

## S CORPORATION ESOPs CREATE INVESTMENT, ACQUISITION, AND EXIT STRATEGY OPPORTUNITIES FOR PRIVATE EQUITY GROUPS

William W. Merten, Esq.

*M&A advisers are becoming increasingly familiar with leveraged ESOP transactions and are routinely considering the ESOP platform as an exit/acquisition alternative. This article describes (1) the way leveraged ESOPs have historically been used to provide a tax-advantaged exit strategy for privately held business owners, and (2) the ways in which private equity groups are now using ESOPs as an exit/acquisition alternative.*

### INTRODUCTION

Leveraged ESOPs are now being used by venture capital and private equity firms (collectively, “private equity groups”) as an investment platform and as an exit strategy.

A number of private equity groups—and the management teams within their portfolio companies—are now also engaging in acquisitions in which a leveraged ESOP is being adopted as a strategic transaction component by the acquisition company and/or the target.

ESOPs have, of course, for some time provided a ready exit strategy for privately held business owners. ESOPs have also provided a platform for management buy-outs. Changes made to the Internal Revenue Code effective in 1998, however, now allow ESOPs to hold shares of an S corporation. The 1998 changes to the Code also provide ESOPs with an exemption from the application of the unrelated business income tax (UBIT).

An S corporation is a pass-through entity that is not required to pay federal corporate income tax. Instead, its owners pay income tax in proportion to their stock ownership on the S corporation’s income. As a qualified plan, an ESOP is a tax-exempt entity. Accordingly, in a 100 percent ESOP-owned S corporation, neither the corporation nor the ESOP pays any federal income tax on the employer corporation’s income. Where the ESOP owns less than 100 percent of an S corporation’s stock, the proportion of the corporation that the ESOP owns will be exempt from federal income tax.

The purpose of this article is to briefly describe the way leveraged ESOPs have historically been used to provide a tax-advantaged exit strategy for privately held

business owners and then to describe the ways in which private equity groups are now using ESOPs.

### ESOP 101 (TYPICAL LEVERAGED ESOP TRANSACTIONS PRIOR TO S CORPORATION ENHANCEMENTS)

#### Nature of the ESOP Plan

An ESOP is no more than a defined contribution plan (like a profit sharing or 401(k) plan). The ESOP is designed to invest most of its assets in the stock of the sponsoring corporation.

Unlike other qualified plans, an ESOP can purchase the stock of the sponsoring corporation using both borrowed money and funds rolled over from other retirement plans and/or “conduit” IRAs (IRAs consisting solely of money(ies) rolled over from benefit plan(s) and the earnings thereon).

#### Description of Typical Financing Structure and Possible Tax Deferral

A corporation wishing to engage in a leveraged ESOP stock purchase transaction (the “Company”) first adopts an ESOP. Then, the Company’s ESOP typically borrows money from the Company (with any portion borrowed by the ESOP from the Company probably first being borrowed by the Company from a senior lender). The financing obtained by the ESOP is used to buy Company shares from the individuals or entity(ies) wishing to sell Company shares to the ESOP (the “Seller(s”).

In general, as long as (1) the ESOP purchases at least 30 percent of the Company's shares and (2) the Company was (a) privately held (or an OTCBB company) for at least one year prior to the ESOP's stock purchase, (b) not a member of a corporate controlled group that included a public company (other than an OTCBB company) during such period, and (c) a C corporation at the time of the ESOP's stock purchase, then an individual, trust, partnership or S corporation Seller who/which has held its shares for at least three years prior to the sale closing date is able to make a tax-deferral election with respect to the sale under Section 1042 of the Internal Revenue Code (the "Code").

Such an election will allow the Seller to sell his/her/its shares on a tax-deferred or tax-free basis. *Tax-deferred* sale treatment will generally be available if the Seller reinvests the Seller's sale proceeds in domestic stocks and bonds ("replacement securities") within 12 months of the transaction closing date. *Tax-free* sale treatment will generally be available for a non-C-corporation Seller under current law if replacement securities in an amount equal to the ESOP purchase price are so acquired by the Seller and then held until his/her death.

### Repayment of the ESOP Stock Acquisition Loan

An ESOP loan (whether from a bank, the Company (which borrowed the funds from a bank), and/or the Seller(s)) is repaid with (1) contributions made by the Company to the ESOP plan and/or (2) C corporation dividends or S corporation distributions paid on the ESOP's Company shares (the "ESOP shares"). Since an ESOP is a qualified plan, an ESOP sponsor receives a deduction for the contributions the sponsor makes to the ESOP. A C corporation sponsor is also able to deduct reasonable dividends it pays on ESOP shares if the dividends are used to retire the ESOP indebtedness.

To retire both the Company's bank indebtedness (which was loaned to the ESOP) and the ESOP's debt to the Company, the Company (1) makes periodic contributions to the ESOP and/or (2) pays dividends/distributions on the ESOP's Company shares. These payments from the Company to the ESOP are made in an aggregate amount equal to the debt service.

Upon its receipt of the contributions and/or dividends/distributions, the ESOP uses the monies received to repay its debt service to the Company. The Company, in turn, repays its debt service to the bank. Both the Company's contributions and, where the Company is then a C corporation, its dividends used to service the debt, are generally deductible.

The aggregate amount of contributions and dividends are enough to service, first, the ESOP's indebtedness to the Company and, second, the Company's indebtedness to the bank. The Company is, thus, effectively able to deduct both the interest and the *principal* on its bank loan.

In terms of sourcing the funds necessary to make the contributions and/or dividends that will be used by the ESOP to repay its debt, the Company can, of course, take dollars from its cash flow. Additional sources of funds include:

1. the annual use of dollars previously contributed as a matching contribution to its 401(k) plan (continuing the "match," if desired, within the ESOP in the form of Company shares), and/or
2. the use of the income tax dollars that the Company is saving due to either (a) the ESOP-generated deductions (in a C corporation context) or (b) the ESOP's ownership percentage (in an S corporation context, as more fully described below).

*"The selling shareholders . . . can get tax-deferred or tax-free treatment on the sale of their shares to an ESOP when the ESOP purchases as little as 30 percent of the sponsoring company's outstanding shares."*

In addition, prior to the ESOP's purchase of Company stock, it may be possible to *reduce* the amount of ESOP (and, thus, Company) indebtedness. This reduction is accomplished by giving the Company's employees a one-time opportunity to transfer some or all of their other retirement plan balances and/or conduit IRA accounts to the ESOP for investment in Company shares. The dollars coming to the ESOP reduce the amount of ESOP debt and, therefore, the amount of Company debt.

### Post-Transaction S Corporation Tax Status Election Possibility

The selling shareholders of a C corporation can get tax-deferred or tax-free treatment on the sale of their shares to an ESOP when the ESOP purchases as little as 30 percent of the sponsoring company's shares. However, there is nothing to stop an ESOP from acquiring substantially all or even 100 percent of a Company's outstanding shares.

This type of transaction could occur (1) through the ESOP's purchase of the shares of every shareholder or (2) through (a) the ESOP's purchase of shares held by particular shareholder(s) and (b) the conversion of all or substantially all of the shares held by remaining shareholder(s) to debt and/or synthetic equity.

Where an ESOP acquires all of a Company's outstanding shares, it will be the sole stockholder of the Company. If

the Company is a C corporation, the employer corporation may be able to make an S election following the ESOP's purchase of all of the Seller(s)' Company shares.

An S corporation is a pass-through entity, and an ESOP is a tax-exempt entity. Accordingly, if an S corporation election is made, there will be no federal income tax at either the corporate level or the shareholder level.

The Company can then operate on a go-forward basis as an entity exempt from federal (and, in some cases, state) income taxes. The same result will occur if:

1. the Seller(s) decides not to make a Section 1042 election,
2. an S corporation retains its S corporation status at the time of the ESOP's employer stock purchase, and
3. the ESOP becomes the sole owner of the S corporation.

### Post-Transaction Retention or Gain of Significant Equity Ownership Stake By Non-ESOP Shareholders

Assuming that the ESOP becomes either the sole stockholder or a partial stockholder of the Company, the transaction can be designed so that one or more of individuals (e.g., one or more of the Seller(s), their family members, and/or members of the Company's management team) can still gain a significant ownership stake in the Company. This ownership control can be accomplished vis-à-vis options granted to the individuals(s) outside the ESOP.

Company management team members can also receive share allocations under the ESOP. This will be true provided that, if the ESOP acquired shares in a Section 1042 transaction, the management members:

1. did not hold 25 percent or more of a class of the Company's stock prior to the transaction,
2. did not elect Section 1042 treatment, and
3. are not the family members of Seller(s) identified in (1) and/or (2).

An ownership stake so realized (e.g., by key management team members) can, in turn, be designed to grow over time. Such growth can be accomplished by having the Company repurchase and retire ESOP shares that are (1) eventually allocated to other plan participants and then later (2) distributed and redeemed.

Should these steps occur, a management team member's proportionate ownership stake—both within and outside of the ESOP—will necessarily increase as the ESOP's ownership percentage shrinks through a combination of share distributions made to departing employees and the Company's redemption/retirement of distributed shares.

## USE OF LEVERAGED ESOP TRANSACTIONS BY PRIVATE EQUITY GROUPS

### Use of An ESOP as an Exit Strategy

By law, an ESOP cannot pay more than the fair market value for privately held company shares on the date the shares are purchased. This rule does not, however, preclude an ESOP from paying up to the fair market value of a company's shares.

In addition, an ESOP can purchase shares even when the company is not being sold. In other words, an ESOP can purchase the shares of one shareholder (e.g., the private equity group) while other shareholders remain with the company.

Accordingly, if a private equity group has a "sideways" company that is neither an IPO nor a strategic sale candidate, it may still be able to (1) sell its shares in the company to an ESOP and (2) provide cash proceeds to its shareholders.

Moreover, if the portfolio company is a C corporation and the investors in the private equity group are either individuals, partnerships or certain kind of trusts, it may be possible for the private equity group to exit the company on a tax-deferred or tax-free basis under Section 1042, as described above.

The funding for the transaction will likely include a combination of:

1. employee rollovers (from retirement plan accounts and/or conduit IRAs to the newly formed ESOP);
2. funds borrowed by the company from its senior and mezzanine lenders and, in turn, loaned by the company to the ESOP;
3. enhanced cash flows created by the special income tax incentives for ESOPs (i.e., either the deduction of principal (in the C corporation context) or, of even greater value in the S corporation context, the fact that the ESOP's share of S corporation income will be completely untaxed); and
4. the use of what previously had been company 401(k) matching dollars.

If investors in the private equity group are not interested in making, or are unable to make, a Section 1042 election (and thus, will be taxed at capital gains rates on their sales proceeds), the transaction may be structured so that part of the shares sold are redeemed and part are purchased by the ESOP. If redeemed shares are retired so that the ESOP winds up owning a smaller dollar value of shares, employee monies rolled into the ESOP by company management team members will represent a larger amount of the ESOP's aggregate company ownership, as will awards

of synthetic equity outside the ESOP (e.g., to management team members). This process, in turn, will provide the company management team members with a significantly larger ownership stake in the company.

Employee monies rolled into the ESOP will be viewed by a senior lender as transaction equity. The enhanced cash flow created by the special ESOP income tax incentives will, in turn, greatly enhance the company's creditworthiness and financial strength. This will (1) cause the lenders to loan the company more money than they otherwise would and (2) allow the transaction's indebtedness to be repaid at an accelerated rate.

To the extent that senior and mezzanine lenders are unwilling to lend an aggregate amount which, when taken with employee rollovers, will cover the purchase price for the private equity group's shares:

1. a different private equity group may infuse cash into the transaction (for the investment reasons described below) and/or
2. the exiting private equity group may decide to provide a measure of seller financing (which, for example, may be designed to include detachable warrants).

### Illustrative Example

ABC Company, Inc. (the "Company") is currently a C corporation. Following a transaction which will include (1) the purchase by a newly formed ESOP of the Company shares and (2) the redemption of all shareholders of the Company other than the ESOP, the Company will elect to become an S corporation for federal income tax purposes.

The Company will establish the ESOP. Its board of directors will appoint an institutional trustee as trustee of the newly created ESOP and amend its 401(k) plan to appoint an investment manager to direct the trustee of the 401(k) plan to transfer the assets of participants (i.e., to move the percentage of each participant's account that the participant elects to have transferred to the ESOP).

The participants of the 401(k) plan will be given a special one-time election to (1) liquidate a portion of their conduit 401(k) plan accounts and (2) transfer such amounts from their 401(k) plan accounts to the ESOP. The 401(k) plan participants will also be given the opportunity to roll over IRA account balances to the ESOP. It is anticipated that participants will elect to transfer an aggregate amount of \$11,000,000 in 401(k) plan and IRA account balances to the ESOP. The ESOP will use the transferred funds to purchase stock of the Company.

The Company will then use \$57,000,000 in cash (funded as hereinafter described) and \$3,000,000 in "seller financing" notes and warrants to (1) redeem the stock of its existing non-ESOP shareholders, (2) pay related transaction expenses, and (3) refinance existing term loan indebtedness.

To finance the aggregate \$60,000,000 of redemption/expense/refinancing debt, the Company will:

1. source \$11,000,000 from the proceeds it receives on the sale of Company shares to the ESOP (as described above);
2. execute various debt instruments with senior lenders and mezzanine lenders totaling approximately \$48,000,000;
3. issue "seller financing" notes with detachable warrants, totaling approximately \$3,000,000, to a group of its current shareholders (comprised of Company management team members) who are interested in "reinvesting" in the Company; and
4. issue new investor notes with detachable warrants to individual investors totaling approximately \$6,000,000.

As a part of the transaction, the terms of the seller notes, the new investor notes, and the detachable warrants will satisfy certain income tax rules relating to S corporation ESOP companies.

The Company will apply the \$60,000,000 as follows:

1. the shares held by the Company's existing private equity group will be redeemed for approximately \$44,500,000 in cash;
2. the other non-ESOP shareholders who are not "reinvesting" in the Company will have all of their shares redeemed in cash for \$1,500,000;
3. the non-ESOP shareholders who are "reinvesting" in the Company will have their shares redeemed for approximately \$10,000,000, comprised of \$7,000,000 in cash and \$3,000,000 in seller notes with detachable warrants;
4. an existing \$3,000,000 term loan will be repaid with \$3,000,000 in cash; and
5. \$1,000,000 in transaction expenses will be paid in cash.

As a result of the foregoing purchase and redemption transaction, the ESOP will become the owner of all of the Company's outstanding stock and, as the Company's sole shareholder, the ESOP will make an S corporation election with respect to the Company.

The S corporation election and the ESOP's income tax exempt status will greatly enhance the Company's cash flow, with the additional cash being used to pay off the acquisition indebtedness on an accelerated basis.

As shares are distributed from the ESOP over time and redeemed, the ESOP's fully diluted percentage of the Company will shrink and the warrants held outside the ESOP by the management team (together with their ESOP share allocations) will represent an increasingly greater percentage of the Company's equity.

### Use of an ESOP as an Investment Platform

If a private equity group invests in a portfolio company that adopts a leveraged ESOP, it will have an exit vehicle that can be employed if the private equity group wishes to exit the Company prior to a Company sale or an IPO. The ESOP need not be a drain on cash flow. If desired, the debt associated with the ESOP's initial purchase of Company shares can be limited to an amount of share value that can be serviced with (1) enhanced cash flows created by the special ESOP income tax incentives and/or (2) dollars which were previously being contributed by the Company as a matching contribution in its 401(k) plan.

The enhanced cash flow created by the special ESOP income tax incentives will enhance the Company's creditworthiness and financial strength and, especially in the S corporation context, the ESOP will provide a private equity group with a ready exit strategy.

For this reason, a new private equity group may be willing to invest in a portfolio company from which an existing private equity group is exiting. This may occur, for example, if an ESOP purchases the majority of the outstanding shares of an S corporation (or a C corporation that is converting to S corporation status). Just as enhanced cash flow may cause a lender to loan more money to an ESOP-owned S corporation than it would lend to another corporation, a private equity group may find the portfolio company more attractive on a post-ESOP-purchase basis due to its enhanced financial strength and creditworthiness.

### Use of a Leveraged ESOP to Provide an Acquisition Platform

Using an ESOP structure as a means of acquiring a target entity can have significant advantages. First, to the extent that the a target shareholder is able to make a Section 1042 tax deferred/tax free election, the shareholder may be willing to pass on part of the shareholder's income tax savings in the form of a reduced purchase price. Second, to the extent that IRA and 401(k) dollars are rolled into the target ESOP by target company employees, the amount of funds needed to acquire the target company can be reduced.

Following the acquisition, the target entity can be merged into the acquiring corporation, and the target entity's ESOP can be merged into the acquiring corporation's ESOP.

In a C corporation context, both the interest and the principal of the ESOP acquisition indebtedness will be tax deductible. In an S corporation context, the portion of the target entity that the ESOP owns will be exempt from federal income tax.

The acquisition indebtedness can be repaid through:

1. the annual use of the dollars that the target entity would have previously contributed as a match to its 401(k) plan

(again, if desired, continuing with the "match" under the ESOP in the form of company shares), and/or

2. the use of tax dollars saved due to either (a) ESOP-generated income tax deductions (in a C corporation context) or (b) the ESOP's ownership percentage (in an S corporation context as more fully described above).

To the extent that the Section 1042 election is not utilized in the acquisition, the target entity's ESOP purchase of a target shareholder's shares can be coupled with a redemption. If it is and the redeemed shares are retired (so that the ESOP winds up owning a smaller dollar value of shares), equity interests held outside the ESOP (e.g., synthetic equity held by a private equity group and/or management team members of the acquisition corporation) will represent a significantly larger ownership stake of the combined company.

### SUMMARY AND CONCLUSION

The ready exit strategy, which has for years been available to private company shareholders through the use of an ESOP platform, is now a strategy being reviewed and used for sales of portfolio company shares held by private equity groups.

Where shares are held in a portfolio company that is neither an IPO candidate nor a strategic sale candidate, the shares can be sold to an ESOP before the portfolio company is sold. Although the ESOP cannot pay more than the fair market value of the shares, the value of an entity's shares fluctuates over time and, in many cases, the equity group can control the timing of the sale transaction.

Depending on portfolio company financial characteristics, (1) monies rolled into the ESOP and (2) enhanced portfolio company cash flows created by special ESOP income tax incentives can make it possible for a private equity group to sell all of its portfolio shares for cash. To the extent that the same group or a different private equity group wishes to carry a continuing equity interest in the company, the interest can be accommodated outside the ESOP (e.g., in the form of synthetic equity).

Because of (1) the enhanced cash flow generated by ESOP-related income tax incentives and (2) the ready exit vehicle afforded by the ESOP platform, private equity groups—and the management teams of their portfolio companies—are more frequently employing the platform as a component of their investment and acquisition strategies.

Given the advantages afforded by this platform, M&A financial advisers are becoming increasingly familiar with leveraged ESOP transactions and routinely considering the ESOP platform as an exit/acquisition alternative.

*Bill Merten is a partner with the international law firm of McDermott Will & Emery, where he concentrates his practice on business succession planning and executive compensation. Bill can be reached at (312) 984-7647, (212) 547-5557, or [wmerten@mwe.com](mailto:wmerten@mwe.com).*