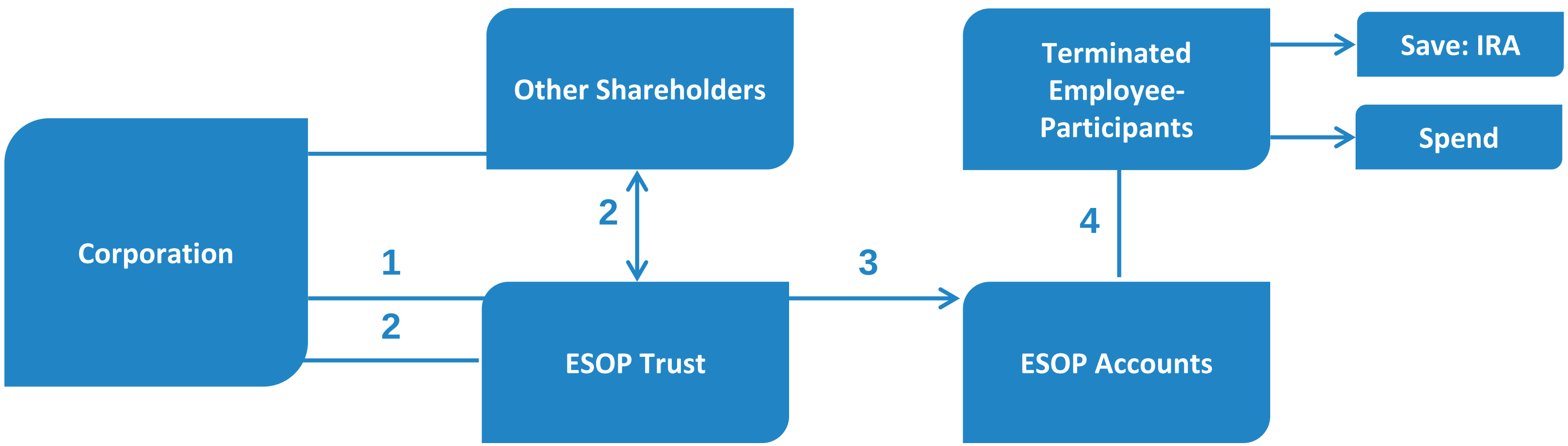
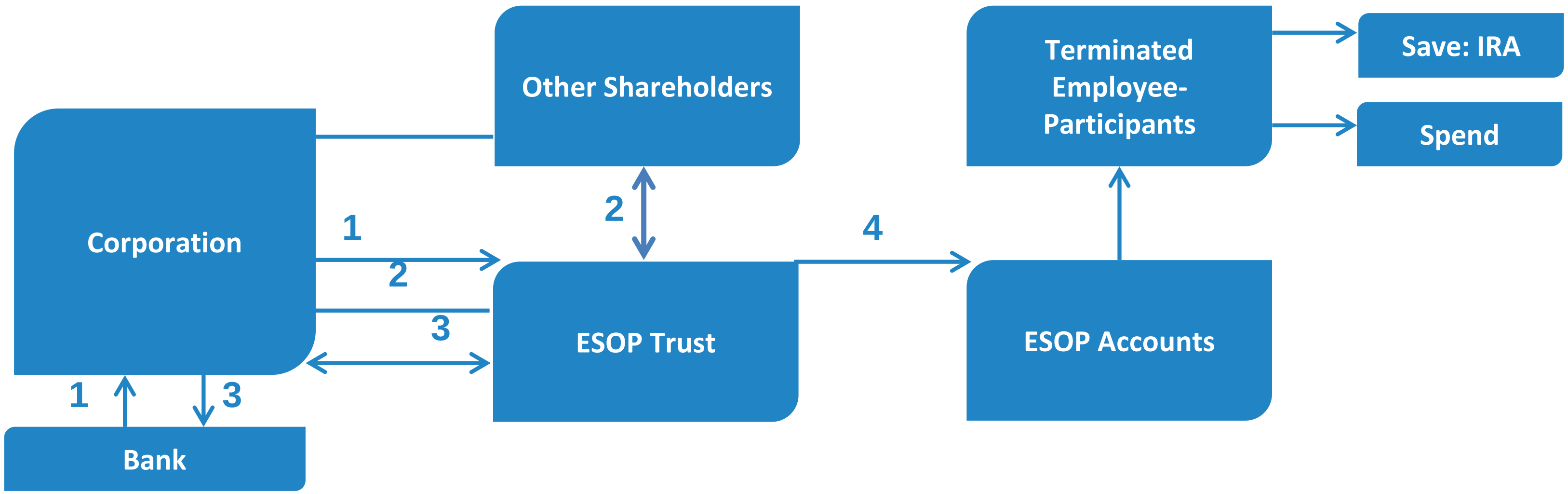
How Does an ESOP Work?
(Non-Leveraged)



1. Corporation makes annual tax deductible cash and/or stock contributions to ESOP Trust; and/or
2. ESOP Trust uses cash contributions to acquire stock from existing shareholders or the Corporation.
3. ESOP Trust allocates stock or cash to Participant accounts and tells employees how much stock has been allocated to their accounts and how much such stock is worth.
4. Employees receive stock or cash when they leave Corporation and must sell stock back to Corporation, which must purchase such stock.

How Does an ESOP Work?
(Leveraged)



1. Bank loans funds to the Corporation, which loans funds to the ESOP Trust.
2. ESOP Trust uses loan proceeds to acquire stock from existing shareholders or the Corporation.
3. Corporation makes annual tax deductible cash contributions to the ESOP Trust; ESOP Trust makes payments on the loan; Corporation makes payments on the Bank loan.
4. ESOP Trust allocates stock to Participant accounts and tells employees how much stock has been allocated to their accounts and how much such stock is worth.
5. Employees receive stock or cash when they leave Corporation and must sell stock back to Corporation, which must purchase such stock.

Financing the ESOP Transaction

ESOP Transactions are funded with a variety of capital sources:

- Debt
  - Senior Bank
  - 2nd Lien/Junior
  - Structured Equity
  - Seller Financing
- Equity (Less Common)
  - Senior Management
  - Private Equity
  - Employees

Financing the ESOP Transaction (Continued)

When both Bank and Seller Financing are utilized:

- Statutory and regulatory restrictions on ESOP acquisition loans preclude subordination, however, Banks typically do not request subordination if the seller-financing is structured as two mirror loans
  - External Loan: Loan from Selling Shareholder(s) to the Company (may be and almost always is subordinated to the Bank)
  - Internal Loan: Company's loan of the External Loan proceeds to the ESOP
    - No net impact on corporate cash flow from servicing the ESOP loan repayments (sourced in tax deductible employer contributions and/or tax deductible dividends or S corporation distributions), so the Bank does not request subordination of the Internal Loan

Code Section 1042 Tax-Deferred ESOP Transaction

- A shareholder of a “closely held” *C corporation* may sell qualified employer securities to an ESOP and defer the taxation of gain upon sale of such employer securities to the extent that he or she reinvests in securities of other corporations (“qualified replacement property” or “QRP”)
- The QRP has a carry-over basis from the shares of Company Stock sold to the ESOP.
- If the seller holds on to the QRP until the seller’s death, the QRP will pass to the seller’s heir(s) with a stepped-up basis for tax purposes.

Code Section 1042 Tax-Deferred ESOP Transaction (Continued)

Qualifying Employer Securities

- Not readily tradable on an established securities market, and:
  - Common stock (best dividend and best voting rights); or
  - Convertible preferred stock
- Selling shareholder did not receive pursuant to an incentive program
- Long-term capital gain
- Three-year holding period

Code Section 1042 Tax-Deferred ESOP Transaction (Continued)

TRANSACTIONS MUST HAVE 5 CHARACTERISTICS

1

It must be one that would otherwise result in long-term capital gain (LTCG) to the selling shareholder

Code Section 1042 Tax-Deferred ESOP Transaction

TRANSACTIONS MUST HAVE 5 CHARACTERISTICS

2

The selling shareholder's holding period for the stock must be at least 3 years

Code Section 1042 Tax-Deferred ESOP Transaction

TRANSACTIONS MUST HAVE 5 CHARACTERISTICS

3

The selling shareholder must not have received the stock from a qualified employee plan (such as an ESOP), by exercising a stock option or through an employee stock purchase program

Code Section 1042 Tax-Deferred ESOP Transaction

TRANSACTIONS MUST HAVE 5 CHARACTERISTICS

4

After the sale, the ESOP must own (on a fully diluted basis) at least 30% of the Company

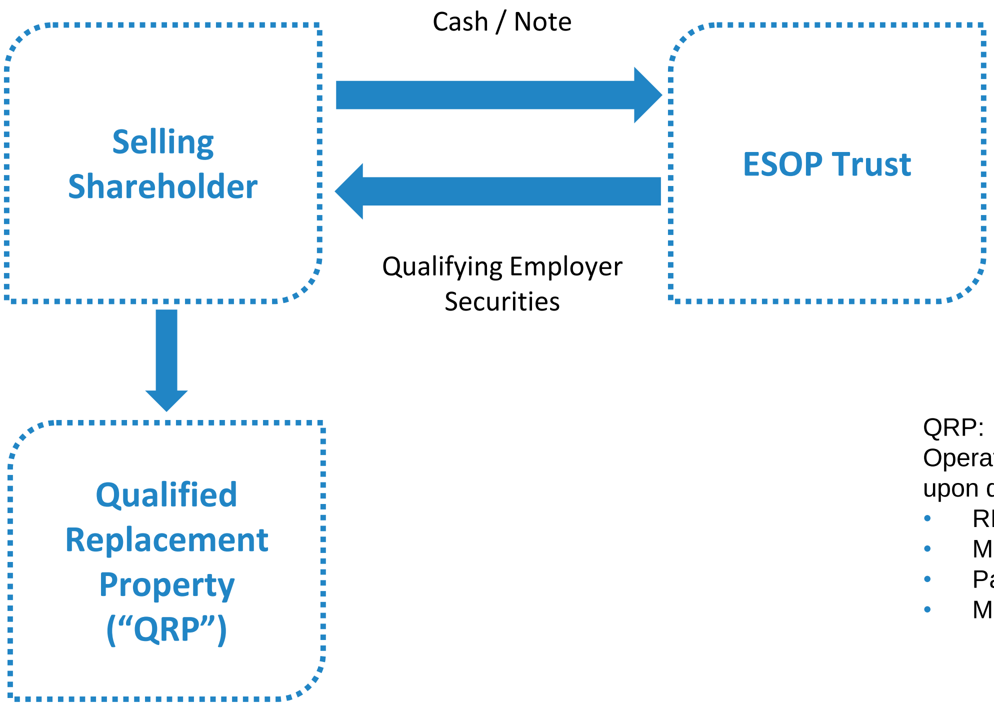
Code Section 1042 Tax-Deferred ESOP Transaction

TRANSACTIONS MUST HAVE 5 CHARACTERISTICS

5

The selling shareholder must purchaser the QRP within a 15-month period that begins 3 months before and ends 12 months after the sale of Company Stock to the ESOP

Tax-Deferred Reinvestment under
Section 1042 of the IRC C Corporations Only



QRP: Debt or Equity in a Domestic Operating Corporation (Stepped-up basis upon death). QRP Excludes:

- REITs
- Mutual Funds
- Passive Investment Companies
- Municipal Bonds

Qualified Replacement Property

- Generally, "qualified replacement securities" must be securities of U.S. operating companies whose passive investment income does not exceed 25% of gross receipts.
- The replacement securities are defined to include equity (stocks) and debt (bonds) of U.S. corporations, either public or private, including common stock, preferred stock, corporate notes and bonds, convertible bonds and floating rate notes.
- Qualified replacement property does not include U.S. government municipal securities, foreign securities, mutual funds, interests in limited partnerships, REITs, passive investments, or the stock of the corporation (or its affiliates) that is the subject of the ESOP transaction.

Qualified Replacement Property (Continued)

- Some brokerage and investment firms offer products that essentially allow the sellers to borrow against the replacement securities
- Floating rate note QRP securities (“FRNs”) are designed specifically to address this leverage opportunity
- The FRNs are designed specifically to be held until death of the selling shareholder

Prohibited Allocations if Capital Gains Deferred Under Section 1042

50% excise tax if allocation occurs (generally within 10 years of transaction) of company stock acquired from the selling shareholder to:

- Taxpayer who received tax deferral (selling shareholder);
- Individual related to selling shareholder; and
- Any person owning more than 25% of any class of outstanding stock of the sponsoring corporation

* **Note:** Children/Grandchildren of the selling shareholder may receive 5% in the aggregate under certain conditions.

Comparison of Stock Sale Structures

	Sale to ESOP without Code Section 1042 Tax-Deferral	Sale to ESOP with Code Section 1042 Tax-Deferral
Long-Term Capital Gains Tax	Federal: 15% or 20%, depending on the selling shareholder's tax bracket. Plus the long-term capital gains tax rate of the state of residence of the selling shareholder	Deferred until subsequent disposition of QRP
Affordable Care Act Medicare Investment Tax (ACA Tax)	3.8% on the lesser of: (a) Net investment income (mostly passive investments, unless material participation exception applies), or (b) Modified AGI (e.g., amount over $250,000 for married joint filers)	N/A
Result	Net Proceeds = Purchase Price – Combined Federal and State taxes	Net Proceeds = Purchase Price – QRP Acquisition Cost; QRP Acquisition Cost is invested

Code Section 1042 Tax-Deferred ESOP Transaction – QRP Examples

Filing an election under Section 1042 of the Code after selling shares of Company Stock to an ESOP for $1,000,000, the seller may invest the $1,000,000 proceeds in QRP and avoid capital gains taxation.

DIRECT QRP ACQUISITION EXAMPLE
Sale to the ESOP for $1,000,000 in cash payment
$1,000,000 in QRP acquired with cash
$1,000,000 in QRP has carryover basis (often negligible)
If the $1,000,000 in QRP is sold after the seller's death, the capital gains is measured by the stepped basis or fair market value basis at death
If the value at death is $1,500,000, the basis is stepped to $1,500,000 at death and no tax is applied

Code Section 1042 Tax-Deferred ESOP Transaction – QRP Examples

FINANCED QRP ACQUISITION EXAMPLE
Sale to the ESOP for $1,000,000 in cash payment
$1,000,000 in QRP acquired as FRNs with $200,000 in cash and $800,000 in margin loan proceeds
$1,000,000 in FRN QRP will generate interest income to pay the margin interest on the $800,000 margin loan
$800,000 (net of the $1,000,000 proceeds from the sale to the ESOP less the $200,000 cash down payment to acquire QRP) is available for other investments
$1,000,000 in QRP has carryover basis (often negligible)
If the $1,000,000 in QRP is sold after the seller's death, the capital gains is measured by the stepped basis or fair market value basis at death
If the value of the FRNS at death is $1,000,000, the basis is stepped to $1,000,000 at death and no tax is applied

Installment Sales

- Tax Rates – Notes Regarding Installment Reporting (Internal Revenue Code Section 453):
- Installment reporting is the default method for installment sales.
- Each payment is included in income in the year of receipt.
  - This means that each installment payment is subject to the Federal LTCG rate prevailing for the year of payment.
- The Seller may "opt out" of installment reporting (Schedule D) and pay taxes *on the entire purchase price in the year of the sale* at the then current rates.
- $5M caveat

Partial Installment Sale Reporting

A partial Code Section 1042 election and installment sale is permissible; however, the IRS requires the allocation to be based on the entire selling price.

EXAMPLE DIRECT QRP ACQUISITION
$1,000,000 sale to the ESOP; $200,000 received in cash and $800,000 seller note
$200,000 of QRP acquired with cash under Code Section 1042
The cash received is treated as 20% subject to Code Section 1042 tax-deferral and 80% reportable under the installment method (i.e., no ability to match the cash and the 1042)

Potential Tax Liability

Select Provisions Relevant to Companies:

- Federal corporate tax rate dropped from 35% to 21%
- 20% deduction for qualified pass through entities
- Interest deduction limit of 30% of EBITDA (beginning after 2021, limit becomes 30% of EBIT)
- Immediate expensing of capital expenditures
- Repatriation tax rate of 15.5% for cash and 8.0% for non-cash assets

Potential Tax Liability (Continued)

- Given new corporate tax rates, it is possible that C-Corp structures may be nearly as efficient as alternative structures
- C-Corps provide much more flexibility in sourcing and structuring capital compared to S-Corps
- Tax leakage is significantly lower than before and may justify running a financial analysis to compare alternatives
  - Additional C-Corp tax shields that may be available are abnormally high interest expenses if there was a recent leveraged ESOP transaction, non-cash ESOP benefit expenses, depreciation, etc.
- Strategy may be particularly interesting for partial year S-Corp ESOPs: ability to minimize flow of cash into the ESOP attributable to proportionate S corporation distributions

Potential Tax Liability (Continued)

C-Corp Advantages and Disadvantages	
Advantages	**Disadvantages**
Do not have second class of stock and other restrictions of an S-Corp	Although tax leakage is less due to lower tax rate, there is still tax leakage compared to S-Corp structures
Ability to efficiently source capital of all types depending on situation	
Recent tax law changes make tax leakage lower	
For partial S-Corp ESOPs, can better control benefit levels realized by ESOP	
Depending on situation, acquisitions as a C-Corp can allow sellers to elect 1042	

Potential Tax Liability (Continued)

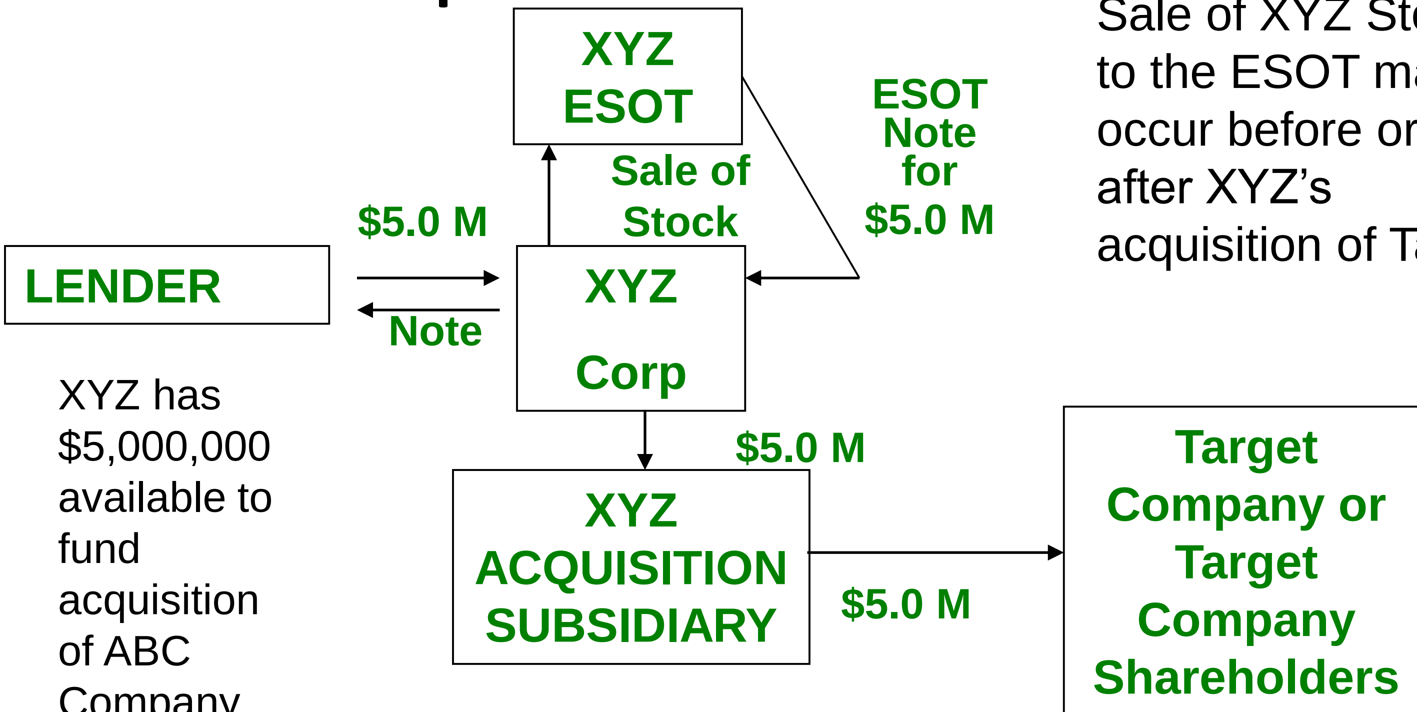
Potential Tax Liability Without 1042 Election	
Selling Shareholders' realized gain	$1,000,000
Highest marginal tax rate for Federal long-term capital gains	$200,000 (20%)
New York Income Tax	$88,200 (8.82%)
Federal Excise Taxes under the Affordable Care Act	$38,000 (3.8%)
Total Taxes (excluding NYC taxes)	$326,200

ESOPs as M&A Tools

- Beyond a vehicle for business succession planning purposes, ESOPs can be used to maximize tax advantages in other M&A Structures
  - ESOP tax savings can help free up available corporate cash flow for servicing corporate debt payments
  - ESOP's tax-exempt status shelters income stream of target company on a post-acquisition basis
  - An ESOP-owned company can leverage the tax advantages of ESOPs to be a successful bidder in the acquisition of a target company

ESOPs as M&A Tools – Transaction Structure Example 1

Sale of XYZ Stock to the ESOT may occur before or after XYZ's acquisition of Target



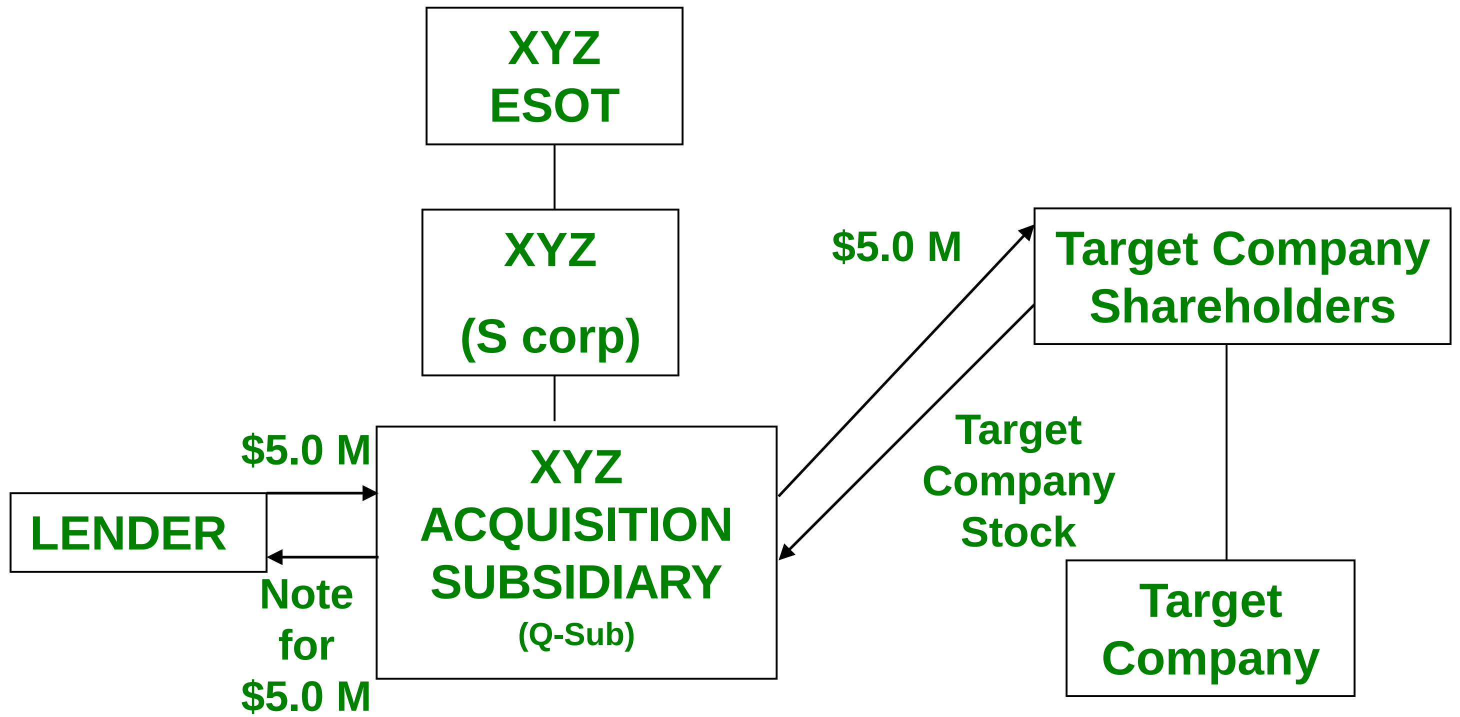
XYZ has $5,000,000 available to fund acquisition of ABC Company

<u>Post-transactions:</u>

- XYZ Corp's contributions to XYZ ESOT to allow repayment of the ESOT Note generates tax deductions and increases cash flow available to XYZ Corp to make payments on $5.0 M note from Lender.

- Taxable to Target Company Shareholders

ESOPs as M&A Tools – Transaction Structure Example 2



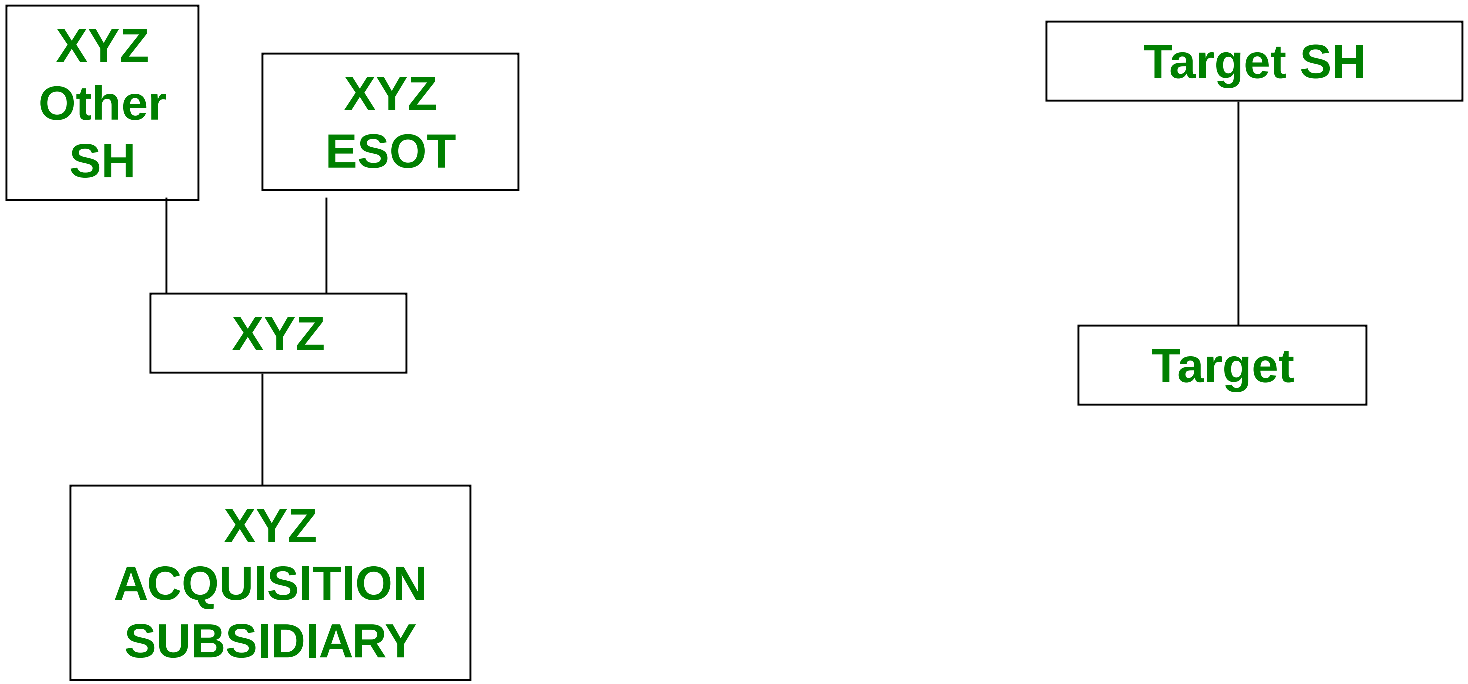
<u>Post-transaction:</u>

- Taxable to Target Company Shareholders

- Target Company's earnings become tax-exempt (following qualified subchapter S subsidiary election for Target Company), and more employees participate in the XYZ ESOP

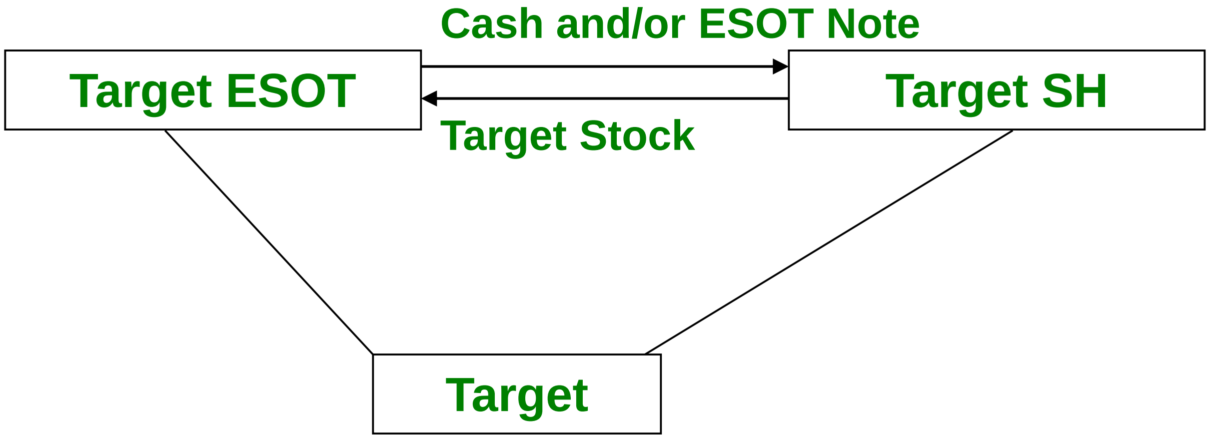
ESOPs as M&A Tools – Transaction Structure Example 3

Pre-Transaction Corporate Entities:



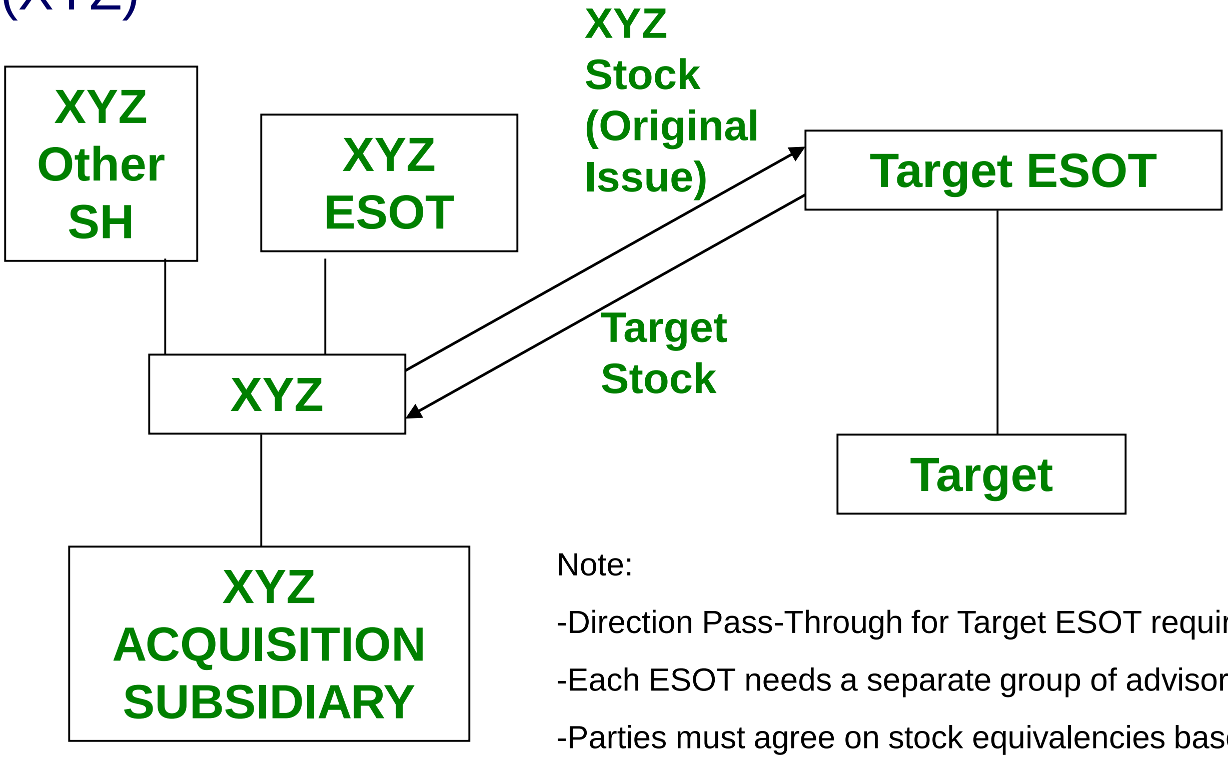
ESOPs as M&A Tools – Transaction Structure Example 3 (Continued)

- Step 1:
  - Target Establishes ESOP and Trust
  - Target SH sells to Target ESOT
  - Target SH (seller) elects to defer recognition of capital gains taxes under Code Section 1042:



ESOPs as M&A Tools – Transaction Structure Example 3 (Continued)

- Step 2: Stock exchange between Target ESOT and Acquirer (XYZ)



Note:

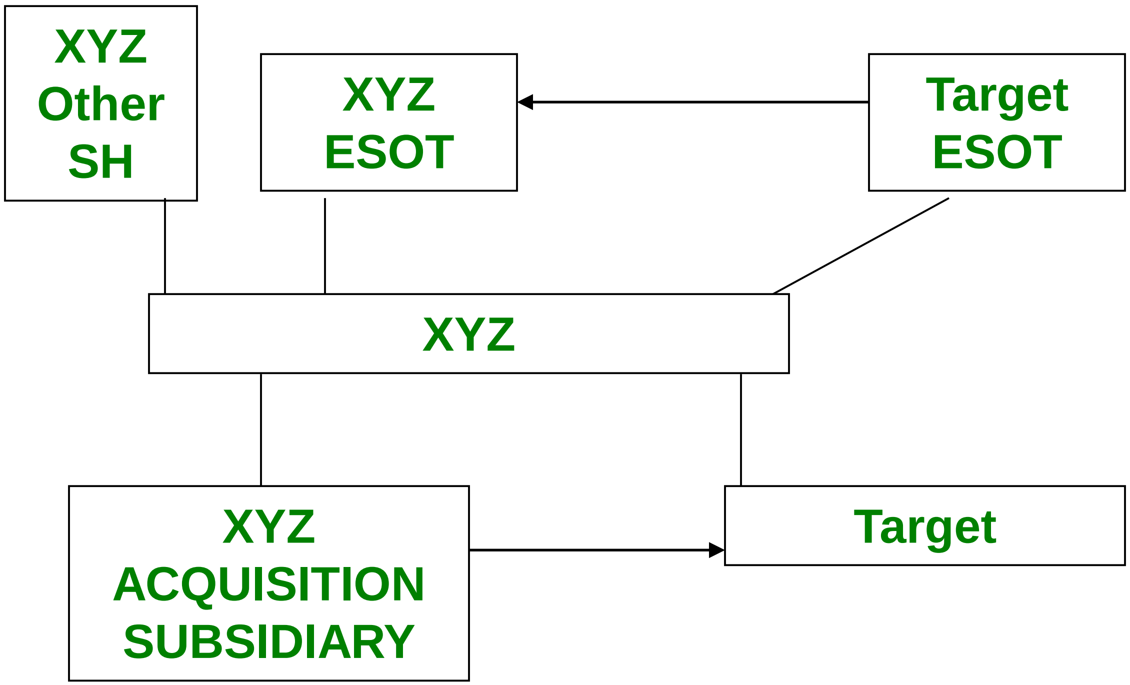
-Direction Pass-Through for Target ESOT required

-Each ESOT needs a separate group of advisors

-Parties must agree on stock equivalencies based upon separate independent valuations

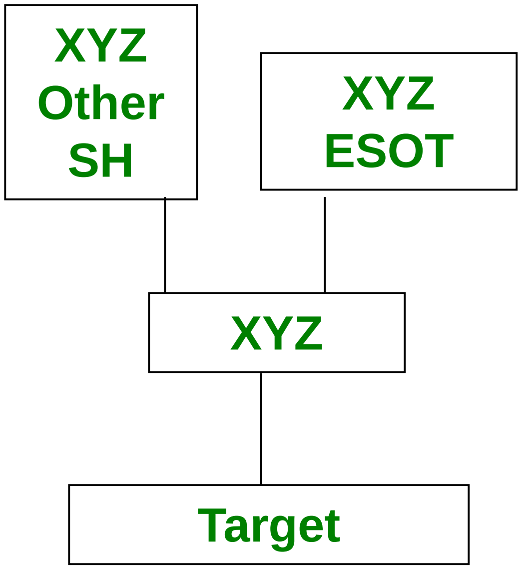
ESOPs as M&A Tools – Transaction Structure Example 3 (Continued)

- Step 3: Merger of ESOPs and Merger of Subsidiaries



ESOPs as M&A Tools – Transaction Structure Example 3 (Continued)

- Post-Transaction:
  - Capital gains tax-deferred for Target SH (seller)
  - Target's eligible employees participate in the XYZ ESOP
  - XYZ's acquires Target without need for cash assets or financing (although assumes Target's liabilities), except for transaction expenses



Best Practices for ESOP Transactions

- Retain expert legal, tax, and accounting advisors
- Commission an ESOP feasibility analysis
- Confirm available sources of financing as part of the corporate transaction structure planning process
- Design and structure the ESOP Transaction
  - Legal, tax, and accounting advisors should collaborate with the Company for tax planning purposes and to ensure that the future financing repayment obligations will not significantly impair the Company’s cash flow

Best Practices for ESOP Transactions

- Address conflicts of interest
  - Retain an independent Trustee for the ESOP in conjunction with the establishment of the ESOP
    - The independent Trustee will retain an independent appraiser and financial advisor for the ESOP and may retain separate legal counsel for the ESOP (collectively, the “ESOT Advisory Team”)
  - Appoint one director (a non-selling shareholder if possible) to serve as the Company’s contact person for communications with the ESOT Advisory Team
  - Ensure advisors are not representing more than one party to the transaction

Best Practices for ESOP Transactions (Continued)

- Respond promptly and thoroughly to due diligence request of the ESOT Advisory Team
- Maintain a detailed and written record of the due diligence production and negotiations
  - Ideally, set up an electronic data room
- Develop any new management incentive programs concurrently with the transaction and disclosure such plans to the ESOT Advisory Team
  - This ensures the inclusion of future equity or synthetic equity grants to senior management in the ESOP's fairness evaluation at the time of the transaction
- Be patient
  - Lenders and the ESOT Advisory Team will need time to review due diligence documents, financing agreements, and other transaction documents.

Best Practices for ESOP Transactions (Continued)

- Obtain a copy of the ESOP’s fairness opinion letter
  - Note only the ESOP Trustee will receive the accompanying valuation report
- Develop and implement a plan for educating employees about the ESOP and fostering an employee-ownership culture

David R. Johanson

Brief Bio

David R. Johanson, the Partner-in-Charge of the Napa office and a Partner in the San Francisco, Los Angeles, and New York offices of Hawkins Parnell Thackston & Young LLP, has helped hundreds of corporations form ESOPs and create effective employee ownership through other equity incentives during the past almost 30 years. Mr. Johanson assists clients in designing ESOP and equity incentive plans and accomplishing ESOP-related transactions, including mergers and acquisitions of all kinds. Mr. Johanson also defends ERISA fiduciary actions in Federal Courts throughout the U.S and is actively involved in defending regulatory and enforcement actions by the Internal Revenue Service and the U.S. Department of Labor. Recognized nationally for his experience and expertise in the ESOP and executive compensation field, Mr. Johanson is a past chair (1993-1995 and 2005-2007) of the legislative and regulatory advisory committee of The ESOP Association. He also is a past chair of The ESOP Association's advisory committee chairs council and is a former member of its board of directors. Mr. Johanson was honored at the 17th annual conference of The ESOP Association as the outstanding committee chair for 1993-94. Mr. Johanson served for more than ten years as General Counsel to The National Center for Employee Ownership and on its board of directors. Mr. Johanson writes and speaks frequently about employee ownership throughout the U.S.

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