

# Vermont Employee Ownership Center Annual Conference June 9, 2010

## Transitioning to an ESOP

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# Program Agenda

- Ownership Transition for Privately-Owned Companies
- ESOPs & Transaction Examples
- Employee Opportunity: The Quid Pro Quo



# Ownership Transitions for Privately-Owned Companies

# Liquidity and Succession: Some Common Goals

- Maximize after-tax proceeds
- Control timing of succession and transfer
- Diversify personal wealth
- Legacy

# Liquidity & Succession Alternatives

## External buyers

- Strategic
- Financial
- IPO

## • Internal Buyers

- Family
- Management
- Partner (Redemptions & Buy-Sells)
- ESOP

## • Liquidation



# ESOP Basics



# What is an ESOP?

- “Employee Stock Ownership Plan”
- Company funded only, no employee contributions
- Employees do NOT own the stock
- Qualified retirement plan under IRS
- Only qualified retirement plan that can borrow money
- No corporate financial disclosure required except in limited circumstances

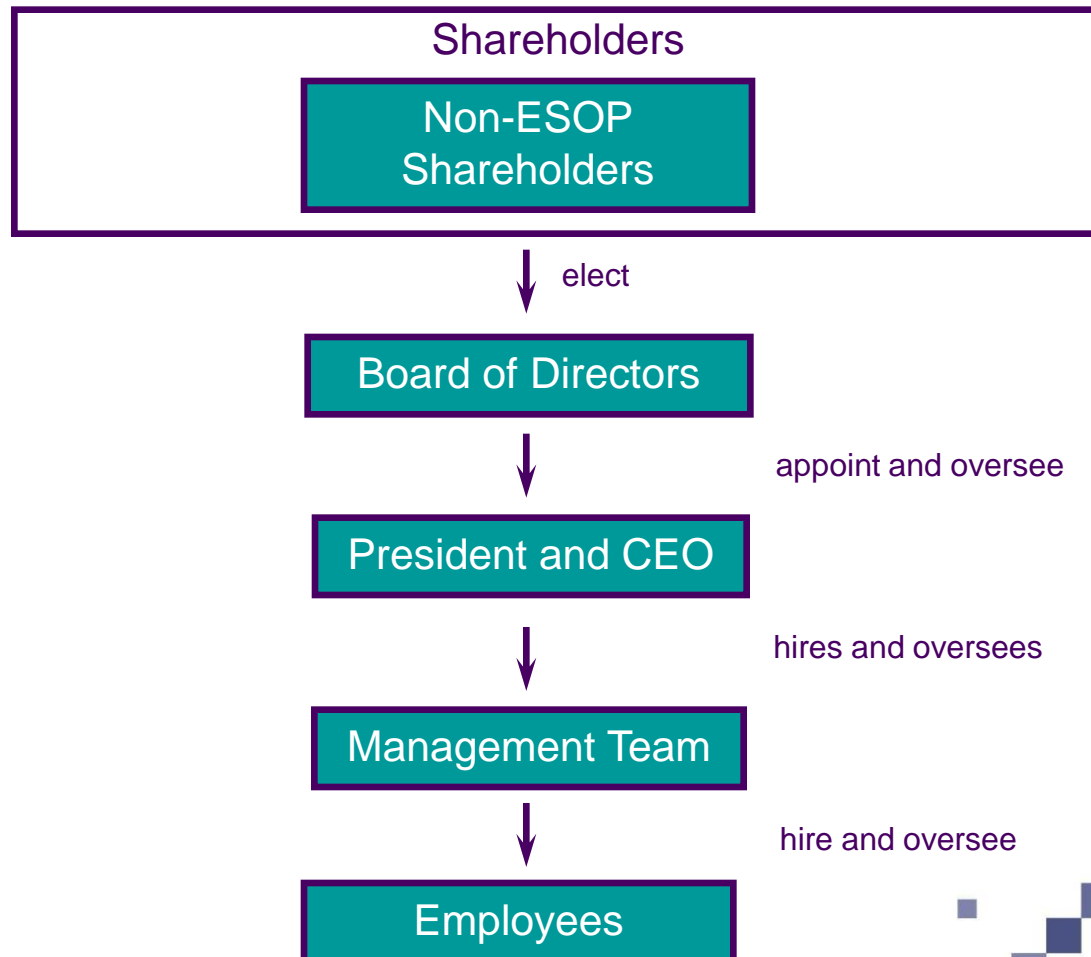
# Why Use An ESOP?

- **Shareholder Liquidity:** Create a market for part of the owners' stock
- **Shareholder Tax Minimization:** Defer payment of capital gains taxes
- **Corporate Tax Minimization:**
  - Effectively create interest AND principal payments tax deductions
  - S corporation ESOP federal income tax exemption
- **Succession Planning:** Shareholders can sell shares while maintaining control of the company
- **Legacy:** Maintain company's independence
- **Employees:** Motivate, retain and reward employees

# ESOP Trust Ownership: Beneficial vs. Direct Ownership

- Shares purchased by the ESOP are owned in a trust, not by plan participants
  - Eligible employees are “beneficiaries” of the trust
- An independent trustee represents the interest of ESOP participants

# XYZ Structure Pre-ESOP





# Common ESOP Misperceptions

- Participants own and vote the stock
  - Untrue unless you are a public company or shareholders get to vote on a major issues (which does not include voting for the Board)
- Participants are entitled to company financial statements
  - Untrue, unless you are a public company
- All of the company's stock must be sold to an ESOP
  - Most ESOPs do not own the entire business
- A company has to be a C corporation to sponsor an ESOP
- A company has to use debt to sell stock to an ESOP



# ESOP's Primary Roles

- Help owners convert paper wealth into cash and liquidity
- Help manage the succession/continuity of the business
- Reward the people that have helped grow the company
- Transition in a controlled and tax efficient manner

# Good News!

- ESOP is an **internal buyer** and is a more controlled and less distracting alternative than selling to a third-party in the market place
- ESOP transactions can be done in stages, over time, rather than all at once
- Tax savings to the company minimizes cash flow costs of buyout
- Companies with seller financed ESOPs have more flexibility than those with bank financed ESOPs
- Business continuity and opportunity for everyone
- Impressive estate planning opportunities for the selling owner as well

# Situations Not Befitting an ESOP

- No successor management
- Owner only wants a few people to own the company
- There may not be enough “Es” to “SOP”
- Owner’s price is “opportunistic”



# Vermont Systems, Inc.



# Vermont Systems, Inc.

## —Who we are

- From July 1985 to December 1998 we were family owned by 5 shareholders with about 25 employees in 1998
- Since January 1999 we have been 100% ESOP-owned with 90 employees AND the family is still involved!

# Vermont Systems, Inc.

## —Our Counts Before the ESOP

- Employees - - 25
- Gross Revenues - - \$5.5mm
- Net Income - - \$1.4mm
- Income Taxes - - \$700,000
- Share price - - \$551.47 per share



## Vermont Systems, Inc.

### —Our Counts After the ESOP

- Employees - - 90
- Gross Revenues - - \$16.7mm
- Net Income - - \$4.2mm
- Income taxes - - \$10,000
- Share value - - \$45,055 (adjusted for splits)

# Why ESOP for Vermont Systems, Inc.

- Taxes, taxes, taxes!!!
- It keeps the ownership local
- It creates employee loyalty to the company
- Low debt burden to the company
- Lender is friendly
- The taxes not paid, paid the owners for the company
- The previous owners, now employees, gain shares in the company ESOP

# The Forming ESOP Process

- An ESOP Trust is established
- An ESOP Trustee is appointed (Internal)
- An outside appraisal of the company
- The owners sell their stock to the Trustee and Company
- The Trustee and the Company issues notes to the owners
- The owners get an employment contract and non compete agreement
- 10 year structure; employees now own the company!

# Living the ESOP

- Every month the ESOP is paid down and the old owners get a check
- At the end of each year:
  - A new appraisal is done on the company (Empire Valuation)
  - Stock is distributed to eligible employees (Pension Works)
  - Stock is distributed at original sale price but assumes new price in employee account.
- A company meeting is held and everything is explained
- Employees are eligible after 1 year and 1000 hours
- Employees are vested:
  - At 65
  - After 5 years
  - Upon death
  - Upon Disability

# Miscellaneous VSI Notes:

- Employee reaction to ESOP
- Impact on the company
- How do the old owners feel about the decision now?
- What would we do different
- Advice to Others:
  - Keep employees informed once per month
  - A bonus system with defined rules, reviewed monthly
  - The rumor mill paints a far worse picture of a company than the truth.
  - Remember that the previous owner may now be another employee.
  - Have a succession plan in place



# Other Common ESOP Transaction Examples

# Typical ESOP Transactions: Case Study Assumptions

- XYZ Corp. has two shareholders, Jim who owns 80% and Pat owning 20%
- XYZ is profitable and has a payroll of approximately \$8 million
- The company's book value is \$10 million
- Earnings (EBITDA) average approximately \$3 million per year
- FMV is \$15 million

# Case I: Non-Leveraged ESOP

- Jim is seeking to sell his stock over several years as he approaches retirement
- XYZ Corp. would prefer to remain debt-free

## **Solution**

“Pay-as-you-go” ESOP

# Pay-as-You-Go ESOP

XYZ Corp

\$500,000 Cash Contribution

①

ESOP

②

\$500,000 Cash

③

3.3% of  
XYZ  
Shares

Jim  
(Taxable Transaction)

## RESULT:

- Company contributes to ESOP each year based on profits
- Here, ESOP buys 3.3% of XYZ Corp. from Jim, who will then own 76.7%
- Post transaction, Jim may be appointed Trustee and votes the ESOP's stock
- Jim can continue this stock sale strategy each year at his discretion

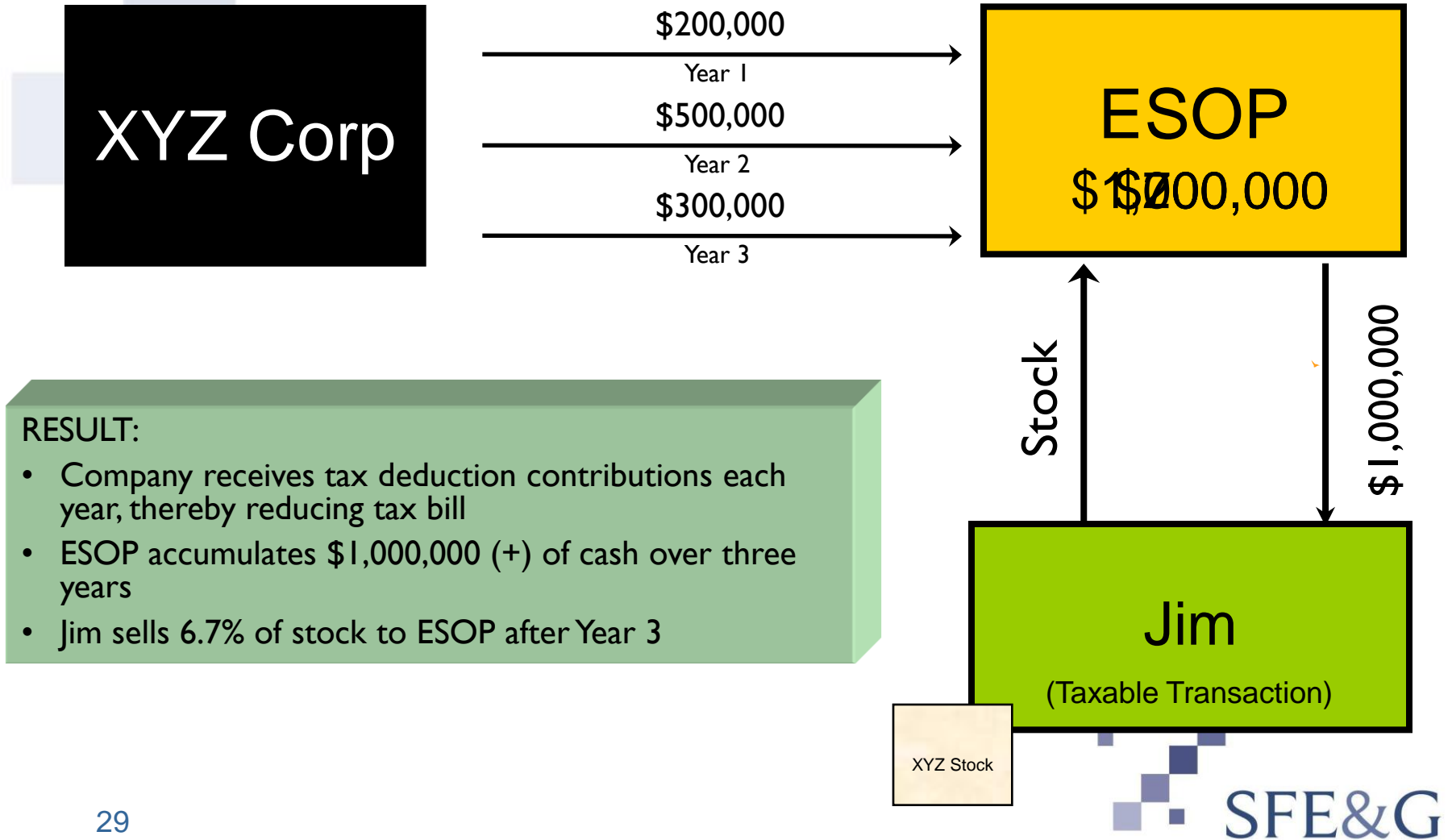
# Case II: Non-Leveraged ESOP

- The company has just experienced several financially challenging years, but the company's prospects are now much brighter
- Jim would prefer waiting to sell stock until the share price has improved
- Company wants to immediately reduce income taxes

## **Solution**

Pre-Funding the ESOP

# Pre-Funding the ESOP



# Case III: Partial Leveraged ESOP Transaction

- Jim wishes to sell a large percentage, ***but not all***, of his stock to the ESOP
- Jim does not want to pay capital gains taxes
- The company has “debt capacity”

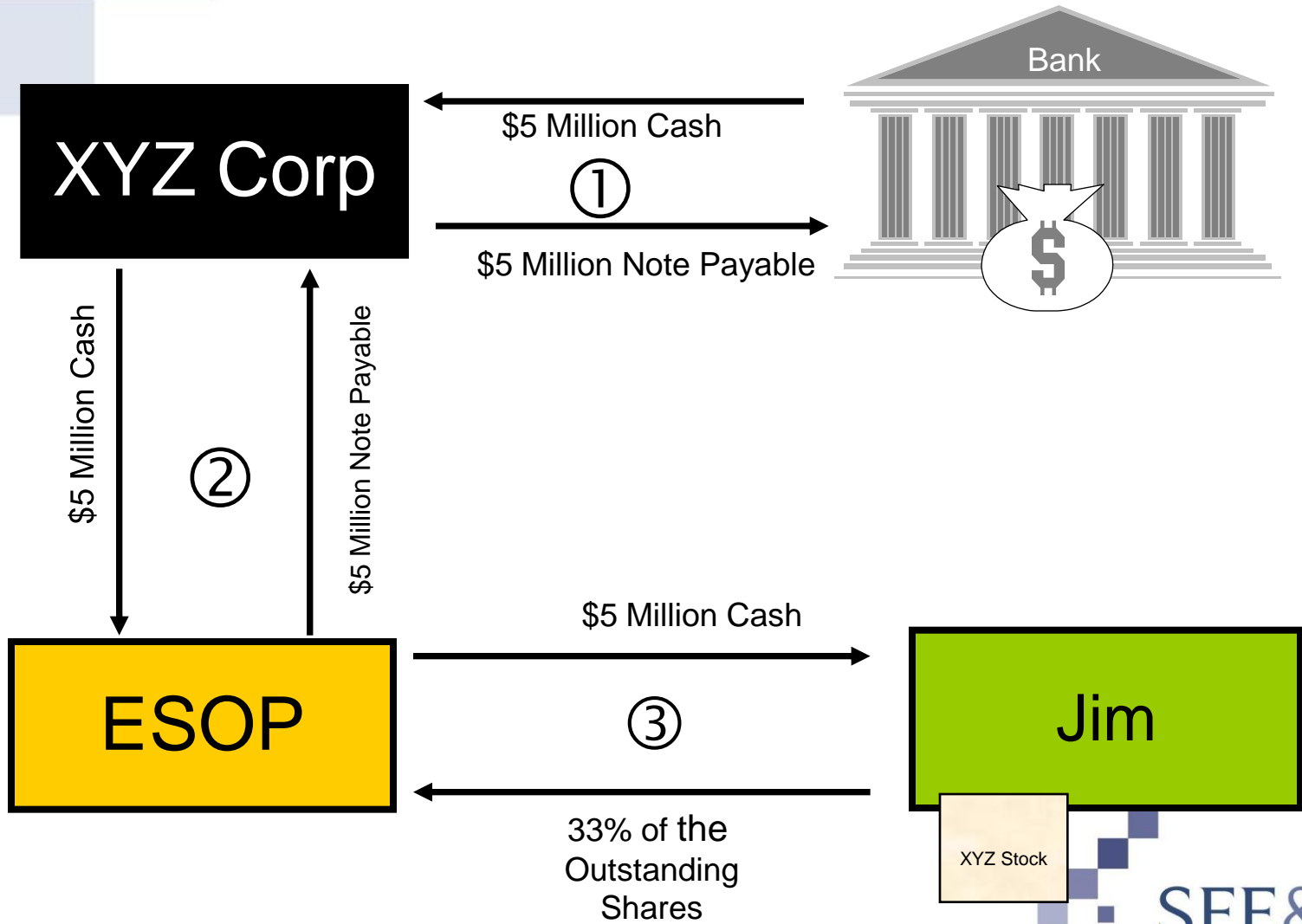
## **Solution**

### The Partially Leveraged ESOP

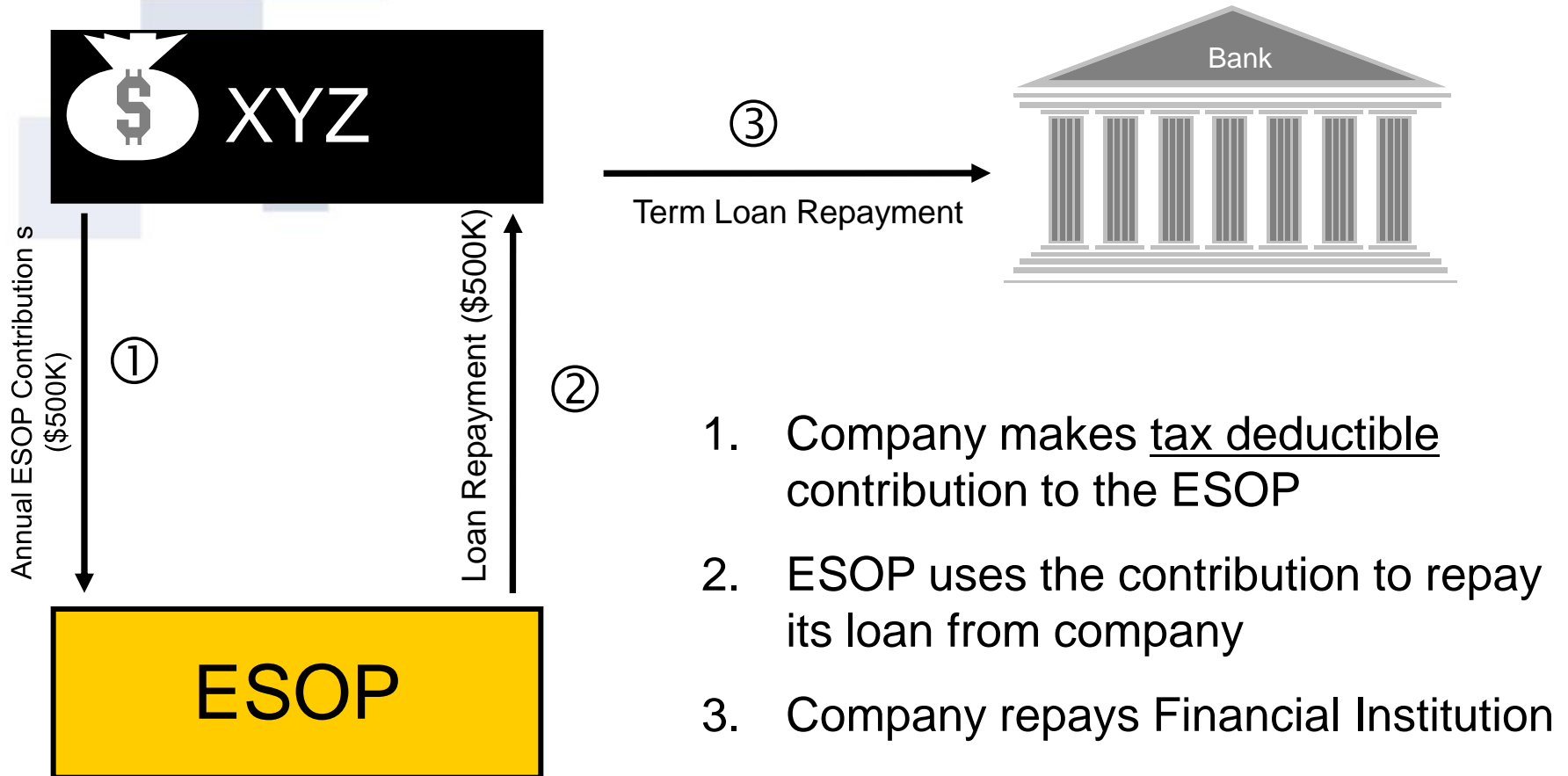
# Partial Leveraged ESOP

- The ESOP purchases 33% of XYZ's stock from Jim for \$5 million
- The stock purchase is financed with a \$5 million loan, which will be repaid over time

# Partially Leveraged ESOP



# Paying Off The Debt

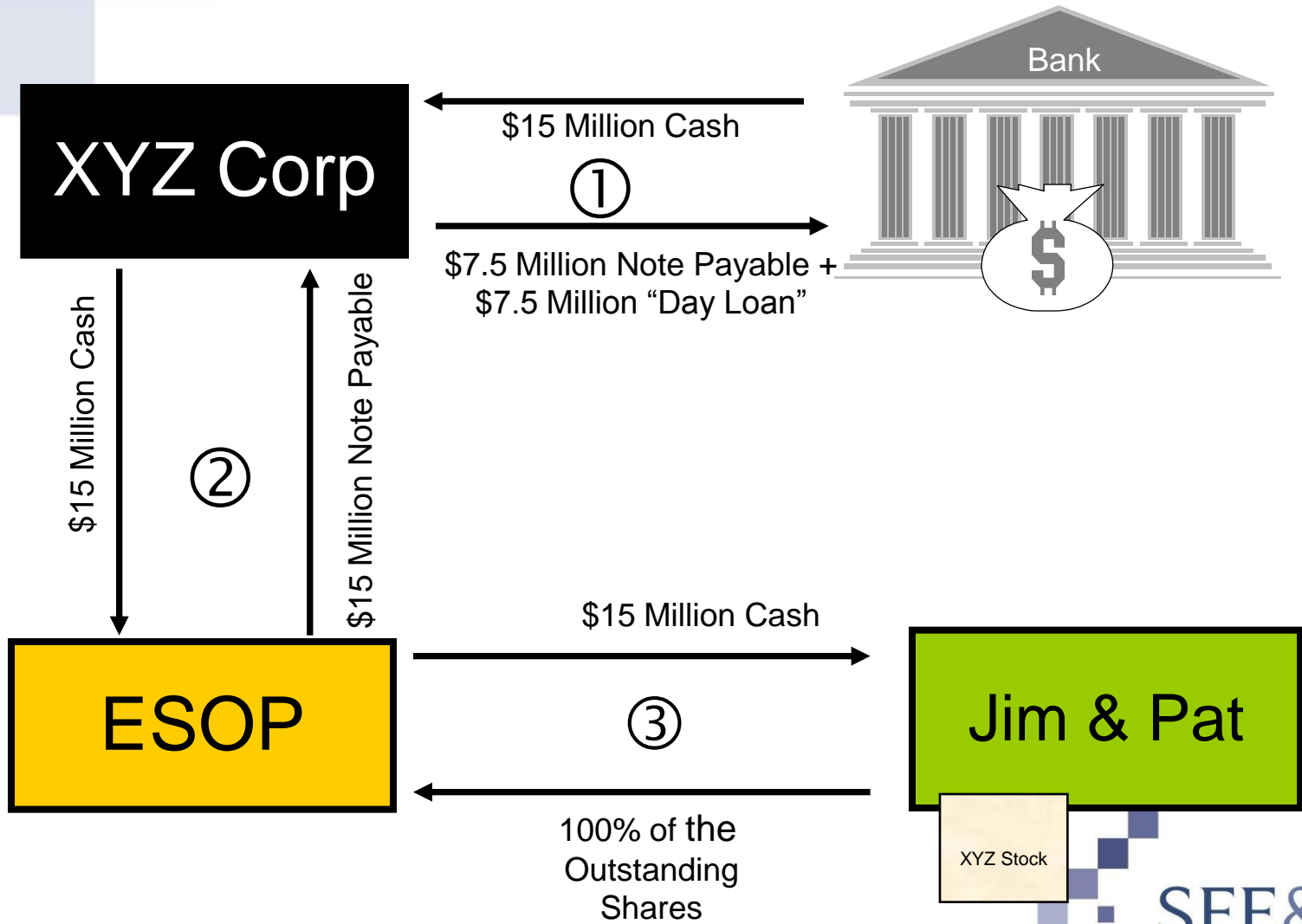


1. Company makes tax deductible contribution to the ESOP
2. ESOP uses the contribution to repay its loan from company
3. Company repays Financial Institution

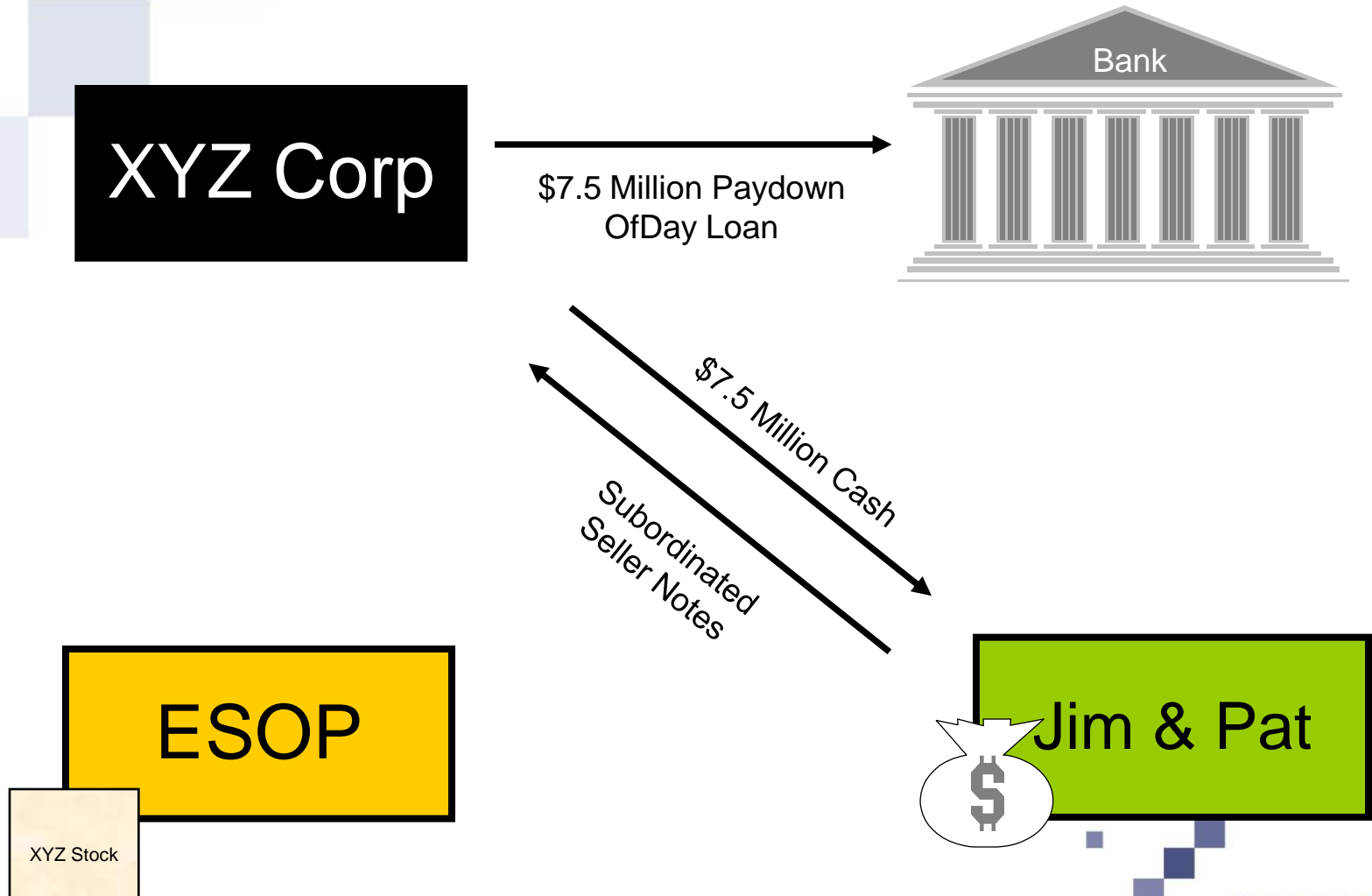
# Case IV: 100% ESOP Buyout

- Jim and Pat sell 100% of their XYZ stock to the EOSP for \$15 million
  - The stock purchase is financed with a \$7.5 million bank loan and \$7.5 million subordinated seller note, with warrants
- Selected managers participate in a Management Incentive Plan that is tied to the value of equity
  - This benefit is in addition to their ESOP participation

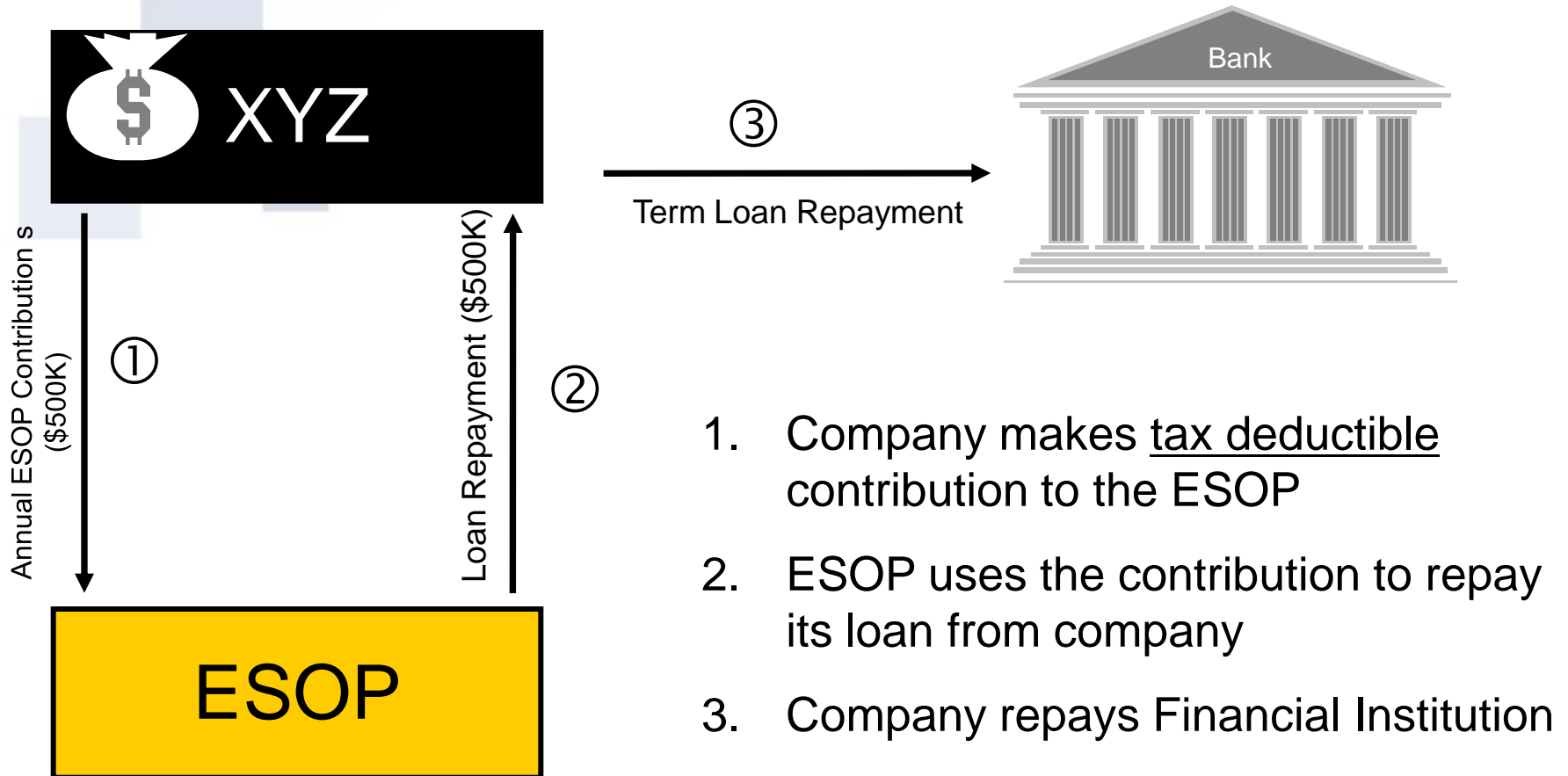
# 100% Leveraged ESOP



# 100% Leveraged ESOP

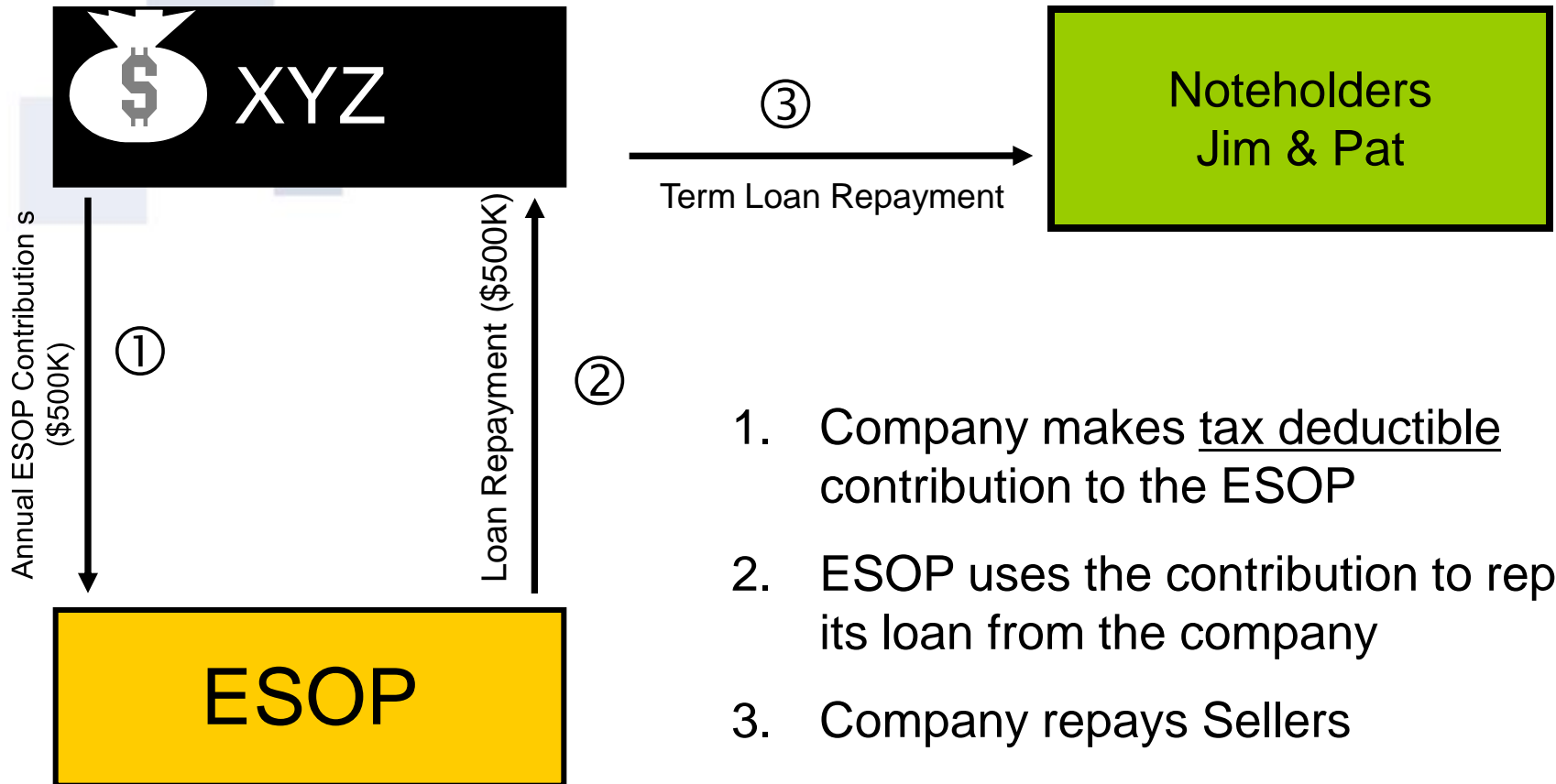


# Paying Off The Debt



1. Company makes tax deductible contribution to the ESOP
2. ESOP uses the contribution to repay its loan from company
3. Company repays Financial Institution

# Paying Off The Debt



1. Company makes tax deductible contribution to the ESOP
2. ESOP uses the contribution to repay its loan from the company
3. Company repays Sellers

# Seller Note Characteristics

- Seller notes yield between 12% and 14%
- Part of the yield is made up of a “current pay”, or interest income
  - Minimum imputed rate is 4.04%
- The balance of the yield is made up of stock warrants, or a right to buy stock at a certain price, for a certain period of time
- The amount of warrants is determined by the amount of interest income and the total targeted yield on the note
- Many owners are using the seller notes as a bridge loan to senior debt until the credit markets improve
  - They also like the total targeted return on the note

# Management Incentive Plans

- Key managers are awarded synthetic stock incentives
- This ownership is not direct ownership of stock, which limits complexity, but conveys economic value based on company performance
- Non-qualified plan that can be designed from “whole cloth”
- KEY: needs to be tied to increased equity value so ESOP is not overly diluted
- Target value of these plans should not exceed 30% of the value of the equity, in total
  - Dilution can be managed by good plan design

# Results

- Jim & Pat have locked in their value at \$15 million, having collected \$7.5mm in cash at closing
  - Seller note warrants could bring in additional value
  - No capital gains taxes due (C corps only)
- Jim & Pat can remained employed as officers / employees as they wish
- Selected managers could have a claim on equity value as high as 30%
- Employees will receive new retirement benefit that is tied to the success of the company
- The company has eliminated federal and (most) state corporate income taxation

# Capital Gain Tax Deferral Rules

- Company has to be a C corporation at time of transaction
- S corporations still can do ESOPs, but no capital gains tax benefit (more on this later)
- ESOP's ownership must be  $\geq 30\%$  to qualify for the capital gains tax benefit (if ESOP owns less than 30%, capital gains tax will be due)
- Seller must reinvest the proceeds in “*Qualified Replacement Property*” within 12 months

# Qualified Replacement Property

- Stocks, bonds, notes, debentures of U.S. corporations, public or private
- Can be a brother/sister, but not a subsidiary of the ESOP sponsoring company
- 50% or more of assets must be used in active conduct of business, and passive revenue cannot exceed 25% of total revenue



# Non-Qualified QRP

- Common investments that ***do not qualify*** for the capital gain deferral
  - Real estate
  - Foreign securities
  - Mutual Funds
  - Government Securities
  - CDs
  - “Toys”

# Seller Capital Gain Tax Deferral: QRP Considerations

- Issue: If any QRP is sold, the pro rata deferred capital gains tax becomes due
  - Implications:
    - ✓ The QRP portfolio cannot be actively managed
    - ✓ Minimize callable securities
- Solution: Purchase an “ESOP Bond”

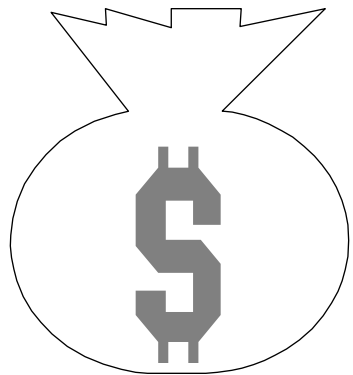


# ESOP Bond

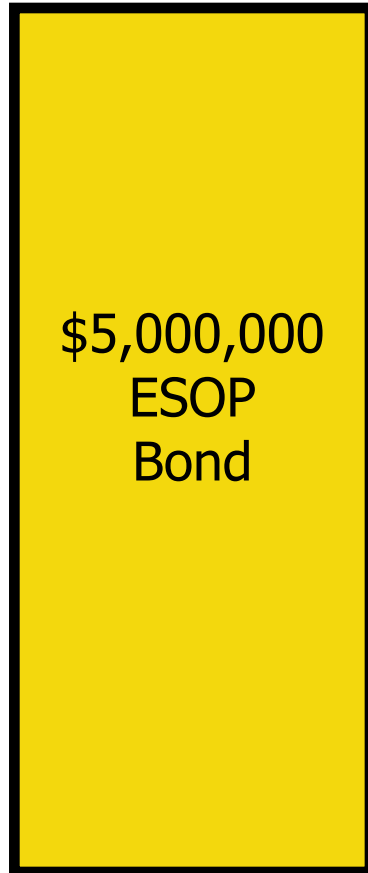
- Issued by AAA and AA credits
- Long term:
  - Typically a 50 year maturity
  - Non-callable for 30 years
- Floating rate interest paid quarterly using LIBOR

# Unlocking the QRP Lockup

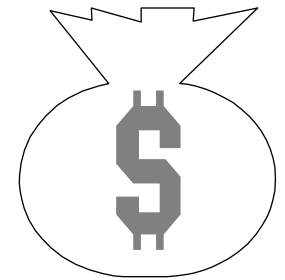
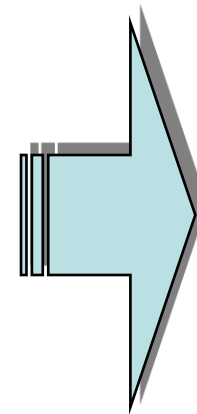
\$5 Million  
From ESOP  
Stock Sale



\$5,000,000  
ESOP  
Bond



\$4,500,000  
Margin  
Loan  
Proceeds



Net  
Unrestricted  
Proceeds  
To Seller

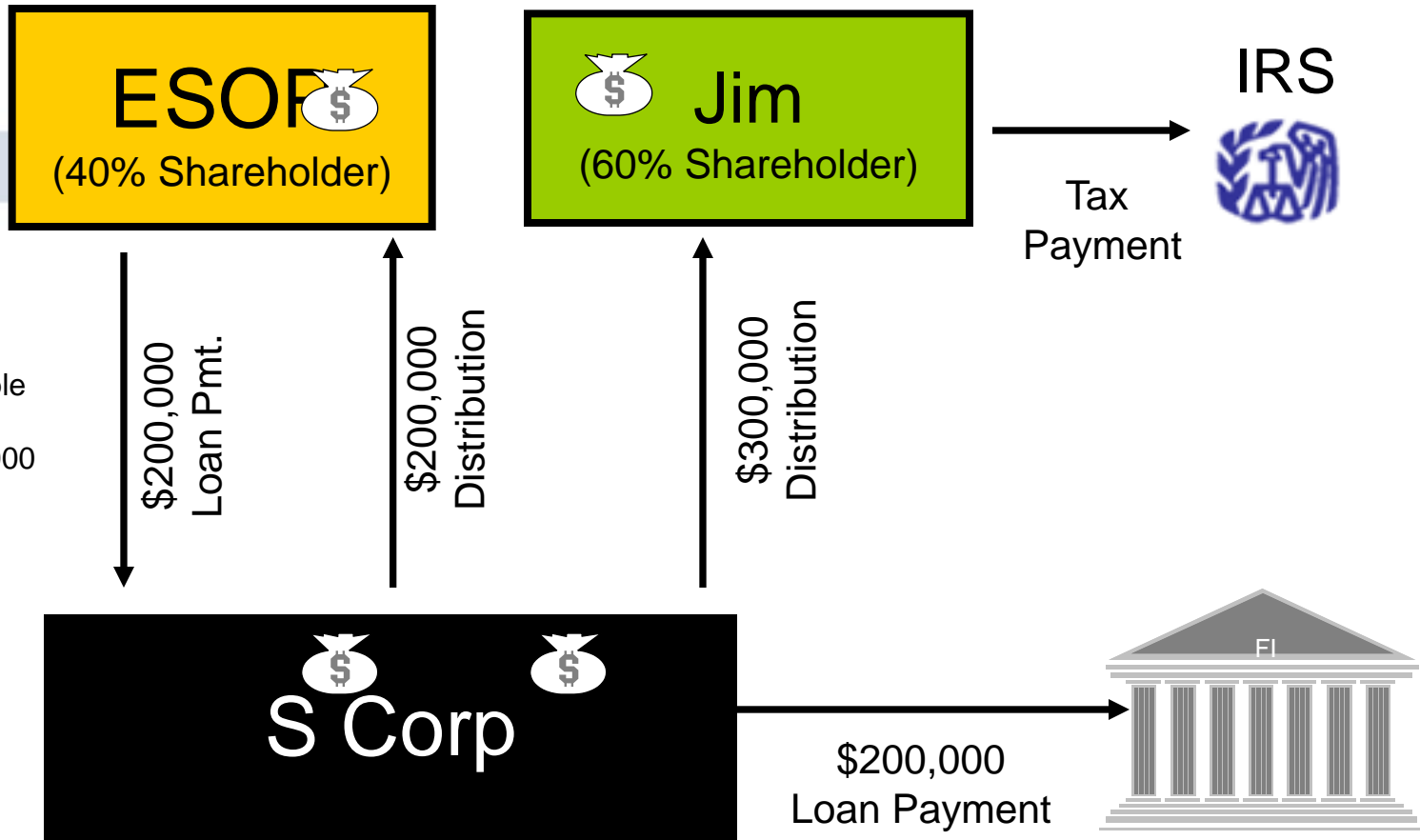
SFE&G

# S Corporation ESOP Tax Benefits

- S corporation shareholders are responsible for paying their pro rata share of the company's tax liability
- An ESOP is a qualified, tax-exempt trust similar to a 401(k) trust
- As an S corporation shareholder, the ESOP is not required to pay its pro rata share of the company's taxes
- ESOP can use distributions it receives to pay debt rapidly

This company is exempt from paying federal and most state income taxes

# S Corporation Distributions with ESOPs



## Assumptions

- S Corp generates taxable income of \$1,000,000
- S Corp makes a \$500,000 distribution to its shareholders pro-rata



# Short Summary of The Estate Planning Opportunities for Owners

# C Corporation Seller

- 1042 Transaction
  - Ability to use family limited partnerships prior to sale
  - Interest on floating rate bond can fund insurance
- Charitable planning with shares
  - Direct gifts
  - Indirect gifts through Charitable Remainder Trusts




# S Corporation Seller

- Seller Financing
  - Warrants for subordinated debt
  - Can be easily gifted for future generations
  - Financing can support additional life insurance
- Charitable gifts of shares prior to sale



# Employee Productivity:

## The Quid Pro Quo



Do ESOPs  
Really  
Increase  
Employee  
Productivity





# Do ESOPs Increase Employee Productivity?

- Research by Blasi, Kruse, Freeman and others says yes
- Anecdotaly the answer is yes as well

# Power of the Multiple

## ASSUME: 100 EMPLOYEES

Each employee increases profits by \$2,000 in a year

= \$200,000 increase in pretax earnings

Price/Earnings (P/E) multiple is 5x

= Company's value increases \$1,000,000

Direct shareholders own 70%

= \$700,000 extra value for direct shareholders

ESOP owns 30%

= ESOP value increases \$300,000 or \$3,000 / employee account



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