

ESOP CONNECT

EMPLOYEE STOCK OWNERSHIP PLANS (ESOP) FINANCING



An ESOP is the only tax-qualified retirement plan that may borrow money. Both principal and interest, subject to limits, on debt incurred to purchase stock from a selling shareholder are deductible to the corporation. Therefore, due to the tax advantages afforded only an ESOP, most ESOP transactions are financed through borrowed (leveraged) funds.

SENIOR BANK DEBT TO FINANCE AN ESOP

ESOP financing may come from many sources. Generally, ESOP financing begins with senior debt from bank familiar with ESOP lending which has its advantages and limitations. Senior debt financing from a bank usually has relatively low interest rates but is usually limited to a

multiple of earnings, which may or may not cover the desired transaction amount. A sale above the senior lender's limit may require additional sources including mezzanine, venture or seller financing to facilitate the entire sale.

OTHER SOURCES OF ESOP FINANCING

Once senior bank debt is exhausted, debt subordinated to the senior bank debt may be available. Private lenders are often willing to lend at levels above what the bank is willing to lend. The availability of an alternative lending source increases the immediate cash payment to the seller but since the debt is subordinate to the senior bank debt, the lender may demand a significantly higher interest rate.

SELLER FINANCING

Seller ESOP financing is becoming more popular in today's lending environment and can be a very viable and rewarding method of financing a sale of stock to an ESOP. As discussed, a traditional lender may not be willing to finance the entire transaction amount but the interest rates and inflexibility of mezzanine/venture capital lenders may be undesirable. The seller playing the role of a subordinate lender by taking a note for the difference between the senior debt and transaction amount has many advantages. First, the seller may enjoy the reward affordable to subordinate lenders such as a higher interest rate or other payment-in-kind, such as warrants, that are not as burdensome to the cash flow of the company. Secondly, the seller note payments are more flexible during times when the corporate cash flow may be better diverted to other priorities or during periods of economic stress. Lastly, in situations where bonding is necessary, seller debt is often viewed as equity rather than debt for bonding company debt to equity ratio purposes.

HOW SELLER FINANCING WORKS

1. The ESOP buys stock from the seller in exchange for seller note.
2. The Company assumes the ESOP's debt to seller in exchange for a note between the company and the ESOP.
3. The company makes tax-deductible contributions to the ESOP.
4. The ESOP uses the contributions to repay its debt to the company.
5. The company uses the debt repayment to satisfy the seller's debt.

HOW WARRANTS WORK

The seller who takes a note for the portion of the sale price is most likely subordinate to senior lenders and therefore is entitled to a market rate of return for this type of debt or a Payment In Kind (P.I.K.) such as warrants. Warrants are the right of the warrant holder to purchase stock at a later date at a specified price. In ESOP

transactions, the warrants are usually only exercisable once all outstanding debt has been repaid. The number of warrants are calculated on the interest due versus interest taken on the seller note. The exercise price of the warrants and the value per share at time of exercise determine the overall "in the money" proceeds to the seller.

IS THE IRC§1042 CAPITAL GAINS TAX DEFERRAL AVAILABLE WITH SELLER FINANCING?

Yes. The IRC§1042 capital gains tax deferral may still be elected to successfully defer the capital gains tax on the entire sale with seller financing. Even though the seller is receiving periodic payments over many years, proper planning can allow the seller to enjoy the indefinite tax deferral despite the requirement that the entire amount must be re-invested into Qualified Replacement Securities within 12 months of the sale.

1. Company makes a down payment to the seller equal to approximately 10% of sale price.
2. Seller borrows approximately 90% of sale price via a one-day note (or series of one-day notes).
3. Seller purchases IRC§1042 eligible Floating Rate Note (FRN) using down payment and one-day note.
4. Seller immediately margins/borrows approximately 90% of the FRN and pays off the one-day note.
5. Seller continues to receive capital gains tax-deferred seller note payments.

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