# Lending to ESOPs: Of a Different Color, This Horse Still Races

by Michael Golden and Matthew Wright

This article provides an overview of ESOPs—how they work, where the lending opportunities are, and the unique challenges involved in underwriting them. ESOPs' tax advantages also can cause problems in reporting capital on the balance sheet. Also, sharehold-er comings and goings can create risk, and there are no "rules of thumb" in determining a minimum capital base. But ESOP-specific attention paid to cash flow, capital, collateral, and character can help lenders reap the benefits of this win-win-win situation.

"You mean this is what it's *supposed* to look like?" Many lenders have asked that question about lending to an Employee Stock Ownership Plan (ESOP). Yet, ESOPs have been proven to provide a win-win-win situation. Selling shareholders receive tax benefits as well as cash proceeds, employees become equity stakeholders in their companies, and lenders receive strong yields for substantially risk-free credits.

There are more than 10,000 of these plans in the U.S. today, in almost every industry imaginable. They're in private companies with values below $1 million, and in multi-billion-dollar public companies, like United Airlines. All in all, there are nine million ESOP participants; through their plans, they own more than $200 billion of U.S. company stock.[1] And most of these ESOPs are leveraged, meaning there is a lot of opportunity out there for lenders.

### It's No Fable

An ESOP is a qualified retirement benefit plan, governed by the Employee Retirement Income Security Act (ERISA). As a trust established for the benefit of a company's employees, the ESOP is analogous to a 401(k) plan. Unlike a 401(k), the employee makes no contribution and participant accounts must invest primarily in employer stock.

This ERISA oversight means that ESOPs are complex and subject to a plethora of government regulations. It also means that ESOPs—and the companies that establish them—can benefit from significant tax advantages.

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A major advantage of ESOPs is that they are the only employee benefit plan that can use bank financing to purchase company stock. For all other qualified employee-benefit plans, this would be a prohibited transaction under ERISA. This leverage opportunity is encouraged by other tax advantages, both to the company and to its shareholders. According to a survey of ESOP transactions from 1997, 88% were leveraged[2]—of these, banks financed 74%, other agents financed 9%, 11% were self-financed, and the seller financed the remaining 6%.

Many of the tax incentives that exist for ESOPs have been granted to promote their use as a technique of corporate finance. They also provide an attractive incentive for corporations to share the benefits of corporate financial transactions with their employees.

These benefits flow through indirectly to the lender, enhancing the creditworthiness of the borrower. For example, since ESOPs are qualified retirement plans under the IRS code, company contributions to them are tax-deductible.[3] In fact, ESOP contributions intended to repay an acquisition loan are deductible for both interest *and principal*. The lender can then use pre-tax cash flow, or as discussed later, adjusted earnings before interest, tax, and depreciation/amortization (EBITDA) to assess coverage of the proposed ESOP debt.

## Good News, Good News, Bad News

If a shareholder in a C corporation sells stock worth more than 30% of the company's value to an ESOP, selling shareholders are permitted to "roll over" the proceeds into other U.S. domestic securities, stocks or bonds. By using the sale proceeds to purchase this "qualified replacement property" (QRP), a seller avoids paying the 20% federal capital gains tax, under Section 1042 of the Internal Revenue Code. Applicable capital gains taxes would become due only when the shareholder sells these new holdings and would be based proportionately on the securities sold. This represents a valuable tax and estate planning tool for owners of private companies.

It becomes a good-news-good-news-bad-news scenario for the selling shareholder. The good news is that the shareholder temporarily avoids paying federal capital gains taxes on the sale of his/her company stock. More good news is that when the QRP moves into the shareholder's estate, the basis is stepped up to the securities' own acquisition price. The bad news for the selling shareholder is that the estate benefits accrue only upon his/her death. The heirs, however, are 20% better off, and the selling shareholder was able to cash out while maintaining control over the structure and timing of his/her exit.

For example, Mr. Jacob sells 100% of his interest in Jessie & Michelle's Cookies to his employees through an ESOP. While the company was valued and sold at $11 million, Jacob's total basis in his stock was only $1 million, since he built the company from nothing after buying the rights to the name and some fixed assets. The gain on his shares is $10 million, on which he would normally be liable to pay 20%, or $2 million, in federal capital gains taxes. Since Jacob is selling more than 30% of the company's value to an ESOP, however, he can roll over the proceeds into $11 million of QRP, perhaps including some specifically-designed sophisticated bond instruments. He could design his portfolio to provide significant cash dividends for income. Jacob could also, for example, borrow against the margin to take more cash out immediately.

The good news for Jacob is that he has deferred $2 million in capital gains taxes. The bad news for Jacob is that five years into his retirement world cruise, he and his wife are eaten by lions in Kenya (a freak accident). Fortunately for Jacob's heirs, his QRP portfolio enters his estate with an $11 million basis rather than the original $1 million basis. The $2 million in capital gains tax liability based on the original ESOP sale has been deferred forever.

Most private company ESOPs are designed to allow the owner to exit. Of those sellers who used the Section 1042 tax exemption, 91% cited business succession as their goal.[4] For private companies, ESOPs often are used to provide gap financing for a management or family buy-out in which the buyers cannot immediately raise all the necessary capital from their own resources.

For both private and public companies, the tax advantages of leveraged ESOPs increasingly are finding new avenues. They are being used to provide capital for expansion or acquisition, to buy out outside shareholders, to finance capital expansion, to take public companies private in ESOP leveraged buyouts, to spin off current or acquire new divisions, and virtually any other legitimate corporate financial transaction. Even governments are getting into the act, using ESOPs to privatize divisions or functions.

### The Willie Sutton Syndrome

Previously, lenders underwrote the ESOP Trust itself, looking for a guarantee from the company. Currently, most ESOP loans in private companies are to the company rather than to the Trust. From the lender's point of view, the Trust will have no assets until after the transaction. Even then, its only assets will be encumbered company stock. A lender's choice is then between a borrower with no assets—guaranteed by a company with assets—or the company, which generally has hard assets and equity. So, it makes sense to look to the company, which has a portfolio of assets, to be the borrower. This could be called part of the Willie Sutton School of Lending. Sutton, when asked why he robbed banks, said, "Because that's where the money is."

### Borrowing—Setting Up the Mirror

The first thing to understand is that the buyer and seller do *not* set the price in an ESOP transaction. For a public company, the value of the stock is determined in the market. For private companies, ERISA requires an outside, independent valuation. This is intended to ensure that the employees are protected and that the price represents fair market value. It also serves to provide a degree of comfort for the lender.

Since the company valuation is part of a protection to the employees under ERISA, the independent valuation is ordered by the ESOP trustee. While later the ESOP trustees are often company managers, during the transaction phase this trustee is often an outsider hired for this purpose to protect the company from even the appearance of interference. The valuation itself is based on the concept of fair market value in an arm's-length transaction, as determined by the valuation firm in a manner appropriate to the industry, the company, and the specifics of the transaction. The ESOP is permitted to pay any price up to and incuding this figure.

Figure 1 presents the first stage of an ESOP transaction—the original loan and the mirror loan, as described below and working clockwise in the diagram.

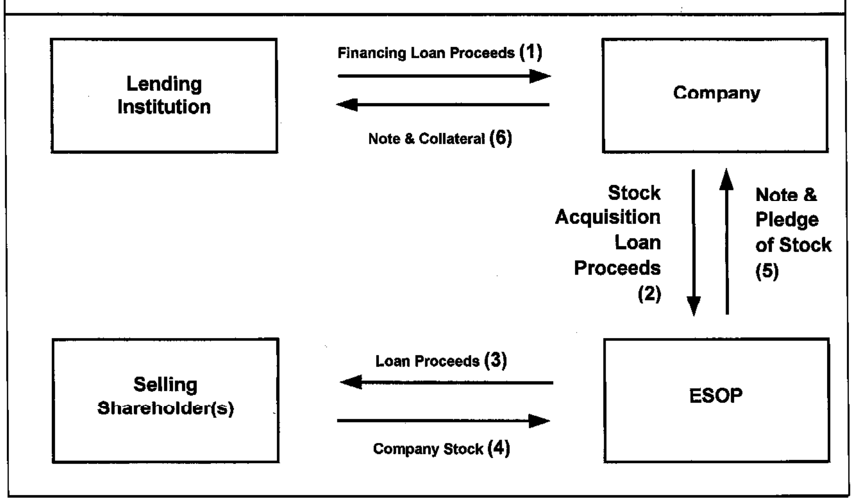
1. The lender provides cash to the company.
2. The company, in turn, loans the cash to the ESOP Trust.
3. The Trust uses the cash to buy company stock, from the company or selling shareholder(s), who might roll the proceeds over into QRP.

Next, as we work back counterclockwise through the diagram:

4. The shareholder transfers his/her stock to the Trust.
5. For collateral on the mirror loan, the Trust provides the company with a note and lien of the stock just acquired. (This lien assignment can help a lender perfect its security position above a general lien on corporate assets.)
6. On the bank loan itself, the company provides a note and any agreed liens and collateral. The selling shareholder also might provide a pledge of some portion of the QRP.

Figure 1

**Initial ESOP Transaction**




### Repayment—Dizzy Yet?

Figure 2 depicts the repayment process.

1. The company makes annual contributions to the ESOP and

pays any dividends required out of pre-tax cash flow.

2. The Trust makes its loan payments to the company, which then...

3. ...releases from suspense the appropriate amount of company stock. (The Trust then allocates this released stock to eligible participants.)

4.The company then repays the lender as agreed, which...

5. ...releases the company's note and collateral. At this point, if QRP has been pledged, the lender releases it on the agreed schedule.

Generally, the mirror loan "mirrors" the terms of the loan the company secured, but this is not required. Therefore, it is possible for the company, through timing differences, to take advantage of the opportunity to accelerate tax deductions associated with the transaction. Keep in mind that the principal portion of the tax deduction is based upon the company's ESOP contribution, while its interest deduction is based upon its own (mirror) loan schedule.

ESOP transactions often work in stages. It is not unusual for a selling shareholder to sell enough stock to qualify for the 1042 capital gains tax exclusion (30% of the company's value) in an initial transaction, and then complete the sale of the company over one or more subsequent ESOP transactions. Each of these transactions is likely to provide an opportunity to extend credit to the company. For example, Amy June owns 100% of her C corporation, M&S Enterprises. In 1994, she decided she wanted to safeguard some of the value she had created. She sold 30% of the value of the company to an ESOP, meeting the threshold at which she could roll the proceeds into QRP. Cash for the original transaction was provided by B&A Savings Bank. Now, as the original loan matures, June has decided to sell 25% more of the company to the ESOP, while gifting 10% to her son as part of her succession strategy. Her plans are that by 2003 she will have disposed of 100% of her interest in the company, while remaining as CEO until her 60th birthday in June 2005.

## Four Cs with a Twist

ESOPs are complex. Outside of the financial issues addressed herein, there are many other separate issues a lender should be familiar with when underwriting a proposed ESOP transaction.

Although there are industry-specific idiosyncrasies to each ESOP deal, the basics remain rooted in cash flow, capital, collateral, and character-but with a difference. While the tax advantages can play havoc with the *reporting* of capital on the balance sheet, they also can provide decided benefits in cash flow and collateral.

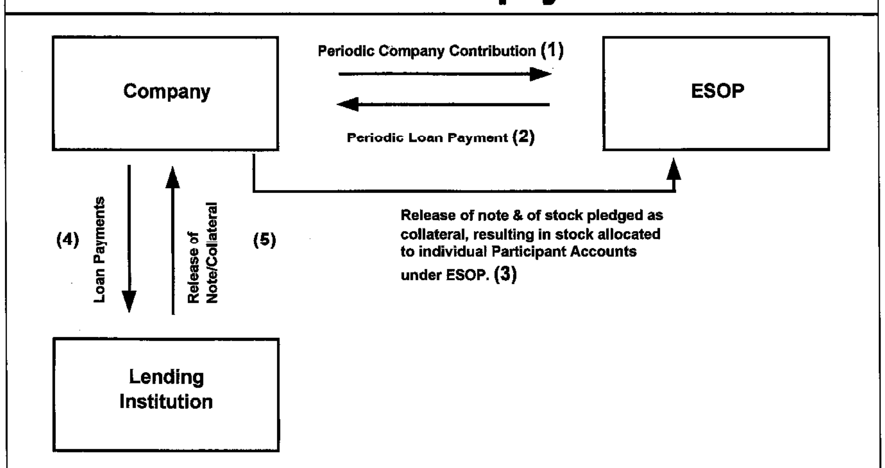
**Cash flow.** Cash flow is one of the most important underwriting components in any industrial and organizational analysis. Will the borrower have the cash to make his payments? It is no different when underwriting a company's sponsorship of an ESOP. Correctly understanding the effects on cash flow pre- and post-ESOP is an integral part of the underwriting process.

In cash coverage, the de facto deductibility[5] of principal—and thereby loan repayment with pre-tax cash flow—can provide a unique level of lender comfort. In analyzing the credit, then, it is often advisable to use an adjusted EBITDA in cash coverage ratios.

In using adjusted EBITDA, interest is included in cash flow for total debt coverage, particularly if other term debt will be refinanced as part of the new ESOP loan. This said, the underwriter

Figure 2

**ESOP Loan Repayment**



should still be sure to account for any cash obligations to revolving credit agreements, removing this cash from the total available.

Since, as discussed above, the ESOP debt principal and interest can be paid with pre-tax cash, tax obligations also should be removed from the ratios. As we add back the cashless expenses of depreciation and amortization, the underwriter should examine the company's historical capital expenditures (CAPX), and then subtract from cash available a reasonable estimate of future CAPX requirements. The first section of Figure 3 depicts a basic cash coverage equation: *EBITDA - CAPX = Available for Debt Service.* In addition, a look at the company's historical performance and future projections will point out changes in working capital. Will company growth chew up cash through increases in receivables?

An important cash flow enhancement that could be available post-transaction in an ESOP credit is the selling shareholder's compensation package. Is the shareholder's long-term intention to remain with the company or depart? A departing shareholder, whether exiting immediately or spacing his/her exit over a period of years, is likely to understand that selling the company dictates reduced compensation. We can make an assessment of the cost of salary and benefits for comparable replacement management acquired on the open market.

It's easy to think about this in the context of an S corporation and then extend it logically to a C corporation. For example, let's say that in the S corporation Newbold, Inc., with $1 million in revenues, the shareholders are taking out $500,000 in salary, benefits, and distributions, zeroing out corporate income. If the shareholders wanted to hire a manager or managers to fill their roles, they likely could do so for $150,000 in total annual costs. The $350,000 difference can be considered "excess" owners' compensation—a return to equity cloaked as management compensation.

**Figure 3**

**Typical Cash Flow Analysis**

| | |
|---|---|
| | **EBITDA** |
| — | **CAPX*** |
| | **Cash Available for Debt Service** |

*CAPX represents a reasonable estimate of future capital requirements based on historical capital expenditures.

**Typical ESOP Cash Flow Analysis**

| | |
|---|---|
| | **EBITDA** |
| ⊇ | **Excess Owners' Compensation** |
| ⊃ | **Redirected Employee Benefits** |
| — | **CAPX** |
| | **Cash Available for Debt Service** |

As a return on equity, this cash is available to the new ownership—the ESOP—for debt repayment. The shareholder may sell less than 100% of the company or participate in an advisory or board position. In either case, this total compensation savings is often quite substantial and may go a long way towards servicing the new ESOP-related debt in a private company, whether S or C corporation.

In addition, the company may have other new sources of cash for ESOP debt repayment. For example, the company is likely to terminate its own contributions to other retirement plans at the earliest opportunity. The expense of the company match of an employee's contribution to a 401(k) will be replaced by the cost of the ESOP contribution; other plans may be terminated entirely or rolled over into the ESOP.

The inclusion of the two adjustments listed above results in a restatement of the previously shared basic cash available equation. In an ESOP loan, the equation can be restated as: *EBITDA + Excess Owners' Compensation + Redirected Employee Benefits - CAPX = Cash Available for ESOP Debt Service.* (See Figure 3.)

It also is important to examine the company's history in carrying significant debt as well as any tax ramifications of the post-ESOP period. For instance, under current law, the ESOP trust's proportion of S Corporation distributions is untaxed. In a 100% ESOP-owned S Corporation, therefore, the company is likely to have no federal income tax liability. The result is that this additional cash is available for debt coverage, capital expansion, acquisition, or other business purposes.[6]

**Capital.** Accounting for a company's capital base post ESOP transaction is one of the more

Figure 4

**Is this company a candidate for an ESOP?**

Typically, a company should meet these minimum criteria before considering an ESOP:

- Company value is $1 million or more (the transaction itself may be less)
- 10 or more employees
- Good financial condition

Often, a company will have:

- An owner seeking to develop a succession plan
- Managers who are interested in running the business

unique characteristics of the leveraged ESOP. When a company borrows money for an ESOP transaction, it makes a loan to the ESOP trust (see Figure 1). The ESOP's shares generally are pledged as security by the ESOP trust and held within the trust in a "suspense account" rather than being allocated directly to each employee's account.

Under Statement of Position (SOP) 93-6, which was developed by the American Institute of Certified Public Accountants and approved by FASB in 1993, a leveraged ESOP's debt is recorded as a liability on the employer's financial statements, whether or not the debt is guaranteed by the employer. To accomplish this, a contra equity account, equal to the unpaid principal on the ESOP loan, is set up as the offsetting entry on the company's books. As the debt is repaid, shares are released from the suspense account and allocated to the accounts of the employee participants, and the contra equity is reduced by the cost of the shares.

This accounting treatment wreaks havoc on the company's balance sheet, because it results in a two-fold reduction of the capital base. The company books a long-term liability for the ESOP debt, and the offsetting entry, posted to the contra-equity account, further diminishes the capital base by the initial loan amount. It is not necessarily cause for concern for a smaller company to show negative net worth on the books upon closing an ESOP loan. Lenders must be comfortable with the accounting treatment and acknowledge the leveraged nature of the transaction while discerning between the economic and nominal value of an organization.

There are no "rules of thumb" in determining a minimum capital base or, for that matter, for any financial ratios when underwriting an ESOP transaction. An ESOP is not industry-specific; it is merely a defined contribution retirement plan that uses company stock to fund employees' retirements. Therefore, the onus is upon the lender to understand the dynamics of each industry's capitalization requirements and diligently compare those with the projections provided by the borrower. As always, sensitivity analysis is appropriate and projections must be adhered to and benchmarked.

**Collateral.** By nature, these transactions are leveraged. Lenders often may find themselves inadequately secured with the assignable corporate assets of a sponsoring organization. This is further complicated when the organization being underwritten is capital intensive. In that case, many assets may already be pledged for other term or revolving loans. The opportunity to cross-collateralize might argue for the lender seeking to become the company's primary lender through the ESOP term loan. Or, in lending to a professional service group in which the primary assets walk out the office door at the end of each workday, such as architectural or engineering firms, it might be difficult to attach a perfected security interest in the assets.

There are several structuring alternatives for collateralizing an ESOP transaction in addition to a general lien on corporate assets. The lender may understand the risk well enough to leave a portion of the financing transaction unsecured. Frequently, however, a lender will try to bridge some of the collateral shortfall. When the "airball" is coupled with thin capitalization, mezzanine or subordinate debt might also contribute to the solution.

More normally, depending on the interests of the borrower, some portion of the QRP could be pledged to a lender to bridge this gap. This is a particularly attractive option for a professional firm, which typically could generate adequate cash flow to service the loan but have a weak balance sheet. The amount of QRP the selling shareholder would be willing to pledge is a reasonable subject for the negotiation. Generally, the pledged collateral would be released on an annual basis in direct proportion to the principal curtailment.

**Character.** This is an intangible in all deals but as important to the lender in a leveraged ESOP scenario as collateral, cash flow, and capital. There are two key issues to be addressed regarding character:

1. Why is the shareholder selling stock to the organization in the first place? ESOP financing is a useful means to several ends, such as tax planning, succession planning, employee retention, corporate exit strategies, and mergers and acquisitions. Getting comfortable with a departing shareholder who has played a significant role in the strategic direction of an organization is a complex issue, and needs to be addressed.
2. What is the management depth? Will the selling shareholder have a role in the company post transaction? Who will take over any functions the departing shareholder is relinquishing? Is there a defined succession plan in place? Do the employees understand it? Is senior management comfortable with the plan and the heir apparent?

## Post-Transaction: Record Keeping and Reporting

Since an ESOP is a qualified benefit plan, ERISA has certain requirements for the functioning of the plan. For the lender, the primary concern is the limitations around the company's ESOP contributions. For instance, in a leveraged ESOP in a C corporation, contributions from the company to the ESOP trust and all other qualified pension plans are limited to a total of 15% of eligible (generally W2) compensation. In a leveraged ESOP, this limit increases to 25%.

The company may exceed this 25% ceiling through "reasonable" dividends to ESOP-owned stock if these dividends are used to repay an ESOP acquisition loan. For this reason, professional advisors often recommend the creation of a separate class of dividend-paying stock as part of an ESOP transaction. This approach can maximize the value of the transaction to the customer while ensuring that there is sufficient cash to cover the company's ESOP debt. It may be useful to work closely with the ESOP professional who is advising the company. Many times that person can provide the lender with financial projections founded on the company's own reporting but restructured to demonstrate the available cash coverage more clearly.

Since ESOPs tend to be complicated and part of a sophisticated legal and financial niche, it is reasonable to be interested in the professional advisors helping the company to set up the transaction. For instance, if they have established fewer than three leveraged ESOPs within the previous 12 months, there may be some reason to question their position in the field. For further information about ESOPs or many of the national professionals involved in the field, a lender could contact some of the national associations involved in ESOPs, such as the National Center for Employee Ownership and The ESOP Association.

Eligible employees (participants) have ESOP shares added to their individual accounts as the stock is released from suspense. These distributions are in proportion to their compensation, and, as long as they continue to remain eligible, their shares will vest along a schedule detailed in the ESOP plan document and in line with the requirements under ERISA.

The company is obligated to purchase these shares from retiring or terminated employees along the plan document schedule, subject to mandates under ERISA. These "repurchase obligations" represent a future drain on cash. As a lender faces a second- or third-stage ESOP transaction, the company's ESOP is more mature. Its employee census is more likely to reveal participants who are close to leaving the company and are beginning the repurchase process. It then behooves the lender to understand how the company is funding these liabilities.

## Lender Opportunities

ESOPs provide lenders with more than just the opportunity to passively await a new kind of loan application. Most portfolios contain the types of business owners who might find the ESOP tool a useful exit strategy. These customers tend to be successful business people with very little basis in their company stock. They frequently have the great portion of their wealth tied up in this one illiquid asset. They may be in their early 40s, beginning to think about diversification for retirement. As they reach their 50s and beyond, they often are actively considering estate planning, business succession, and exit strategies—frequently without having made any decisions. Many of these business people feel a strong tie to their employees, who they feel have been an integral part of their own success. Quite often they like the idea of being able to share the fruits of success with their people.

Many of a lender's customers may find an ESOP solution particularly useful in meeting their succession/exit concerns. Figure 4 provides a "quickie" screen to whether a company might be a likely candidate for an ESOP.

Through a managed succession process, the banking relationship can then be extended to the succeeding generation of company management, something that might not happen in a basic sale of the company to an outside party. Further, if the lender manages individual portfolios through a trust division or as part of its core business, there is now the opportunity to manage the assets that were previously tied up in the company.

**Conclusion**

While ESOPs are complicated, they present an exceptional—and tax-advantaged—opportunity to business owners seeking an exit or succession strategy. These plans can provide an internal buyer for a successful operating business that might otherwise just close down, sell at a discount, or be acquired solely for strategic reasons, perhaps even putting out of work the employees who helped it succeed. And ESOPs have a long and successful track record along a variety of uses.

As a business finance or transition tool, ESOPs can provide a win-win-win situation. The selling shareholder implements a strategic business succession plan, the employees acquire an ownership stake in the business, and the lender can enhance a business relationship while booking a good loan for a good purpose. And as Aesop said, "It is thrifty to prepare today for the wants of tomorrow."

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## NOTES

1 Overall market data courtesy of the National Center for Employee Ownership, Oakland, CA, www.nceo.org, 510-272-9461.

2 Survey conducted by the ESOP Association, Washington, DC, www.the-esop-emplowner.org. Contact ESOP Association in Canada at www.esop-canada.com, 416- 749- 0712.

3 There are some specific limitations which apply in administration of the company's plan, post ESOP transaction, but it's not necessary to go into them at this point.

4 ESOP Association, op.cit.

5 There are some limitations to the size of pre-tax contributions to cover ESOP debt, such as those based upon the proportion of debt coverage to overall eligible compensation.

6 At the time of this writing, the President had proposed applying the Unrelated Business Tax (UBIT) to the corporate income of an S Corporation's ESOP trust. This measure, if passed with wholesale application, would eliminate this S Corporation advantage. ESOPs in C Corporations are unaffected by this debate.