February MAC Meeting in Baltimore – ESOP Financing

By Thomas Roback, Jr., CEP, QKA of Blue Ridge ESOP Associates

On February 22nd M&T Bank hosted a MAC seminar focused on ESOP Financing. While the turnout could have been better, the speakers could not have been. It was a shame more companies were not able to attend. Jack Lewin of M&T and Bill Gust of Gentry Locke did an excellent job of outlining the current ESOP Financing environment and the attendees were able to ask specific questions.

Jack Lewin got the discussion started by providing an overview of recent M&T transactions and the current rate environment. The executive dining room of M&T was an appropriate venue for the meeting as it has seen plenty of ESOP deal meetings over the years. While Jack made it clear that M&T and many other banks are "open for business", there is still no question that banks favor stable, predictable cash flow and that some deals are often better off being seller-financed.

Bill Gust titled his presentation "Finding the Money – How to Finance Tax-Sheltered ESOP Transactions" and started with a joke and a lesson that things aren't always as they seem. Bill's strong estate planning background was apparent as he started with schematics outlining how business owners typically end up with a large percentage of their net worth in their closely held business. Without an ESOP, the growth of the business is taxed, the transition of the business is taxed, and death (or horizontal retirement as Bill calls it) can be taxed. According to a University of Michigan study, business owners generally have the following objectives in the following order:

1) To maintain their business in perpetuity ;
2) To generate personal liquidity from the business
   b) To avoid paying personal income taxes on the transaction.

Bill and his ESOP feasibility team have found that a tax sheltered sale of stock to an ESOP meets these objectives as well as any solution available. However, while Bill's clients appreciate an ESOP as a financial engine, he often has to remind them that an ESOP is a qualified retirement plan under IRC § 401(a) to invest primarily in company stock. Solid administration and maintenance of these plans are critical.

Our speakers outlined such matters as, "Where does the money come from?":

1. Tax Favors: An ESOP company can borrow money to buy stock with tax deductible principal and interest payments and use untaxed dividends ("earnings") on ESOP shares to pay for stock.
   - Note that C corporation dividends are deductible when used to retire ESOP debt.
   - Earnings on S corporation stock used to retire debt are untaxed (but not deducted directly).
2. Current retirement plans can often be converted to an ESOP. For example, a 401(k) can be converted to a 401(k) + ESOP ("KSOP") and the profit sharing match used to service debt incurred to buy stock going forward.
3. Particularly attractive is a direct loan from corporate retained earnings to an ESOP. The company gets a tax deduction for paying itself back (Accounting SOP 93-6).

Bill also noted that the process takes time because:

- Most banks are asset-based lenders and look for balance sheet and seller support of the deal.
- ESOPs generally are *not* a "take-the-money-and-run" solution for majority shareholders. Sellers are often on the hook for part of the transaction until the loan is partially paid down.
- Where the combined cash flow and balance sheet-based borrowing capacities are not sufficient to support the deal you want, there are still mechanisms available.

- Rising management can sometimes put some money in the deal (though they are often members of ‘shallow pockets anonymous).
- Seller financing – often with a direct loan to the ESOP augments or avoids the “mirror loan” banking transaction.

For most successful closely held corporations, the balance sheet borrowing capacity is less than the cash flow-based borrowing capacity. The maximum stand-alone debt is usually the lesser of either 1) balance sheet and cash flow borrowing capacity, or 2) a multiple of cash flow to debt. It is also standard for the selling shareholder(s) to make a limited guaranty for the uncollateralized portion of the loan. This limited guaranty is secured by his or her personal assets and sales proceeds are often used as collateral to support the limited guaranty. This guaranty is reduced as the company pays down principal debt and the ratio of loan to fair market value decreases.

Bill shared insight of other considerations he has seen impact ESOP transactions, such as bonding (especially for construction companies), franchisor approvals, repurchase obligations, and many others. Several new ESOP companies like the idea of using a “tax-free ESOP cash warehouse” approach to get started. This involves the plan sponsor contributing tax deductible dollars to the ESOP for the first few years. This approach uses less leverage, keeping key bank ratios and covenants healthy. Caution is recommended when using this approach since the ESOP must be primarily (51%) invested in company stock. The timeframe governing the 51% rule is unclear so the subject is debatable.

Finally, Bill and Jack shared some important considerations when financing ESOP business succession. Work with experienced ESOP professionals, coordinate business continuity with both personal and corporate strategies, and be prepared to deal with complexity! We appreciated the knowledge shared, and thank those who did attend.