WHO SHOULD OWN YOUR BUSINESS AFTER YOU? EXPLORING EMPLOYEE OWNERSHIP

James G. Steiker

SES ESOP Strategies

James.steiker@sesesop.com

Why Employee Ownership? Its Not Just About Money

- Aging Baby Boomers are looking for liquidity and succession…*and*…meaning and role
- Entrepreneur owners often have a complex set of interlocking goals and fears
- The corporate finance marketplace promotes relentlessly the goal and need to achieve the highest financial reward—for some entrepreneurs this is necessary or desirable

Its Not Just About Money…

- For some entrepreneurs, their companies and work are a key part of their identity and retirement is no longer a date certain but a continuum—many of us as we age are not looking to stop working but to reduce the volume and the stress of work and focus on the parts of our jobs that provide the most personal reward
- Often founders and family business successors focus on "legacy" and "sustainability" as core values and look to liquidity and succession strategies that preserve mission, jobs, and the independent identity of the enterprise

But Money Matters…

- Sometimes, the pure financial optimization strategy is the sale to a strategic buyer for a premium and overwhelms all of the other alternatives
- ESOPs provide a unique set of tax attributes and advantages that may help an ESOP approach compete favorably with private equity from a financial point of view

Selling to Employees

- Four Primary Approaches
  - Employee Stock Ownership Plans (ESOPs)
  - Worker Cooperatives
  - Employee Ownership Trusts
  - Direct sale of stock to individual employees
- ESOPs are predominate approach in the United States because of special tax advantages

Who Should Own Your Business After You?

Selling to Employees (cont.)

- Worker Cooperatives mostly in smaller companies where cohesive group of employees will operate the business and not large enough to utilize ESOP tax advantages
- Employee Ownership Trusts (EOTs) mostly in smaller companies where selling shareholder wishes to retain complete control and unmotivated by tax advantages
- Direct sale to employees uncommon because of lack of employee funds

Selling to Employees (cont.)

- ESOPs and direct sales of equity to employees primarily provide equity appreciation realized at termination of employment or retirement
- Worker Cooperatives and EOTs primarily provide entitlement (current or deferred) to a share of company profits during the employee's tenure but no equity entitlement
- This presentation will focus on ESOPs—there is an EOT presentation later in the series

Key Outcomes of the Typical ESOP Transaction

- Cash liquidity event for shareholders typically about 30%-40% of the value of the Company
- Company value similar to value in private equity sale
- Company finances initial cash payout through senior debt and/or excess cash resources
- Shareholders either hold remaining stock or hold debt for balance with warrant (stock option) to gain 15%-30% of future equity value

KEY OUTCOMES OF THE TYPICAL ESOP TRANSACTION (CONT.)

- No change in day-to-day management or operating control of the Company—contractual governance rights as part of shareholder debt
- Opportunities for enhanced management ownership through synthetic equity plans (Stock Appreciation Rights)
- Company operates effectively tax-free as 100% ESOP-owned S-Corporation

Section 1042 Capital Gains Deferral

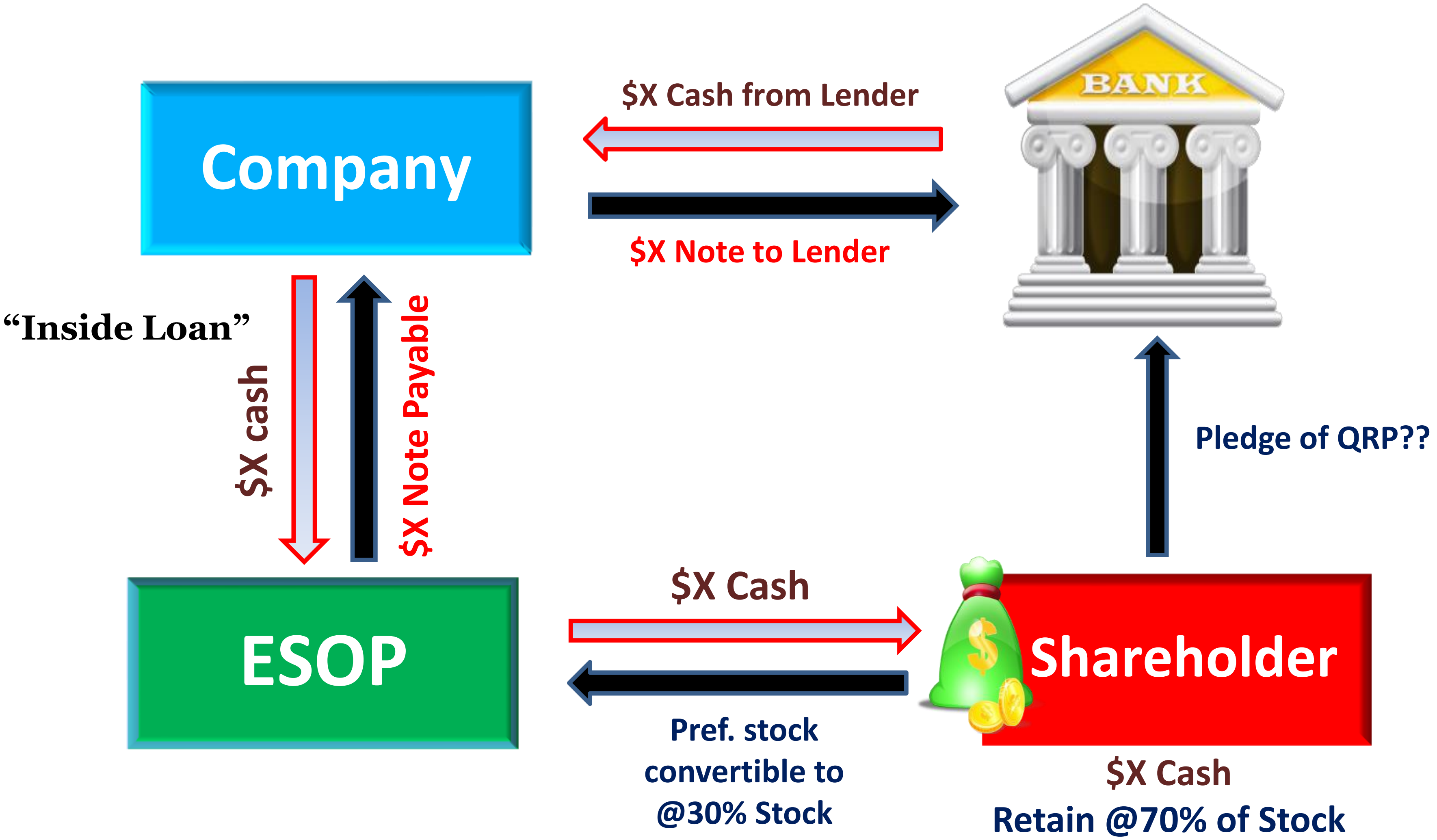
- Permits shareholders selling to an ESOP to defer indefinitely capital gains tax on sale of shares
- ESOP must own 30% of value of all company stock after sale
- Selling shareholders must purchase qualified replacement property ("QRP")—stocks or bonds of any domestic operating corporation
- Company must be C corporation at the time of sale

Why Doesn't Everyone Use an ESOP?

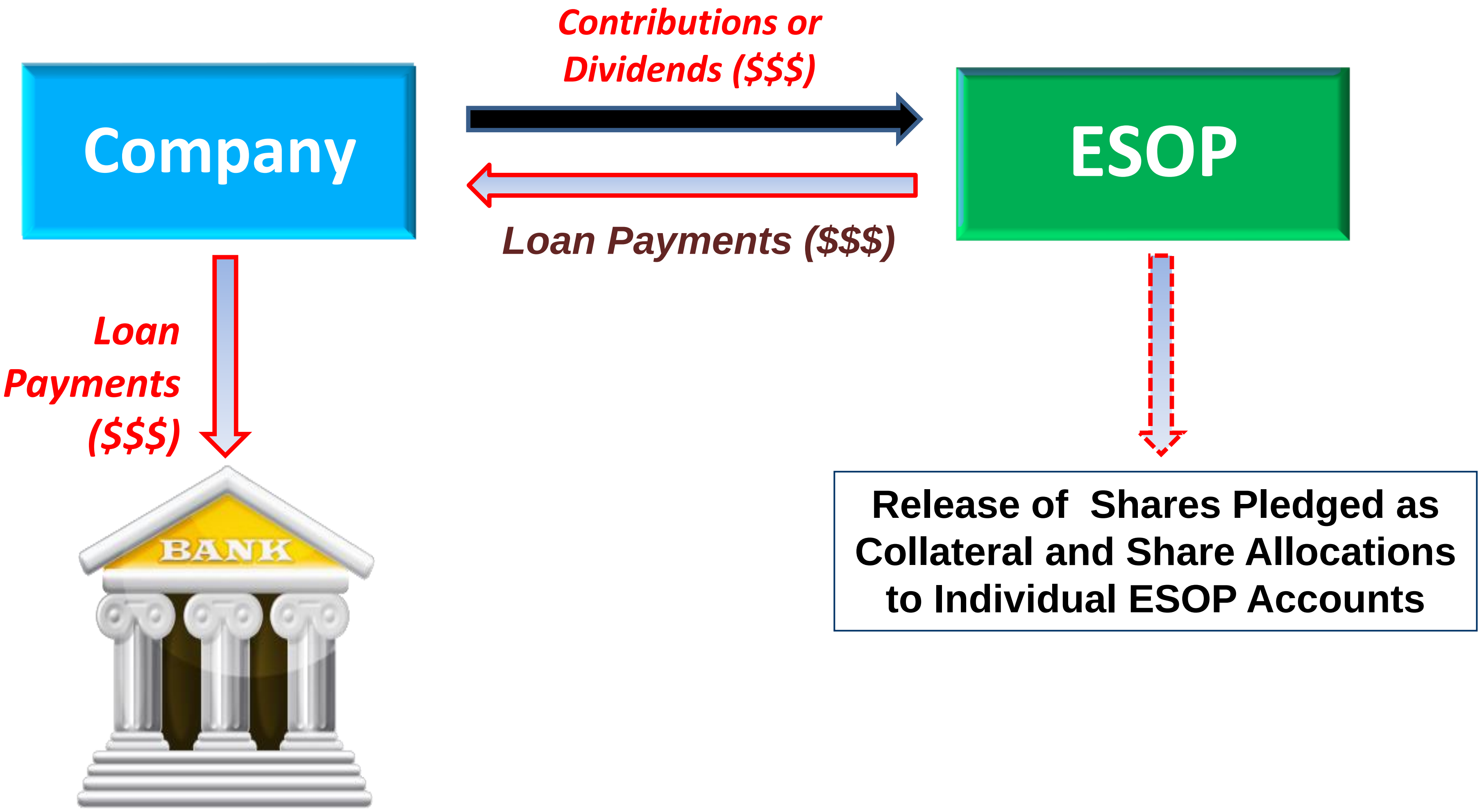
- Complexity
- Leverage
- Potential regulatory scrutiny by Department of Labor
- Creates new shareholder represented by trustee and requires Company to observe corporate "formalities"
- Lack of knowledge

ESOP Who Should Own Your Business After You?

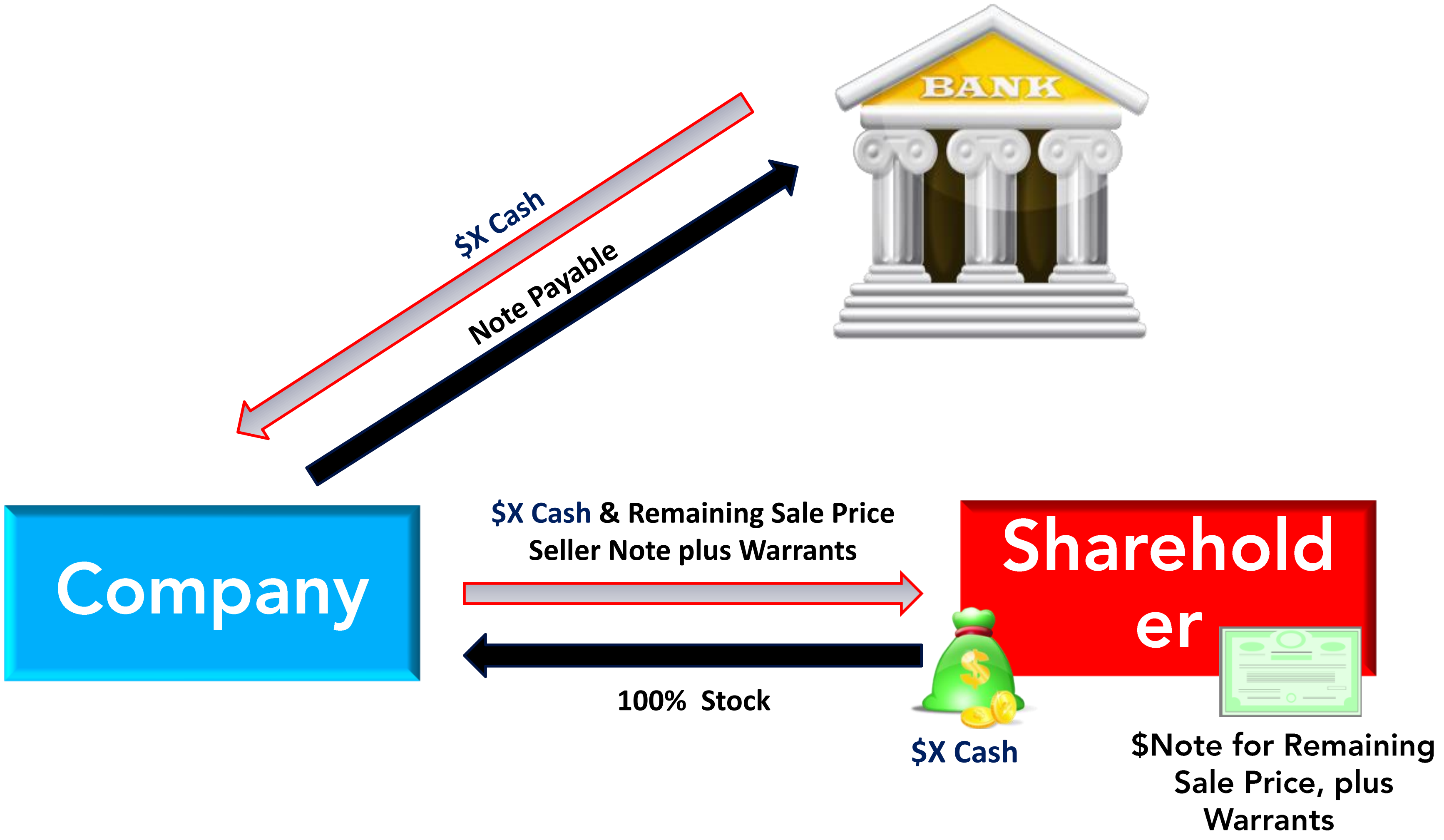
Typical ESOP C Corporation Minority Transaction Using Convertible Preferred Stock (§1042 eligible)



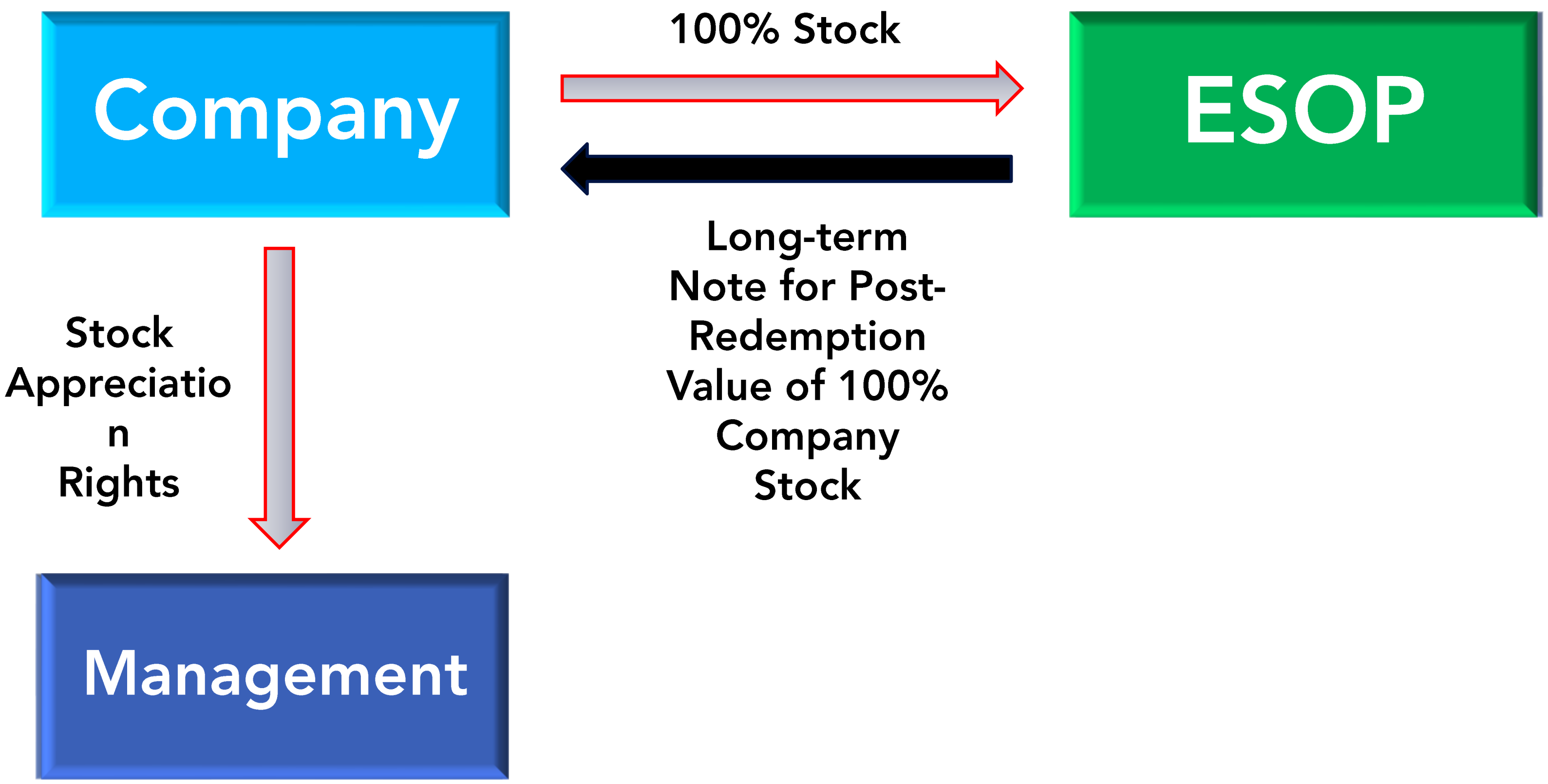
ESOP Loan Repayment



Typical ESOP S Corporation 100% Transaction (Pt. 1)



Typical ESOP S Corporation 100% Transaction (Pt. 2)



The ESOP Process

- Determine that ESOP may be appropriate direction
- Engage lead ESOP professionals to assess and design transaction in detail and develop "board-level" presentation ("Feasibility Study")
- Identify and obtain ESOP financing
- Negotiate ESOP terms with ESOP trustee team
- ESOP plan and operational design and implementation
- Closing

Typical Time Frame

• Feasibility Study	60 days
→ Board/Shareholder decision	
• ESOP Finance to commitment	60 days
• Transaction Due Diligence/Negotiate transaction terms with ESOP Trustee team	60 days (concurrent)
• ESOP Plan Design	60 days (concurrent)
• Closing Documentation	30-60 days
• Total Estimated Time to Closing	10-180 days

Some Important ESOP Q&A

- Who runs an ESOP Company?
- What information must be shared with employee owners?
- What are employee governance rights?
- Who sets the price of the Company in the sale to the ESOP?
- What are pitfalls and traps for the unwary?
- Repurchase obligations??

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Questions?

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