



# ESOP Transaction Structures

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**NCEO**





# Agenda

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Liquidity & Succession Planning & Alternatives

The ESOP Approach



# Why Care About ESOPs?

## The Problem of Liquidity and Succession

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All businesses must be sold or transferred – privately held companies have no ready market

Approach should be based on shareholder goals in the context of achievable alternatives



# Common Liquidity and Succession Goals

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Maximize after-tax proceeds

Control timing of succession and transfer

Shareholder/officer ongoing role as executive

Diversify personal wealth

Legacy



# Common Liquidity and Succession Concerns

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Determine/secure role or opportunities for family members in business

Continuity of business identity and operations

Getting free--ongoing responsibilities as executive officer

Reward key management/employees

Sale of enterprise without continued financial liability/responsibility



# Liquidity & Succession: Alternatives

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## External buyers

- Strategic
- Financial
- IPO

## Internal Buyers

- Family
- Management
- Partner (Redemptions & Buy-Sells)
- ESOP

## Liquidation



# Good ESOP Candidates

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Non-cyclical slow to medium growth

Stable cash flow

Ownership group interested in remaining involved/participating in the business

Patient long-time horizon—not seeking immediate cash payment in full

Ownership group concerned about employees and/or long term future of company/motivated by "legacy" or mission goals in addition to cash

Lack of cash strategic buyers willing to pay significant premium for the company



# Some Core ESOP Advantages and Disadvantages

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## Advantages:

- Tax efficient
- Shareholder directed process
- Control over timing
- Legacy

## Disadvantages:

- Complex
- Regulated
- Often involve Seller notes





# The ESOP Approach

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# What is an ESOP?

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ESOP = “Employee Stock Ownership Plan”

Qualified deferred compensation plan under ERISA and Internal Revenue Code

Similar to Profit Sharing and 401(k) Plans

Must invest primarily in company stock

Can be leveraged



# Typical Goals of ESOP Transactions

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Shareholder Liquidity

Long-term succession plan

Corporate and personal tax planning

Ownership/Partnership incentive for key employees



# Significant ESOP Tax Preferences

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Effective deduction of principal on ESOP loan repayment

Section 1042 Capital Gains Deferral

Deduction of dividends paid on ESOP shares

S Corporation ESOP non-recognition of corporate income



# Section 1042 Capital Gains Deferral

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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



# “S” Corporation ESOPs

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“S” Corporation income attributed to shareholders

ESOP as S Corp shareholder pays no taxes on its share of corporate income

No section 1042 Capital Gains Deferral



# How Does an ESOP Work?

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Company establishes an ESOP Trust

ESOP Trust purchases company stock from shareholders or company

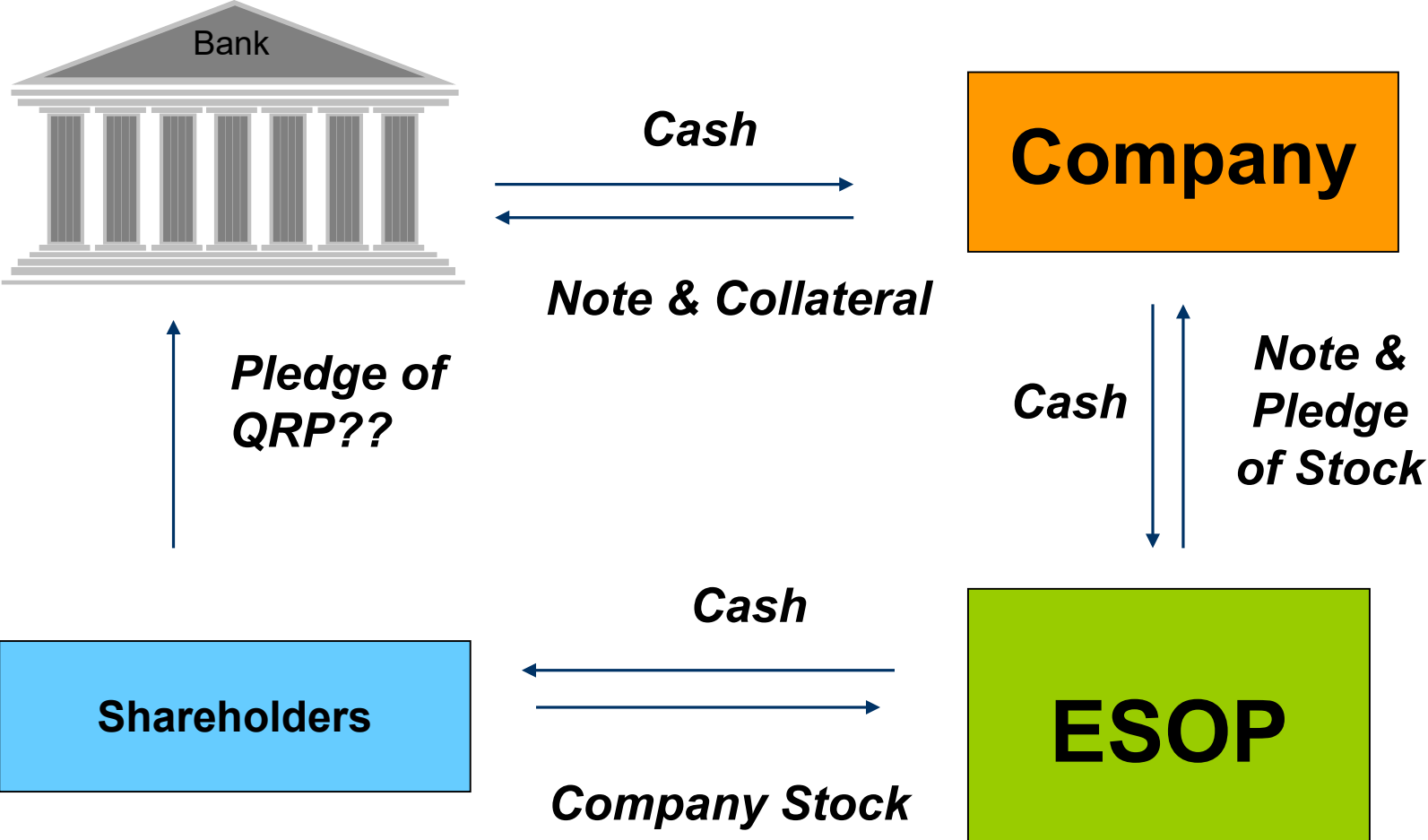
Bank or seller provides financing to Company

Company pays contributions or dividends to ESOP that ESOP uses to repay debt

Company or ESOP repurchases shares from employees after termination



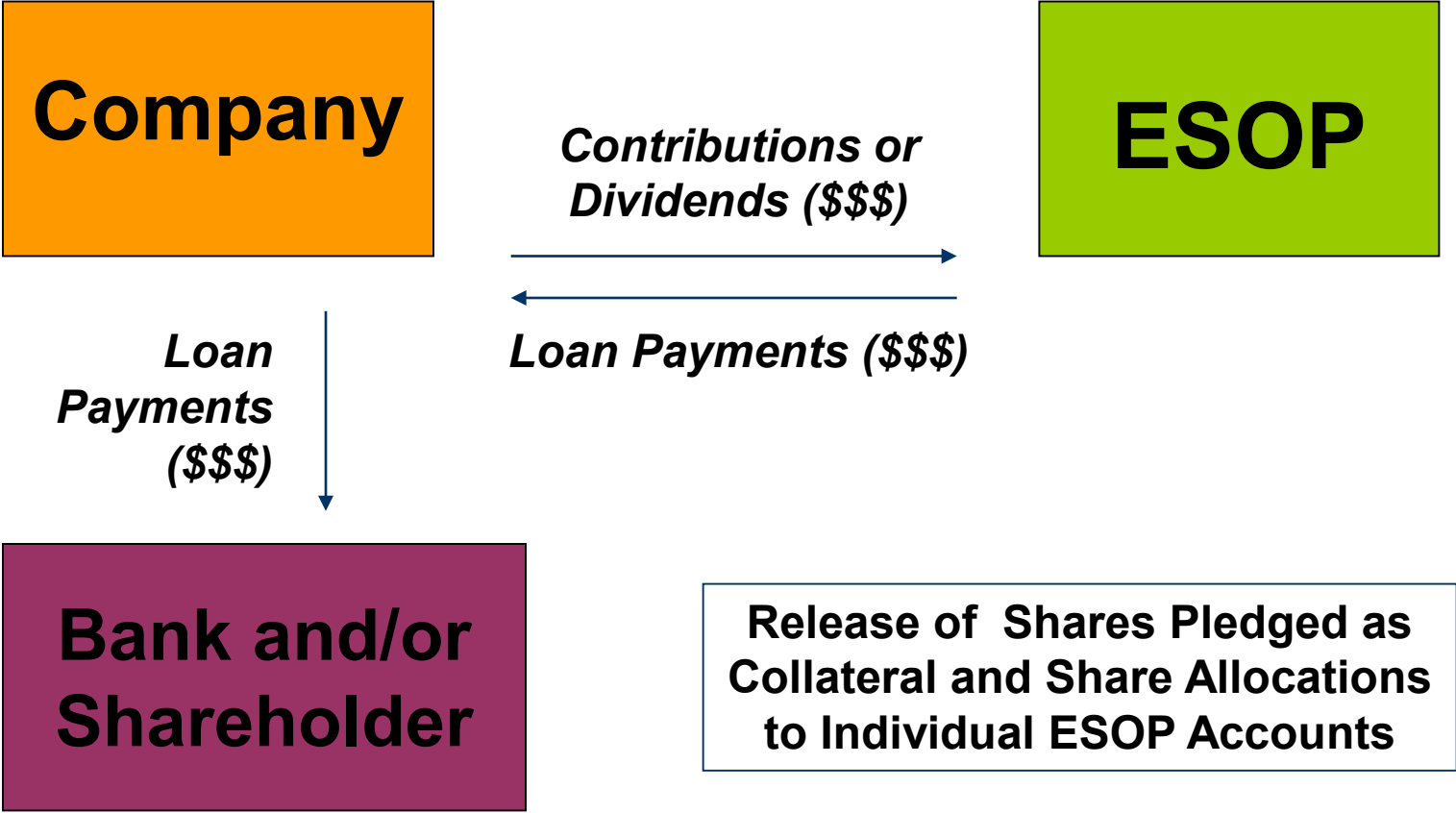
# Initial "C" Corporation ESOP Transaction





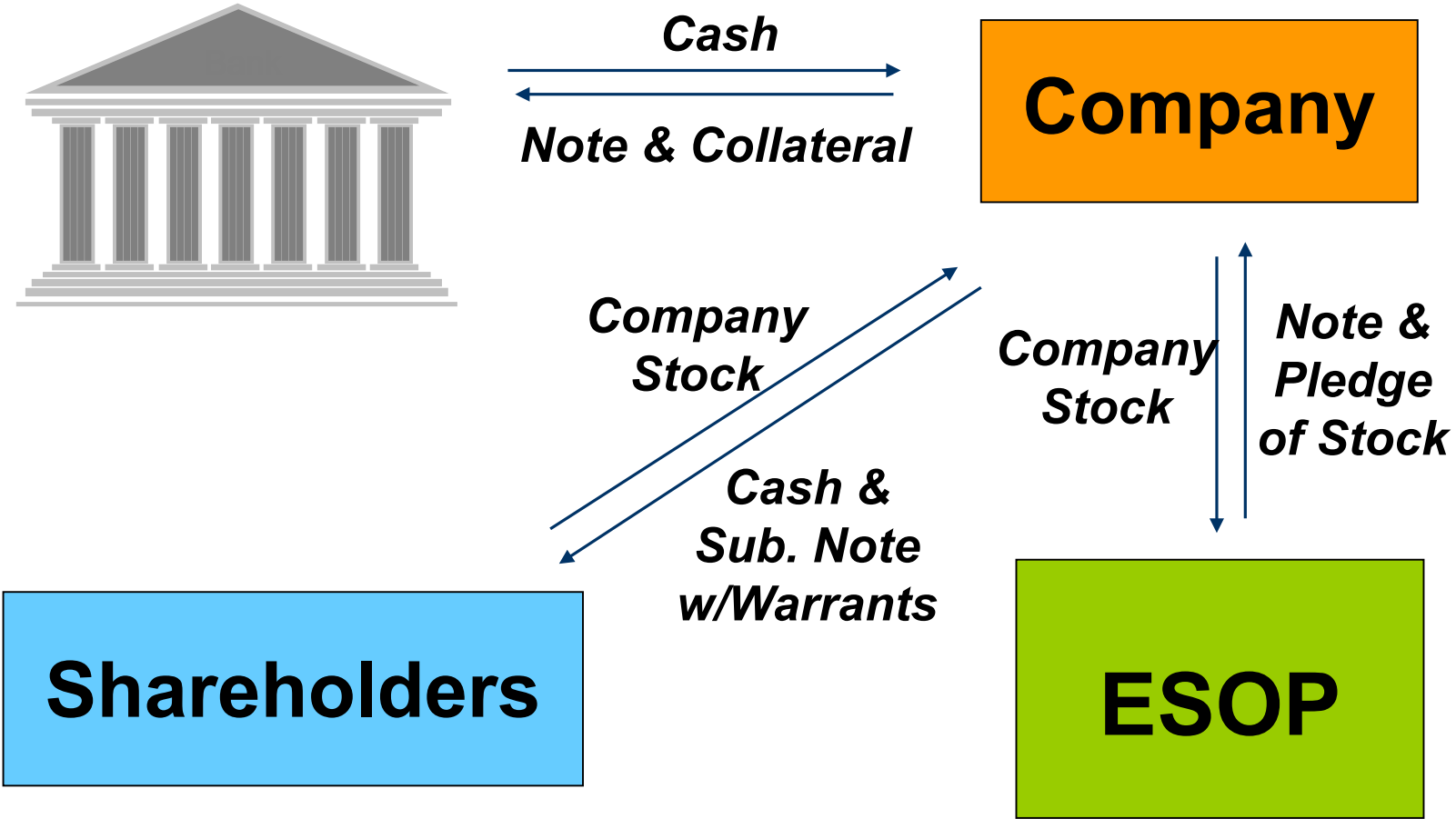


# ESOP Loan Repayment





# Initial "S" Corporation ESOP Transaction





# A Typical ESOP Transaction “Vision”

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One or more Section 1042 ESOP transactions to transfer most or all stock ownership to ESOP

Synthetic equity (usually stock appreciation rights or phantom stock) granted to key management in second stage transaction to allow key executives to own eventually 10-20% of economic value of entity outside ESOP

“S” Corporation ESOP election



# Another Typical ESOP Transaction “Vision”

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“S” Corporation redemption of all of the stock held by current shareholders for cash and subordinated notes with warrants

Synthetic equity (usually stock appreciation rights or phantom stock) granted to key management to allow key executives to own eventually 10-20% of economic value of entity outside ESOP

Company uses “S” Corp tax-free operation to accelerate debt reduction



# ESOP Transaction Concerns

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Valuation

Financing

Effect of ESOP on overall benefits structure

Legal/fiduciary risk

Cost and complexity



# Steps in an ESOP Transaction

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Feasibility study

Financing

Appraisal

Plan Design

Legal Documents

Closing

IRS Determination Letter



# Ongoing ESOP Items

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Annual appraisal update

Annual recordkeeping and administration

Repurchase obligations

Communications training and education

Legal compliance



# About SES ESOP Strategies

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- Together with its affiliated companies, SES ESOP Strategies brings together one of the largest core groups of ESOP lawyers, consultants and investment bankers in the U.S.
- Our depth and breadth of experience set us apart from other ESOP consulting firms. During our three decades of experience, we have implemented ESOPs for more than 500 companies and have completed more than 1,000 ESOP-related transactions
- SES professionals balance the needs of owners, managers, the company and its employees to ensure long-term corporate sustainability with substantial employee ownership
- We work with companies nationwide across all industries not only to install their plans, but also to forge partnerships throughout the ESOP lifecycle
- Our multidisciplinary team provides comprehensive services and support to guide companies through the design, implementation and ultimately, the maintenance of a successful ESOP
- If desired, we can help raise the debt necessary to fund the transaction and all or a portion of the company's future working capital and other needs





# Our Transaction Process and Timeframe



- Meetings with shareholders and other relevant stakeholders to understand goals
- Extensive Company and industry diligence
- Draft detailed feasibility study, including valuation, debt capacity and financing structures
- Model various ESOP outcomes

- RFP process to engage Trustee team
- Develop “board-level” presentation for Trustee kickoff meeting
- Prepare proposed “term sheet” for negotiation with Trustee
- Begin ESOP design process
- Prepare confidential financing memorandum and start debt raise process

- Negotiate the key transaction terms with Trustee
- Run competitive debt raise process
- Management meetings with lender finalists
- Assist in ongoing financial and legal due diligence for lenders and Trustee

- Finalize negotiation of transaction and financing documents
- Finalize ESOP plan and operational design and implementation
- Closing documentation
- IRS Determination letter (Post-Closing)

***THROUGHOUT THE PROCESS, SES MINIMIZES EXECUTION RISK BY KEEPING ALL PARTIES ON A TIGHT, BUT REASONABLE, TIME FRAME AND WITHIN BUDGET.***

INITIAL ENGAGEMENT

180 DAYS

CLOSING



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