

The ABCs of ESOPs: A Tax-Favored Strategy for Business Owners

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AN INTRODUCTION TO ESOPs

What is an ESOP?

An Employee Stock Ownership Plan (“ESOP”) is:

- A form of tax-qualified defined contribution plan
- Designed to invest primarily in employer securities
- 9,500+ ESOPs covering 10.5 million employees with \$675 billion in assets (NCEO Report, as of 2007)

An ESOP Transaction is a sale of stock by the business owner to an ESOP for cash

ESOPs: Key Benefits

- For business owner:
 - Deferral and Potential Elimination of Tax on Sale
 - Cash to Business Owner
 - Diversification
 - Retention of Control
 - Market for Privately Held Stock

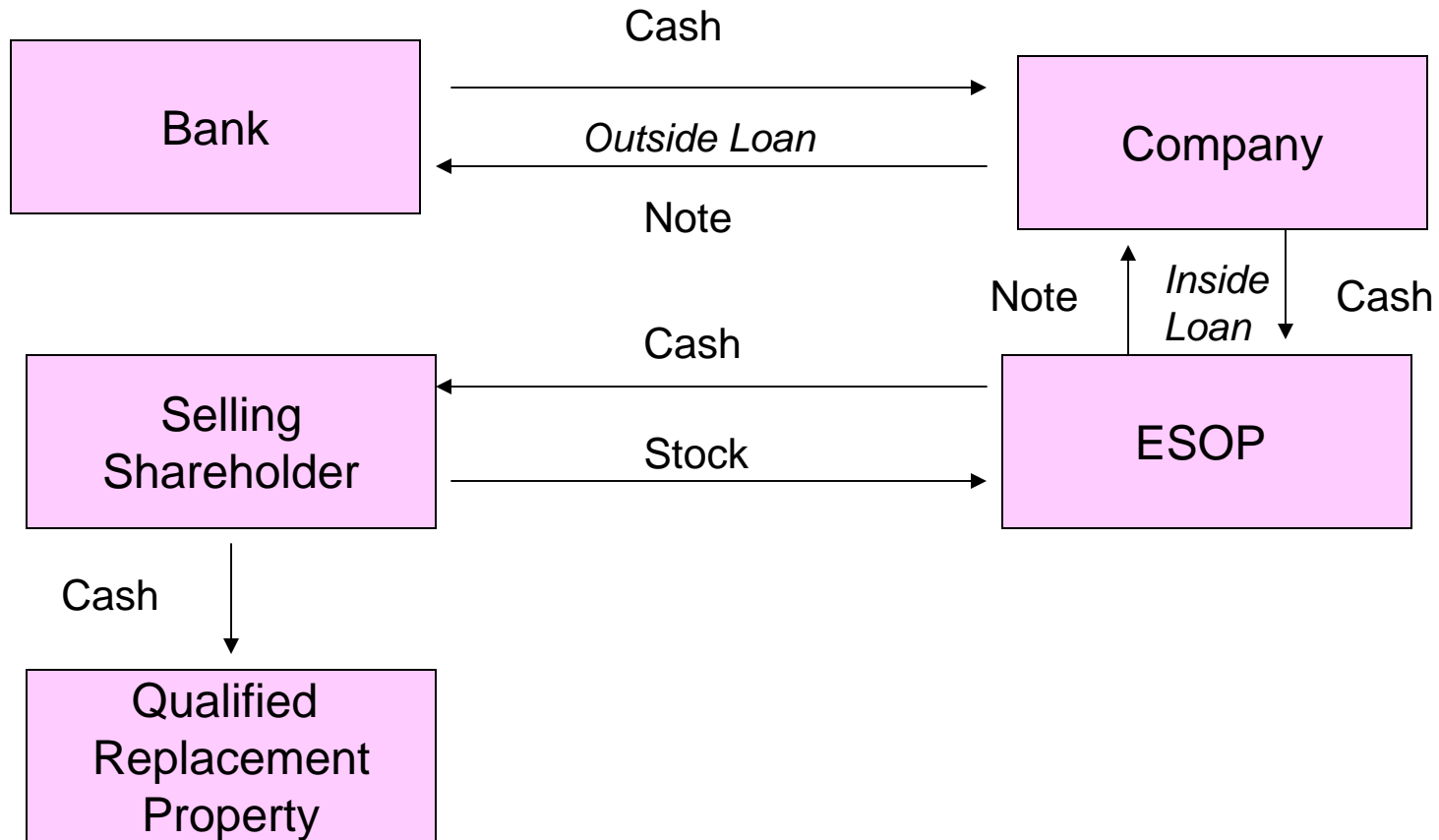
ESOPs: Key Benefits (continued)

- Allows for Gradual Sale of Company
- Incentivizes Employees
- Provides Tax Benefits

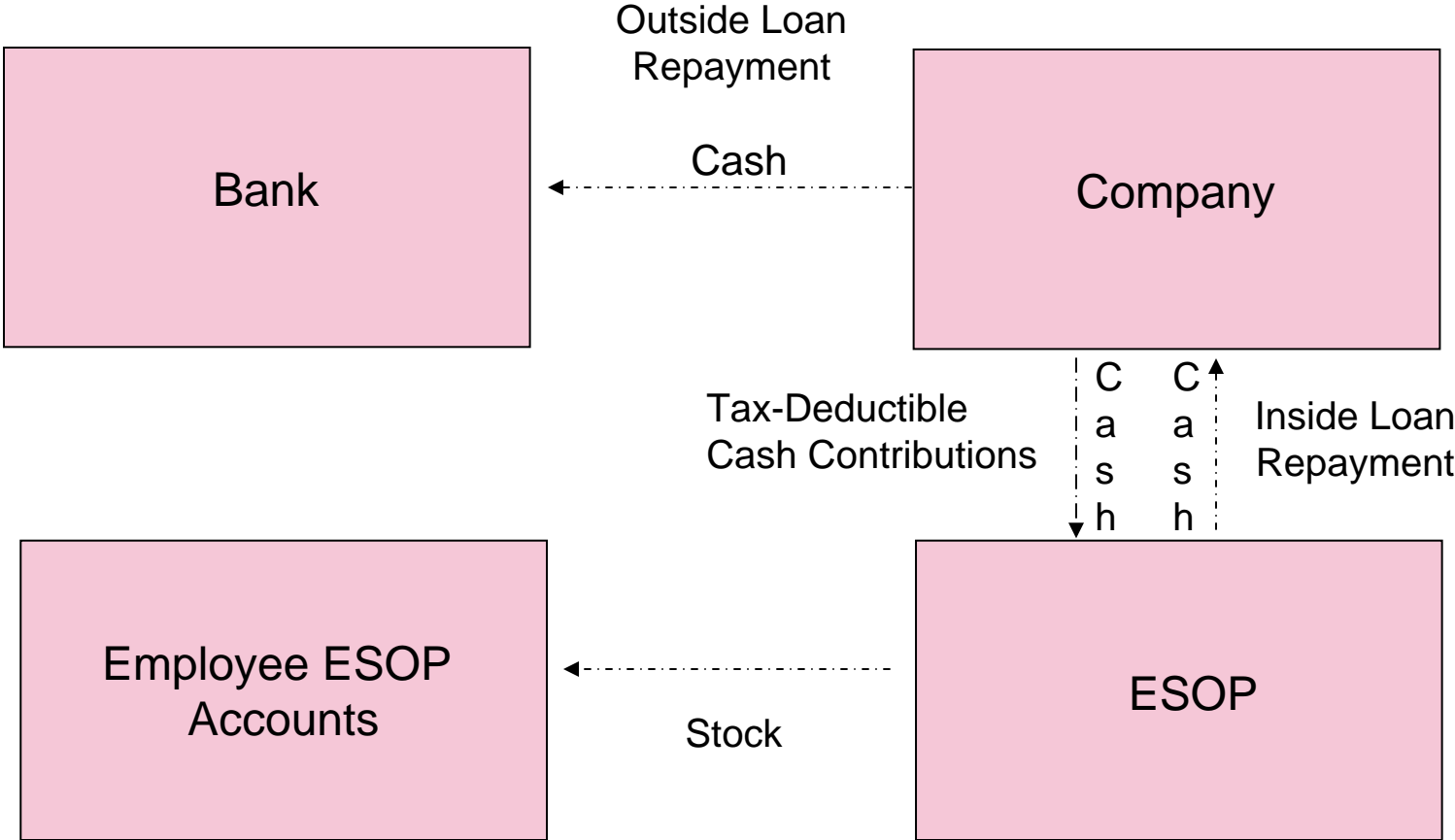
ESOP Example:

1. Owners of business sell 30% of stock of company worth \$50 million to ESOP for \$15 million
2. Sale is financed by \$15 million bank loan
3. Owners use \$15 million proceeds to purchase domestic stocks and bonds
4. Owners retain control of business

Leveraged ESOP: How It Works



Bank Loan Repaid with Tax-Deductible Dollars



ESOPs: Significant Tax Benefits

- Seller defers gain - Section 1042 capital gains deferral provision
- Company deducts:
 - Loan interest and principal payments
 - Dividends paid to ESOP
- Tax exemption for S Corporation earnings
- Tax-deferred employee benefits

Section 1042 Tax Rollover Requirements

- ESOP must own 30% of the stock
 - 30% of each class of outstanding stock of the corporation or 30% of total value of outstanding stock of the corporation
 - Test determined immediately after the sale so once ESOP has achieved 30% ownership, every sale thereafter satisfies the requirement
 - Multiple sellers in a single transaction can be aggregated

Section 1042 Tax Rollover Requirements (continued)

- Employer establishing ESOP must be:
 - Non-publicly traded company
 - C [but *not* S] Corporation (see conversion discussion below)
- Stock sold to ESOP must be employer securities, i.e., issued by a domestic C Corporation which sponsors the ESOP or a member of the controlled group of corporations which includes the corporation sponsoring the ESOP

Section 1042 Tax Rollover Requirements (continued)

- Seller, his family members, and 25% shareholders cannot participate in ESOP
 - Violation of this rule results in employer excise tax, income inclusion to participants who receive impermissible allocations, and potential plan disqualification

Section 1042 Tax Rollover Requirements (continued)

- Seller files election to take advantage of Section 1042 and statement of company consenting to imposition of excise tax, with his tax return for year of sale, if qualified replacement security (QRP) is disposed of by ESOP within three years or if qualified securities are allocated to persons prohibited from receiving them

Section 1042 Tax Rollover Requirements (continued)

- Seller must have owned stock for three years
 - Tacking of holding periods applies, e.g., gifted stock, stock acquired pursuant to tax-free organization, stock acquired in Section 351 transaction
- Seller may not be a C Corporation
 - Partnership can take advantage of Section 1042 provided partnership purchases qualified replacement securities

Section 1042 Tax Rollover Requirements (continued)

- Within 15-month replacement period, seller must reinvest proceeds in QRP
 - No tracking requirement
 - U.S. operating corporations' stocks and bonds
 - *Not* mutual funds or Treasuries

Section 1042 Tax Rollover Requirements (continued)

- Disposition of QRP triggers gain except for transfers in a tax-free reorganization, by reason of death, or by reason of gifts or contributions to a charitable remainder trust
- Carryover basis – Basis of stock sold to ESOP carries over to basis of QRP
- QRP gets stepped-up basis at death

Contributions, Dividends and Allocation Limits

- Loan repayment – tax deductions
 - Company payroll contributions to ESOP
 - *Limits based on payroll – Code Section 404*
 - *25% of eligible payroll plus unlimited interest payments if a C Corporation*
 - Unless more than one third of ESOP contributions are allocated to accounts of highly compensated employees
 - *25% of eligible payroll including interest if an S Corporation*

Contributions, Dividends and Allocation Limits (continued)

- *In the case of a leveraged ESOP sponsored by a C Corporation, 25% limit is in addition to 25% limit for all other defined contribution plans - Code Section 404(a)(9)(A)*
- *Section 404 limits amount deductible, but if company contributes more than it can deduct there is a 10% excise tax on the excess*

– Dividends on ESOP stock

- *Deductible if used to pay ESOP loan used to buy shares on which dividend is paid*

Contributions, Dividends and Allocation Limits (continued)

- *Limits based on comparable transactions and reasonability (for C Corporations) – not an avoidance or evasion of taxation*
- *Dividends deductible in C Corporation's taxable year in which they are used to repay the ESOP loan*
- *Dividends not deductible for AMT purposes*

– Annual Addition Limit

- *Code Section 415 limits yearly amount that can be allocated to all the plan accounts of any particular participant to lesser of 100% of payroll or \$46,000 (\$49K in 2009)*

Contributions, Dividends and Allocation Limits (continued)

- *For C Corporations, forfeitures and interest are not included in annual additions limit, provided not more than one-third of contributions are allocated to highly compensated employees (HCEs)*
- *Penalty for exceeding 415 limits is plan disqualification*

S Corporation ESOP Tax Benefits

- S corporation shareholders are responsible for paying their pro rata share of the company's tax liability
 - ESOP may be S corporation shareholder and as of 1/1/98, the S corporation's share of the ESOP's income is not subject to the unrelated business income tax
- As an S corporation shareholder, the ESOP is not required to pay income tax on its pro rata share of the company's earnings

S Corporation ESOP Tax Benefits (continued)

- Company owned 100% by ESOP is therefore a tax-free entity
ESOP can use distributions it receives to pay down inside loan
- Code Section 409(p) – Prohibited allocation rules limit the establishment of ESOPs by S corporations to those that provide broad-based employee coverage and that provide benefits to rank and file employees as well as HCEs and owners

S Corporation ESOP Tax Benefits (continued)

- S converting to C to take advantage of 1042

Pros:

- Deferral of gain on sale to ESOP
 - *15% federal capital gains rate probably increasing to 20% in 2009*
 - *State tax on capital gains*
- C Corporation can have multiple classes of stock
- Enhanced contribution and deduction limits for leveraged ESOPs

S Corporation ESOP Tax Benefits (continued)

- Potential double taxation but the contributions the company makes to repay the ESOP loan very often eliminate the corporate level tax
- Conversion Issues
 - LIFO recapture
 - Built-in gains tax

Statutory and Regulatory Requirements

- General Benefit Plan Requirements
 - Written Plan and Trust
 - Non-Discrimination Requirements Apply
 - *Coverage. Must cover broad range of employees and satisfy Code § 410(b) participation requirements. Generally, may not require more than one year of service for eligibility.*
 - *Allocations. Must satisfy Code § 401(a)(4) and not discriminate in favor of HCEs. Generally, allocations based on compensation. Integration with Social Security not permitted.*
 - Vesting. Generally, accounts must either become fully vested after 3 years of service or provide for graded vesting over 6 years (2 years – 20%; and 20% each year thereafter).

Special ESOP Rules

- Must be designed to invest primarily in employer securities. “Employer securities” are common stock which is either readily tradable on an established securities market, or, if none, common stock having the greatest voting and dividend rights or preferred stock convertible into such common stock. Code § 409(l).
- Distribution in Employer Stock. An ESOP must permit participants to demand distribution in employer securities. Exceptions: (1) an employer whose charter or by-law restricts ownership to active employees and qualified plan; or (2) an S corp. Where participants receive stock that is not readily tradable, they must also receive a put option. Code §409(h).

Special ESOP Rules (continued)

- Distribution Obligations. Under Code § 409(o), absent an employee election, distributions must begin no later than the earlier of (i) one year after termination of employment by reason of retirement, disability or death or (ii) the fifth year following other terminations of employment. Further delays are permitted for financed shares if ESOP loan has not been paid off. Distributions may be spread out over up to 5 years (more years if balance exceeds \$500,000 indexed).

Special ESOP Rules (continued)

– Voting ESOP Shares.

- *Allocated Shares: Pass-through voting to participants required if employer is publicly traded. Otherwise, pass-through voting only required on all matters that involve a merger, consolidation, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all of operating assets. Otherwise, trustee votes either directly or pursuant to committee direction.*
- *Unallocated Shares: No pass-through voting required.*
- *One Vote Alternative: The plan permits each participant one vote and trustee votes shares in proportion to participant vote.*
- *No requirements to pass through tendering rights.*

Allocation of Shares Acquired with Loan Proceeds

- Shares purchased by an ESOP are initially held by the ESOP trust in a suspense account. The shares are moved (“released”) from the suspense account to the participant accounts, within the ESOP trust, as the ESOP loan is paid off.
- For purposes of determining the rate of this movement, there are two permissible methods. Treas. Reg. § 54.4975-7(b)(8):

Allocation of Shares Acquired with Loan Proceeds (continued)

- *Method One: Each year the number of shares of stock that are released is equal to the number of shares in the suspense account multiplied by a fraction, the numerator of which is the amount of ESOP loan principal and interest paid for the year, the denominator of which is the principal and interest paid that year and to be paid in future years.*
- *Method Two: Each year the number of shares of stock that are released is equal to the number of shares in the suspense account multiplied by a fraction, the numerator of which is the amount of ESOP loan principal that is paid for the year, the denominator of which is the principal paid that year and to be paid in future years.*
- *The second method may only be used if the ESOP loan provides for annual payments of principal and interest at a cumulative rate that is not less rapid at any time than level annual payments for 10 years.*

Allocation of Shares Acquired with Loan Proceeds (continued)

- When loan payments are made with employer contributions to the plan, the shares that are released are allocated to the particular participant accounts in the same manner as contributions generally are allocated under the plan (typically, comp to comp). When loan payments come from dividends or S Corporation distributions, the released shares may, alternatively, be allocated pro rata based on participant account balances.

Diversification Rule

- An ESOP participant who has attained age 55 and has completed 10 years of *participation* must be allowed to elect annually over a six-year period to diversify a portion of his ESOP balance.
- Elections over the first five years may cover up to 25% of the participant's account balance (less, in each year, any portion previously diversified); the election in the sixth year may cover up to 50% of the participant's account balance.

Diversification Rule (continued)

- The diversification requirement may be fulfilled by (1) allowing participants to elect among at least three investment options, other than employer stock, that are made available under the ESOP; (2) allowing participants to transfer the amount to another plan that provides for employee-directed investments; or (3) allowing participants to withdraw the amount.

Prohibited Transactions Sale Exemption

- Sale or exchange of property between a plan and a party in interest generally is a prohibited transaction. ERISA § 406(a)(1)(A).
- Statutory exemption for acquisition or sale by ESOP or other individual account plan of qualifying employer securities if price is not less favorable to the plan than “adequate consideration” and no commission is charged to the plan. ERISA § 408(e).
- For stock of closely held business, adequate consideration is fair market value as determined in good faith by fiduciaries in accordance with the provisions of the plan and DOL regs. ERISA §3(18)(A).
- An independent appraiser must determine fair market value under Code § 401(a)(28).

Prohibited Transaction Loan Exemption

- Lending of money or other extension of credit between a plan and a party in interest generally is a prohibited transaction. ERISA §406(a)(1)(B). This prohibition covers loans and guarantees given by the employer and principal owners.
- Loans to a leveraged ESOP that carry a reasonable rate of interest, are collateralized only by qualifying employer securities, and are for the primary benefit of participants are exempt from this prohibition. ERISA §408(b)(3); Code §4975(d)(3).
- Other requirements for ESOP loan exemption (beyond those previously discussed) include:

Prohibited Transaction Loan Exemption (continued)

- Use of Proceeds. Loan must be used within a reasonable time to acquire qualifying employer securities, repay the loan or repay a prior loan.
- Limited Liability. The lender's recourse against the ESOP must be limited to (1) the employer securities purchased with the loan, (2) employer contributions made to enable the ESOP to amortize the loan and earnings thereon, and (3) earnings on suspense account shares.
- Term. The loan must be for a fixed term. On a default, the lender can only recover the amount of the default.

ESOPs and Estate Planning

- Liquidity created by ESOP transaction:
 - Provides business owner with liquidity to equalize inheritances
 - Can be used to pay estate taxes without having to engage in forced sale to raise funds
- Post-ESOP transaction company value is depressed by leverage incurred to purchase stock

ESOPs and Estate Planning (continued)

- Opportunity for business owner to make gifts of retained interest to family members either outright or in trust through use of grantor retained annuity trust
- Business owner can contribute stock to charitable remainder trust (“CRT”), which pays lifetime annuity to owner and his spouse and then CRT sells stock to ESOP
 - Owner receives income tax charitable contribution deduction

ESOPs and Estate Planning (continued)

- Section 1042 limitations are obviated
- CRT pays no tax on sale to ESOP
- Stock is removed from business owner's estate

ESOPs are a Good Choice for:

- Businesses with --
 - Consistent Annual Profits (including Owner Compensation) of \$1.5 million or more
 - 15+ employees
 - Solid management in place
 - Non-highly leveraged balance sheet

ESOPs In A Tight Credit Environment

Agenda



- Liquidity Alternatives in the Current Environment
- Capital Structure
- Case Study

Liquidity Alternatives in the Current Environment

A Few Certainties in the Uncertain Market

- Recession;
- Difficult lending environment;
- Dormant private equity market.

One Certainty

- Ordinary income taxes are going up 
 - New York City residents in the highest tax bracket will see their combined city, state and federal income taxes exceed 50%.
- Capital gains taxes are going up 
 - New York City residents may see their capital gains taxes rise to over 20% at the federal level and close to 10% at the state/city level.

Sponsoring a Partial or Total LBO of Your Own Company

ESOP = Tax-advantaged leveraged buyout of
your own Company.

ESOP Benefits

“C” CORP

1

**Defer/Eliminate
Capital Gains Taxes**

2

**Company Receives Tax
Deductions Equal to
Sale Value**

Why It Makes Sense

"C" Corp

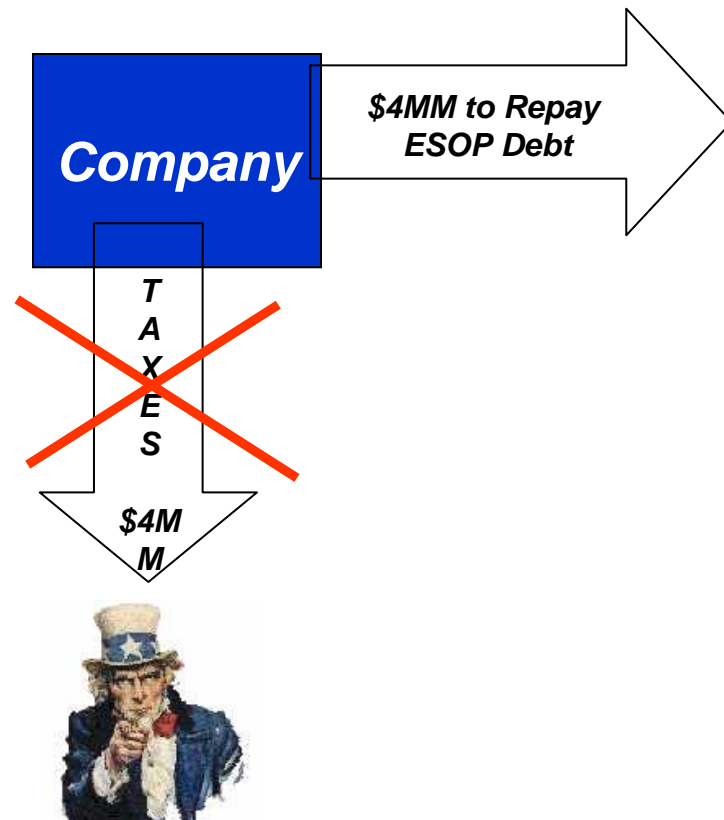
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|---------------------------------------------------------------------------|------------------------|------------------------------------------------|-----------|
| 1. Owner receives cash tax-free | Sale Price
\$10mm X | Capital Gains Rate
Est. Fed 20%
State 9% | = \$2.9mm |
| 2. Company receives income tax deductions (over time) = to purchase price | \$10mm X | Corporate Tax Rate
Est. 40% | = \$4.0mm |

Total Savings = \$6.9mm

ESOP Benefits

“S” CORP

No State or Federal taxes on
100% Employee-owned
Companies



ESOP Advantages

As an incentive to promote employee ownership, the US government provides ESOP-owned companies with a substantial tax-benefit package.

- Corporate income tax deductions received as a result of the ESOP transaction substantially enhance companies' cashflows;
- Provide “downside” protection during business downturns;
- Enhance lenders' confidence in their clients' ability to service debt;
- Improve cash flow coverage;
- Lower creditors' risks vs. traditional LBO/recapitalization;
- Better motivate employees through higher benefit levels and more aligned interests;
- Allow sellers to defer/avoid capital gains tax with 1042 rollover;
- Selling shareholders continue to control their companies.

ESOP Structures – “C” Corps / “S” Corps / LLC

“C” CORPORATION

- Preferred stock is often sold to the ESOP; payroll contributions, preferred dividends are tax-deductible;
- This structure is best used for minority ESOP sales;
- Tax liability is minimized;
- Selling shareholders have an option of deferring capital gains taxes through a 1042 rollover or electing an installment payment treatment and paying capital gains taxes;
- If no 1042, selling shareholders participate in the ESOP – accumulate a substantial amount of the Company’s equity in their ESOP account;
- Selling shareholders maintain a majority ownership.

ESOP Structures – “C” Corps / “S” Corps / LLC

“S” CORPORATION

- “S” Corporations 100% owned by the ESOP are free from federal income tax liability;
- This structure is best used for majority ESOP sales;
- Company’s cashflow can be used to amortize bank debt / seller notes tax-free;
- Company can issue a warrant for the benefit of the selling shareholders or their family members;
- Selling shareholders pay capital gains taxes and elect an installment payment treatment;
- Selling shareholders can participate in the ESOP – accumulate a substantial amount of the Company’s equity in their ESOP account;
- Selling shareholders continue to control the Company, exercising control through the Board of Directors and other corporate governance tools.

ESOP Structures – “C” Corps / “S” Corps / LLC

LLC ESOPs

- Allow substantial structuring flexibility;
- New corporation has to be formed;
- Membership interests in the LLC contributed to a new corporation in a tax-free Section 351 exchange for all the shares of the Company;
- Establish a holding period and avoid tax liability;
- Can elect to do an “S” Corp ESOP transaction (tax-free structure) or a “C” Corp ESOP transaction (1042 rollover, preferred dividend value enhancement);
- Unique option: LLC – “C” – “S”
 - A company first forms a “C” Corp, so its owners can qualify for the 1042 rollover, then makes an “S” election on a subsequent January 1 to become a tax-free entity



Building a Better Company Under Employee Ownership

According to a recent University of Pennsylvania study, ESOPs have a tangible effect on employee morale and productivity (*University of Center for Organizational Dynamics, Work Paper #08-07, July Pennsylvania 29, 2008*).

- Financial success – for all shareholders, i.e., ESOP & others
- Better results for other stakeholders – customers, communities
- A better place to work - better employee attraction & retention, lower turnover
- Higher productivity, cost efficiency

Numeric Example

Free Cashflow Primer (“S” Corp)

No ESOP

SIMPLIFIED INCOME STATEMENT (\$ in thousands)		
Net Revenue	\$	32,000
Cost of Goods Sold		23,000
Gross Profit		9,000
Overhead		(4,000)
Depreciation		(750)
Net Interest		(1,000)
Pre-tax Income		3,250
Income Tax (50%)		(1,625)
Net Income	\$	1,625

CASH FLOW STATEMENT (w/o ESOP)		
Net Income	\$	1,625
Depreciation		750
Working Capital		(500)
Capex		(750)
Free Cash Flow	\$	1,125

With ESOP

SIMPLIFIED INCOME STATEMENT (\$ in thousands)		
Net Revenue	\$	32,000
Cost of Goods Sold		23,000
Gross Profit		9,000
Overhead		(4,000)
Depreciation		(750)
Net Interest		(1,000)
Pre-tax Income		3,250
City Tax (4%)		(130)
Net Income	\$	3,120

CASH FLOW STATEMENT (ESOP)		
Net Income	\$	3,120
Depreciation		750
Working Capital		(500)
Capex		(750)
Free Cash Flow	\$	2,620



Comparative Free Cash Flow Primer ("S" Corp)

CASH FLOW STATEMENT (ESOP)		
Net Income	\$	3,120
Depreciation		750
Working Capital		(500)
Capex		(750)
Free Cash Flow	\$	2,620

CASH FLOW STATEMENT (w/o ESOP)		
Net Income	\$	1,625
Depreciation		750
Working Capital		(500)
Capex		(750)
Free Cash Flow	\$	1,125

COMPARATIVE		
Free Cash Flow w/ESOP	\$	2,620
Free Cash Flow w/o ESOP		1,125
ESOP Incremental Benefit		133%

Free Cash Flow Primer ("C" Corp, w/ESOP)

ESOP TRUST		
Debt to Company - Beginning of Period	\$	10,000
Repayment		(3,250)
Debt to Company - End of Period	\$	6,750

ESOP
Contributions

\$3.25MM

SIMPLIFIED INCOME STATEMENT (\$ in thousands)		
Net Revenue	\$	32,000
Cost of Goods Sold		23,000
Gross Profit		9,000
Overhead		(4,000)
Depreciation		(750)
Net Interest		(1,000)
Pre-tax Income		3,250
ESOP Contributions		(3,250)
Taxable Net Income	\$	-

Repayment of ESOP
Debt to Company

\$3.25MM

CASH FLOW STATEMENT w/ESOP		
Net Income	\$	-
Repayment of Debt from ESOP Trust		3,250
Working Capital		(500)
Depreciation		750
Capex		(750)
Free Cash Flow	\$	2,750

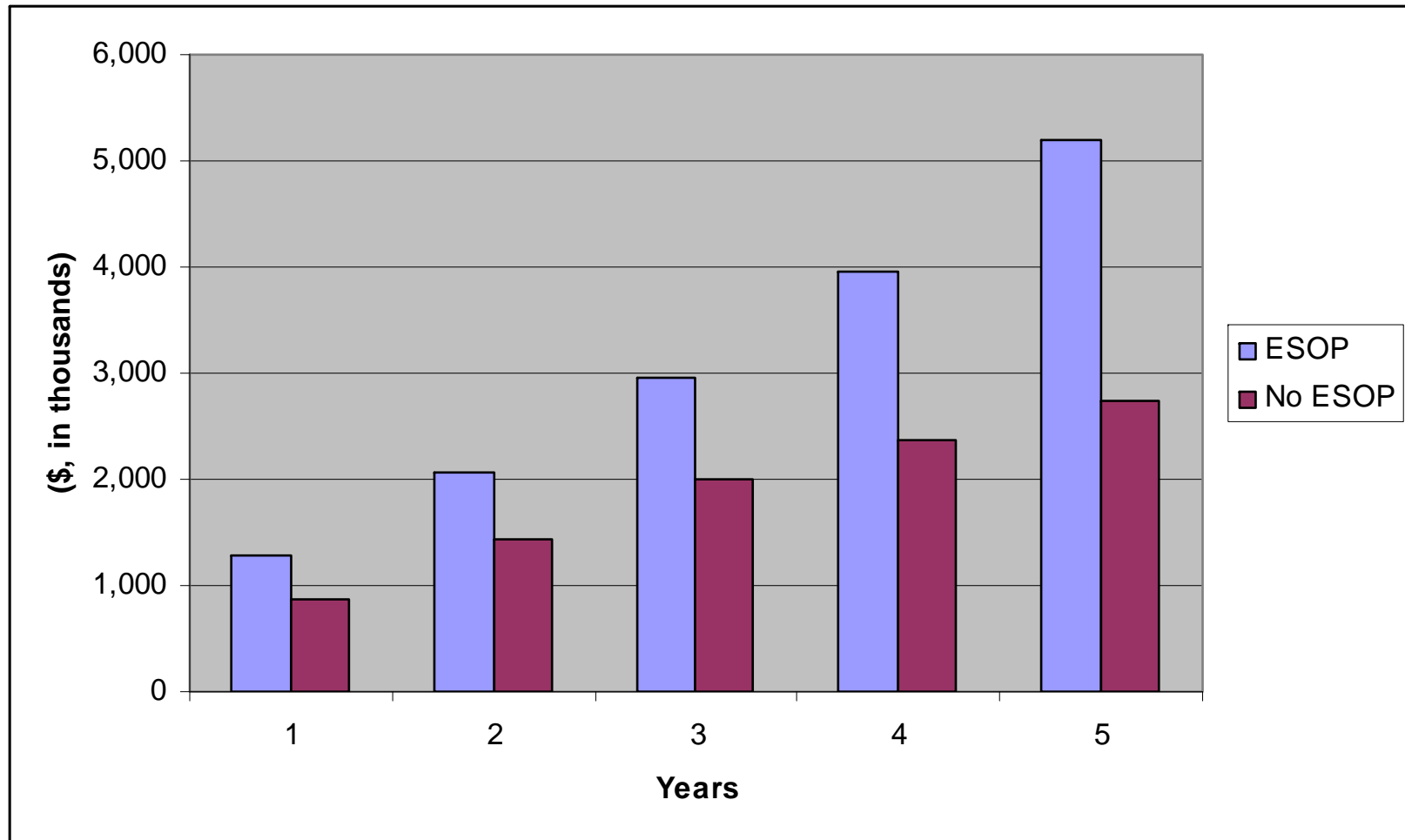
Comparative Free Cash Flow Primer ("C" Corp)

CASH FLOW STATEMENT w/ESOP		
Net Income	\$	-
Repayment of Debt from ESOP Trust		3,250
Working Capital		(500)
Depreciation		750
Capex		(750)
Free Cash Flow	\$	2,750

CASH FLOW STATEMENT (w/o ESOP)		
Net Income	\$	1,625
Depreciation		750
Working Capital		(500)
Capex		(750)
Free Cash Flow	\$	1,125

COMPARATIVE		
Free Cash Flow w/ESOP	\$	2,750
Free Cash Flow w/o ESOP		1,125
ESOP Incremental Benefit		144%

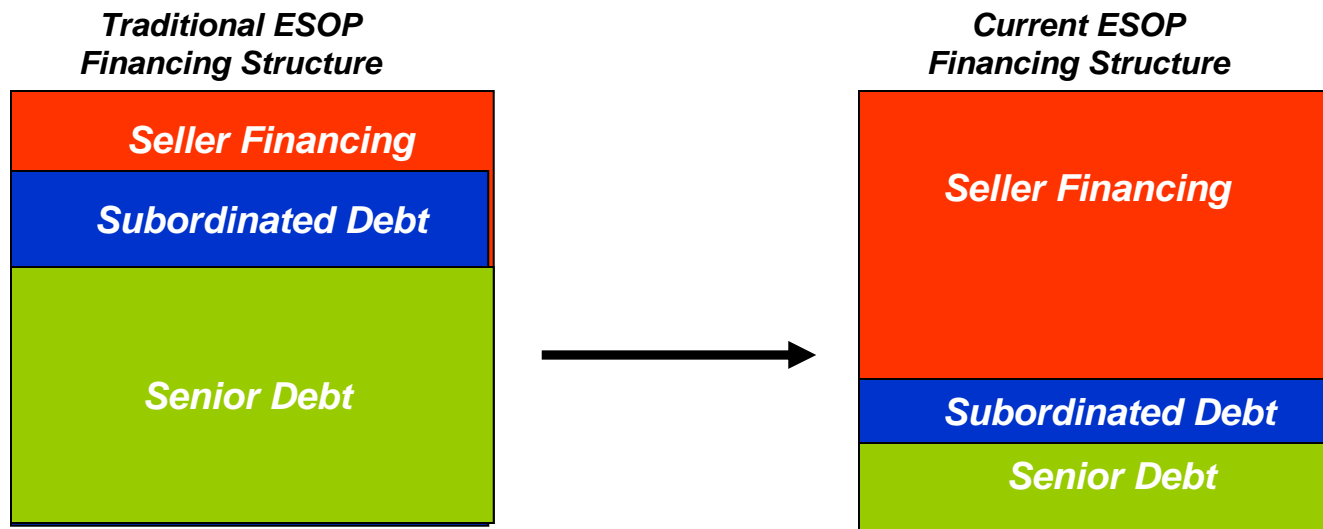
ESOPs – Incremental Free Cashflow (\$5MM EBITDA)



Capital Structure

ESOP Financing Structure under Current Market Conditions

- i. **Senior debt** – traditionally, the least expensive source of outside capital
- ii. **Subordinated debt** – pricier than senior debt, but more readily available in the current environment
- iii. **Seller Financing** – an increasingly popular source of ESOP transaction financing



Senior Debt

- Lenders rely on companies' assets and cashflows in making their lending decisions;
- Capital is cheap (3 Month LIBOR – 0.29%, Prime – 3.25%);
- Require monthly (sometimes weekly) borrowing base reports from their clients;
 - *advance 80%-90% against eligible accounts receivable and*
 - *45%-60% against eligible inventory and letters of credit*
- Fixed assets (e.g., equipment or real estate) and intellectual properties (e.g., trademarks and patents) sometimes would be included as a part of the collateral. In the current environment lenders increasingly prefer to lend against liquid assets;

Senior Debt (continued)

- Asset-based or “hybrid” senior lenders also occasionally “stretch” their loans, advancing funds in excess of their clients’ collateral support. Historically, CSG was able to secure 18-24 month cashflow overadvances for its clients. Presently, this financing window has been shortened to 0-6 months;
- Typical covenants include (i) minimum availability, (ii) maximum fixed charge coverage, (iii) maximum leverage, etc;
- Senior lenders price their loans as a function of Prime or Libor. Typical ranges are L+4% to L+6% or P+0.5% to P+3%;
- Cashflow-based lenders typically advance loans based on multiples of their clients’ EBITDA. Largely unavailable for middle-market companies at this time.

Subordinated Debt

- A more expensive form of financing;
- Mezzanine debt is still available in the current environment; it is typically priced at 16%-23% total target rate of return;
- Typically requires a Subordination Agreement, determining each lender's rights and claims;
- Subordinated lenders typically take precedence over seller debt and may add financial covenants (e.g., total debt to EBITDA) to monitor the company's performance;
- Subordinated debt providers include private equity / mezzanine funds, designated groups within traditional banks, insurance companies, etc.

Seller Financing

- Most inexpensive and most readily available form of financing;
- Selling shareholders accept notes from the company for the entire amount or for the portion of their stock sold to the ESOP;
- Sellers earn current interest (typically, 5%-6%), taxable as ordinary income;
- Companies utilize ESOP-related tax benefits to enhance their cashflows and amortize the seller notes faster;
- The involvement of senior and subordinated third-party lenders may subject the seller notes to various covenants and affect (defer) the timing of their repayment;

In the current environment, seller-financed transactions are becoming increasingly popular, as clients desire the tax benefits associated with the ESOP without having to go through the arduous bank due diligence and approval process. Furthermore, market uncertainty makes financial covenants and other limitations typically imposed by the third-party financing sources substantially less appealing.

Valuation Aspects of ESOPs

What is Value?

- Buyer (ESOP): Price paid
- Seller: Money received
- Sale price is negotiated between trustee and selling stockholders
- Fair Market Value as determined by the trustee

Fair Market Value

- The price at which an asset would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such asset (as defined by the U.S. Department of Labor Regulations)
 - Definition is consistent with IRS Revenue Ruling 59-60
- Not Strategic Value

Adequate Consideration (Key Issue)


- Fair market value determined in good faith by the trustee
- ERISA requires ESOPs to pay no more than “adequate consideration,” or fair market value, as reasonably determined by the Trustee
- Fairness opinion, issued by trustee’s independent financial advisor, that the purchase price is “no more than” adequate consideration

Premises of Value

- Going Concern
 - Value of a business enterprise that is expected to continue to operate in the future
 - Intangible elements of going concern value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place

Levels of Value

- Discounts may apply depending on the ESOP's ownership position and company-specific factors

<ol style="list-style-type: none">1. 100% control2. Ownership sufficient to liquidate, merge, etc.3. 51% operating control4. 50%-50% ownership5. Less than 50%, but the largest equity interest6. Less than 50%, but with swing vote powers7. Less than 50%, but with cumulative voting powers8. Pure minority interests – no attributes of control	<p>Least Impaired Value</p>  <p>Most Impaired Value</p>
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Valuation Approaches

- Income Approach
 - Discounted Cash Flow Method
 - Capitalization of Earnings Method
- Market Approach
 - Guideline Public Company Method
 - Comparable Transaction Method
- Asset Approach
 - Asset Accumulation Method

Income Approach

- Value is based on the present value of all expected future benefits from the business, discounted at a rate that represents the risk of the business
- Rates of return are applied to the expected benefits using two different techniques
 - Capitalization method: Utilizes an estimated income figure (single period) and a capitalization rate
 - Discounting method: Utilizes a projected income stream (multiple periods) and a discount rate

Income Approach (continued)

Capitalization of Earnings Example

<u>Year</u>	<u>Normalized Debt-Free Gross Cash Flow</u>	<u>Weight</u>	
2007	\$ 5,000	5	\$ 25,000
2006	\$ 4,000	4	\$ 16,000
2005	\$ 4,500	3	\$ 13,500
2004	\$ 3,800	2	\$ 7,600
2003	\$ 3,500	1	\$ 3,500
			<u>\$ 65,600</u>
Total Weights			<u>15</u>
Weighted-Average Normalized Debt-Free Gross Cash Flow			4,373
Next Year's Normalized Debt-Free Gross Cash Flow			<u>1.03</u>
Future Maintainable Normalized Debt-Free Gross Cash Flow			4,505
Reserve for capital expenditures			(150)
Working capital needs			<u>(100)</u>
Normalized Debt-Free Net Cash Flow			<u>\$ 4,255</u>
Weighted Average Cost of Capital			0.20
Market Value of Invested Capital			<u>\$ 21,273</u>

Income Approach

Discounted Cash Flow Example

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Terminal Value</u>
Net income	\$ 10,000	\$ 10,500	\$ 11,025	\$ 11,576	
+ Depreciation	1,000	1,100	1,200	1,300	
- Capital expenditures	(2,000)	(2,200)	(2,500)	(3,000)	
- Increase in net working capital	(500)	(600)	(650)	(700)	
= Net cash flow	<u>\$ 8,500</u>	<u>\$ 8,800</u>	<u>\$ 9,075</u>	<u>\$ 9,176</u>	(9,176*1.03) (0.25-0.03)
Net cash flow	<u>\$ 8,500</u>	<u>\$ 8,800</u>	<u>\$ 9,075</u>	<u>\$ 9,176</u>	<u>\$ 42,962</u>
Required rate of return	(1.25) ¹	(1.25) ²	(1.25) ³	(1.25) ⁴	(1.25) ⁴
Present value	\$ 6,800	\$ 5,632	\$ 4,646	\$ 3,759	\$ 17,597
Market Value of Invested Capital	<u>\$ 38,434</u>				

Market Approach

- Based on the principle of substitution, or the premise that a prudent buyer would pay no more for a property than it would cost to acquire a substitute property with the same utility
- Composed of two primary techniques:
 - Guideline public company method – based on the selling price of publicly traded shares
 - Merger and acquisition method – based on the sales prices of acquired / merged companies (also called the transaction method)

Market Approach (continued)

Guideline Public Company Method Example

Guideline Public Companies					
	AAA	BBB	CCC	Mean	Median
MVIC / Sales	1.0	0.8	0.9	0.9	0.9
MVIC / EBIT	7.5	6.3	7.0	6.9	7.0
MVIC / EBITDA	4.7	4.0	4.4	4.4	4.4
Subject Company					
		Median Multiple			
Sales	\$ 10,000,000	0.9	\$ 9,000,000		
EBIT	\$ 1,250,000	7.0	\$ 8,750,000		
EBITDA	\$ 2,000,000	4.4	\$ 8,800,000		
Market Value of Invested Capital			\$ 8,850,000		

Market Approach (continued)

Market Transaction Method Example

<u>Guideline Acquired Companies</u>						
Company	MVIC	Revenue	MVIC-to- Revenue	EBITDA	MVIC-to- EBITDA	
1	\$ 303,800	\$ 370,000	0.82	\$ 55,000	5.52	
2	\$ 243,900	\$ 304,000	0.80	\$ 42,000	5.81	
3	\$ 525,000	\$ 515,000	1.02	\$ 65,000	8.08	
4	\$ 911,900	\$ 1,156,000	0.79	\$ 142,000	6.42	
5	\$ 292,300	\$ 335,000	0.87	\$ 68,000	4.30	
Mean	\$ 455,380	\$ 536,000	0.86	\$ 74,400	6.03	
Median	\$ 303,800	\$ 370,000	0.82	\$ 65,000	5.81	
<u>Subject Company</u>						
		Median	LTM	MVIC		
MVIC-to-Revenue		0.82	450,000	\$ 369,486		
MVIC-to-EBITDA		5.81	60,000	<u>\$ 348,429</u>		
Market Value of Invested Capital				\$ 358,958		

Asset Approach

- Also based on the principle of substitution
- Assumes a prudent buyer would pay no more for a business than it would cost to assemble all of the individual assets and liabilities that comprise the business
- The balance sheet is adjusted to market value by individually valuing all of the tangible and intangible assets of the business and then deducting the market value of all the company's liabilities

Asset Approach (continued)

Example

	As Reported	Adjustment	As Adjusted
Assets			
Current assets			
Cash	\$ 100	\$ -	\$ 100
Accounts receivable	250	-	250
Inventory	400	75	475
Total Current assets	750	75	825
Net fixed assets	400	200	600
Other assets	40	(10)	30
Total assets	\$ 1,190	\$ 265	\$ 1,455
Liabilities			
Current liabilities			
	\$ 400	\$ 106	\$ 506
Long-term debt	500	-	500
Total liabilities	\$ 900	\$ 106	\$ 1,006
Stockholders' equity	\$ 290	\$ 159	\$ 449

S Corporation Valuations

- Tax effect as if the company was a C Corporation
- 100% transactions provide significant tax savings beyond ESOP “funding” period
- Acquisitions with pre-tax earnings

ESOP Transactions Involving Minority Shares

- Limitation Agreement protects the interests of the beneficiaries of the ESOP shares
 - Limit rent
 - Limit compensation
 - Limit perquisites
 - Limit bonuses
- Not available to ordinary common minority stockholders
- Impact of synthetic equity plans

ESOP Transactions Involving Controlling Interests

- Limitation Agreement can still be utilized
- Acquisition tool
- Discounts may still apply
- Impact of synthetic equity plans

Preferred Stock Transactions

- Must be a C Corporation to account for separate classes of stock
- Annual dividend could cause 30% equity interest to be worth 40-45% of the company's value

Lack of Marketability Discount

- LOMD is mitigated by the required put option on the ESOP shares
- These options create a market for the holders of the ESOP shares
- Financial status of the business considered
- Repurchase obligation studies

The Valuation Process as it Relates to an ESOP Transaction

- Preliminary value
- Negotiation
- Structure
- Final value and fairness opinion on entire transaction
- Presentation to trustee committee for approval
- Closing
- Annual reporting including valuation of ESOP shares

Pre/Post-Valuation Differences

- ESOP transaction:
 - Increases leverage
 - Increases risk
 - Increases expenses
 - Increases value with tax shield
 - Increases post-transaction after-tax cash flow

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