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Private Equity

Leveraged-ESOPs Offer Multiple Advantages

The Editor interviews ***Preston C. Delashmit,*** *A Member of the Corporate and Securities Practice of Epstein Becker & Green, P.C. in the firm's Atlanta office.*

Editor: Would you please describe your practice for our readers?

Delashmit: I am a business lawyer. I work with clients through the "life cycle of an organization" – that is, starting from the beginning with a great idea that they are interested in commercializing, to structuring the organization in order to attract both talented people and capital, to helping the enterprise raise money from either debt or equity sources, through the operational stages, and eventually to a variety of exit strategies (most often, mergers and acquisitions). In particular, leveraged-ESOP (Employee Stock Ownership Plan) transactions have been a special emphasis of my M&A practice here at Epstein Becker & Green, P.C. in Atlanta.

Editor: What is the structure of the leveraged-ESOP and why is it beneficial to corporations from a tax and other standpoints?

Delashmit: A leveraged-ESOP is a tax-efficient transaction structure that allows a business to borrow money from a commercial lender, loan that money to a trust created for the benefit of the employees of the company, so that the trust can purchase stock of the company from the founders/shareholders of the company (or directly from the company). There's a "double-edged" advantage. In simple terms, when properly structured the ESOP can use pre-tax dollars to purchase stock from the selling shareholders tax-free (meaning free from capital gains taxes).

The means of repayment of the acquisition financing is a real advantage of the leveraged-ESOP transaction structure. Each year the company makes a tax-deductible contributions to the ESOP sufficient for the ESOP to cover the debt service obligations owed to the company. The company, then, repays its obligations under the credit facility to the commercial lender. The net effect of the transaction is to permit not only the interest on the commercial facility, but the principal of that loan as well, to be tax-deductible (because the full amount of the debt service was contributed to a qualified retirement plan – a deductible expense).

Preston C. Delashmit

Perhaps the most significant benefit, however, is available to the selling shareholders. Under Section 1042 of the Internal Revenue Code, if the shareholders sell at least 30% of the company stock to the trust (and meet a number of other requirements), the shareholders have the opportunity to defer the payment of capital gains taxes on the transaction (that can be as much as a 21% tax savings in some cases). In the last two weeks of December 2005, we closed about $300 million worth of these "1042" transactions, which could have the potential tax savings to the selling shareholders of as much as $63 million. These transactions are significant to the economy in a number of ways. Not only are the dollars deployed by commercial lenders (coming in to finance the acquisitions and improve the shareholders' liquidity), but the law requires that the selling shareholders must re-invest those funds within 12 months in securities of U.S./domestic operating companies. In order to avail oneself of this tremendous advantage the shareholders must redeploy $300 million worth of funds in our capital markets. Ultimately, the retirement of the acquisition debt using pre-tax dollars is a tax-efficient means by which to capture a portion of the equity of the enterprise for the benefit of all employees who participate in the ESOP.

Mr. Louis Kelso, a lawyer and economist is generally known to be the creator of the Employee Stock Ownership Plan (or ESOP). Mr. Kelso envisioned an approach for the government to encourage private ownership and broad-based participation in the ownership of an enterprise among wage-earners and entrepreneurs alike, while acknowledging that access to capital and resources may not be uniform among them. In this approach, everyone who is a part of the organization and contributes to its success generally shares in the success of that enterprise. ESOPs continue to support our government's objectives in other ways as well. ESOPs contribute to what our President refers to as an "ownership society" insofar as equity participation is shared among those contributing to the enterprise. As our nation is faced with the difficult challenges of Social Security and an aging population, ESOP transactions afford another means by which employers might participate to "privatize" some of the risks and costs of retirement. We believe that the government should continue to encourage employers to share in the costs of retirement by offering such a significant employment benefit to a broader segment of the population. Wage-earners share in the success of the enterprise to provide for their own retirement.

Editor: Could you list the industrial groups that Epstein Becker has been instrumental in helping with ESOP-type deals?

Delashmit: The ESOP deals tend to be more manufacturing-based transactions (primarily apparel and consumer goods manufacturing) in which larger numbers of employees are involved. Traditionally, the amount of the deductions for the acquisition financing has been a function of the size of the eligible payroll. Thanks to some favorable changes in the law over the past several years, we have been able to extend the application of leveraged-ESOP transactions into more service industries as well as healthcare, including architecture and engineering firms, physician practices, healthcare systems, real estate

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management and development, automobile dealerships, transportation and distribution. The S-Corporation ESOP is a particularly attractive transaction in the appropriate circumstances. By virtue of the flow-through tax treatment of the S-Corporation, when coupled with ownership by the ESOP (a qualified retirement plan that is not a tax-paying entity), the enterprise can be structured as a "for-profit, tax-exempt entity." This transaction structure can be particularly attractive to the healthcare industry (which has a significant concentration of tax-exempt entities), because so many of them have been interested in ESOPs as a tool to attract talent. Implementation of the S-Corporation ESOP in other industries is attractive as well, because the enterprise can gain a real competitive advantage (because the S-Corporation ESOP's cost of capital is approximately 40% cheaper than that of its taxable competitors).

In summary, in the appropriate circumstances leveraged-ESOPs can offer significant advantages to other deal structures to achieve liquidity and diversification for private business owners who are considering retirement or some sort of exit. In addition, leveraged-ESOP transactions can be used to raise capital in a tax-efficient manner, because pre-tax dollars flow into a company. Because of Sarbanes-Oxley's regulatory requirements on the capital markets, and the significant costs of compliance, there are many small-cap public companies that may not be enjoying the commensurate efficiencies of the capital markets that could benefit from a "going private" transaction through such a leveraged-ESOP transaction (at least for a portion of the transaction financing). Lastly, the S-Corporation ESOP strategies that create a "for-profit, tax-exempt entity" can offer an enterprise competitive advantages in its operations as well as acquisitions of strategic candidates.

Editor: What has your role been in assisting high-tech companies in securing venture financing? Do you represent the start-up company, the venture fund or both at different times?

Delashmit: We represent both at different times. I have a technology background and have been involved in technology transactions since 1990. We do represent a number of emerging companies, in which we have assisted them to design structures that will attract capital as well as talented people. Because of this firm's tradition and strength in healthcare, our firm has a significant fund management practice in healthcare.

Editor: What do venture firms look for in emerging growth companies?

Delashmit: Primarily, they look for good people – people who have great depth and expertise in the subject industry and a track record of success at having started an enterprise, and taken it through the challenges of an entrepreneurial venture, through a variety of financing rounds to a successful exit. Then, perhaps secondly, a successful, well thought-out business plan embracing scalable technologies offering an opportunity for a high rate of return on exit (with relatively lower risk than you might see within the same asset class).

Editor: What do you regard as important before you will represent an emerging growth company as a client?

Delashmit: Most of the same things that we know the investors will be looking for – people who are experienced, high-quality folks of strong character and reputation and a track record of success, together with what looks to be a promising technology. Like the investors, we too, are a participant in the risk, because ultimately a successful attorney-client relationship will depend upon the success of the enterprise.

Editor: The firm will have some money at risk in the sense that there is sometimes a prolonged period over which clients pay your fee or when you close a deal?

Delashmit: In the early stages of the enterprise, before a deal is closed, the firm may have a significant amount of time and energy invested in helping to structure the transaction. Entrepreneurs don't always have the financial wherewithal to make a large retainer deposit, in advance, that will cover all of the time and costs through the early stages of a deal (before a venture investment is made).

Editor: When they come to you do they normally have some venture partners in hand – someone who has signed a summary statement of terms?

Delashmit: Oftentimes they do, but that is not always the case. Many times we see entrepreneurs who have an idea (and a plan), and have been referred to us by other advisors to help structure the organization and perhaps direct them to cultivate the right relationships that will take them to the next level of venture investment. It is part of the business risk of a technology and emerging company practice.

Editor: How do you protect the investors from fraud, loss or other liabilities?

Delashmit: Primarily by undertaking proper and thorough due diligence and document review. In the documentation, of course, we include customary representations and warranties as to the key facts and drivers related to the financial condition and operation of the enterprise, along with indemnification provisions that allow for recovery damages, losses, and costs in the event that the representations or warranties are untrue or misleading. The real measure of protection rests in the integrity of the people in which you are investing. Unscrupulous managers may be able to "hide the ball" in the short term, and investors don't relish the idea of litigation and indemnification provisions (it usually means that some portion of the loss will be uncollectible).

Editor: What elements go into your assembling a group of angels to engage in a venture?

Delashmit: Oftentimes, regular forums are held for angels who are successful and interested in a certain type of investment (for instance, software). Vetting by technology and deal-type is important. The angels meet regularly and are looking for business plans and referrals to new investment opportunities, which we can offer. Usually the angels have other "smart money" relationships in the particular industry, often from previous deals.

Editor: Are your clients mainly in the Atlanta area or are they nationwide?

Delashmit: Nationwide. Most of the ESOP deals are in the Northeast – New York, New Jersey – and on the West coast, in part because of the strong capital markets in those areas as well as the industry focus. We have had a lot of success in the apparel industry with those clients tending to be in the Northeast. Many of our technology clients are also outside the Atlanta area. Really, we are working on transactions all over the country.

Editor: Why do you think there are so many private equity deals today?

Delashmit: I think, in part, because there's been a lot of success in raising private equity capital. As the IPO market and exit strategies have slowed since the late 1990's, investors have been more careful in the placement of funds with successful managers. Funds are being re-deployed in other asset classes. Funds are being invested over longer periods of time and over more follow-on rounds of financing. The 1999 days of creating a company and going public in six months doesn't seem to happen since the "bubble-burst," and the market returned to focus on business principles – including, that dreaded "p" word, Profits.