

ESOP Financial Feasibility Analysis Procedures

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Employee stock ownership plans (“ESOPs”) are occasionally involved in litigation and other regulatory challenges. The regulatory challenges may be brought on by the U.S. Department of Labor (“the DOL”) or the Internal Revenue Service (the “Service”). The litigation claims may be filed by the DOL or by the ESOP participants themselves. The DOL may allege that the ESOP participants paid more than adequate consideration for the sponsor company stock or that the sale of the sponsor company stock to the ESOP was a prohibited transaction. Occasionally, the sponsor company noncontrolling selling shareholders may proceed with litigation claims—typically against the sponsor company controlling shareholder who initiated the ESOP formation. These noncontrolling shareholders may allege that they did not receive a fair price for the stock they sold to the ESOP. While it will not eliminate all litigation claims, an ESOP financial feasibility analysis is an important procedure in the process of installing an ESOP at a sponsor company. Such an ESOP financial feasibility analysis provides evidence regarding (1) the selling shareholders’ and the company board’s due diligence procedures and (2) the controlling shareholder’s and the board’s exercise of its business judgment.

INTRODUCTION

Even when it is implemented and administered with the best of intentions, an employee stock ownership plan (“ESOP”) may become involved in either litigation or regulatory challenges. Sometimes, the DOL may claim that the ESOP participants paid too much for the purchase of the shares of the ESOP sponsor company. In these instances, the DOL may allege that the sponsor company selling shareholders participated in a prohibited transaction.

Sometimes the ESOP participants themselves may claim that they paid too much for the purchase of sponsor company shares. In these instances, the allegation of “paid too much” means that the ESOP trust paid more than fair market value for the sponsor company common stock.

Sometimes, the DOL or the ESOP participants may claim that the ESOP trustee breached its fiduciary duty (to the participants) in the ESOP formation or in subsequent sponsor company stock purchase transactions. Sometimes, the DOL or the ESOP participants may allege that the independent financial adviser to the trustee practiced with gross negligence in performing its stock valuation and other transaction advisory services.

Occasionally, the sponsor company noncontrolling shareholders may file litigation against the sponsor company controlling shareholders—that is, the party who initiated the ESOP formation process. These noncontrolling shareholders may claim that they sold their sponsor company stock for less than a fair price.

Before a private employer company proceeds with the formation of an ESOP, that company

may perform an ESOP formation feasibility analysis. The purpose of an ESOP formation feasibility analysis is to give both the selling shareholder(s) and the sponsor company management/directors the information they need to determine whether to move forward with the ESOP formation and the ESOP stock purchase transaction.

The results of the feasibility analysis should enable the sponsor company, the ESOP trustee, the legal counsel to all parties, and the selling shareholder(s) to structure a transaction that is beneficial to all parties. Of course, such a transaction should be fair to the to-be-formed ESOP from a financial point of view.

This discussion summarizes the process of the ESOP formation financial feasibility analysis. And, this discussion summarizes how the parties to the ESOP formation may use the information developed in the financial feasibility analysis.

In making the decision of the private company to implement an ESOP purchase of sponsor company stock, the shareholders have to consider whether (and at what price) to sell their company shares to the ESOP.

The shareholders also have to decide whether they are willing to give up ownership control of the sponsor company to a new owner—that is, to the ESOP. This transfer of ownership control consideration is also relevant in the ESOP formation structure where the sponsor company itself (and not the current shareholders) sells treasury shares to the ESOP.

The sponsor company managers and directors have to consider whether the company can afford to finance the ESOP stock purchase transaction—particularly if the ESOP formation transaction is a leveraged stock purchase. The managers and directors also have to consider the other (nondebt service) ESOP-related costs—such as plan administration expenses, regulatory compliance expenses, and financial statement impact “costs.”

The information developed during the ESOP financial feasibility analysis allows these parties to decide whether or not an ESOP stock purchase transaction is an effective strategy for achieving their various objectives. Each ESOP financial feasibility analysis may be different—depending on each



sponsor company situation. However, most ESOP feasibility analyses contain the basic considerations in order to:

1. provide meaningful information to all parties and
2. avoid costly mistakes that could impair the long-term success of the ESOP.

THE ESOP FINANCIAL FEASIBILITY ANALYSIS

In general, an ESOP feasibility analysis should consider the following transaction pricing and structuring questions:

- What parties will actually sell the sponsor company shares to the to-be-formed ESOP?
- How will the to-be-formed ESOP finance the purchase of the sponsor company stock?
- How will this new stock acquisition financing (if any) affect the cash flow of the sponsor company?
- What is the best plan design for the sponsor company? For example, should the sponsor company merge the to-be-formed ESOP with its existing 401(k) plan?
- What are the Employee Retirement Income Security Act (“ERISA”) and the Internal Revenue Code (and state securities law) regulations related to an ESOP that the sponsor company management and the selling shareholder(s) should know about?

- What if the actual sponsor company future results of operations vary—positively or negatively—from any sponsor company financial projections prepared at the time of the sponsor company stock purchase transaction?
- How does the selling shareholders' desired sale price for the sponsor company stock compare to the range of stock fair market values estimated by the valuation analyst ("analyst") working for the to-be-formed ESOP trustee?

INITIAL CONSIDERATIONS

The initial considerations regarding the ESOP feasibility analysis may be assessed by the selling shareholder(s)—with the help of the sponsor company management. That is, the ESOP feasibility initial considerations may be determined without the need to retain an independent financial adviser or legal counsel.

In general, private companies that are reasonable candidates to successfully implement an ESOP formation—and to sponsor a sustainable ESOP—have the following characteristics:

- Be a private U.S. company
- Employ more than 50 full-time employees
- Have an established track record of consistent profitability and earnings growth
- Have at least 10 years of operating history
- Report at least \$20 million in company annual revenue
- Have one or more owners who are interested in investment liquidity and in a diversification of their personal wealth
- Have one or more owners who are interested in ownership/management succession planning and in the transition of company ownership to the employees
- Have one or more owners who would consider accepting a reasonably conservative stock value (i.e., a price at the lower end of the range of market participant transaction prices)
- Have a senior management team that supports the concept of an ESOP formation (and of the employee ownership of the sponsor company)

The controlling shareholder(s) should assess the company relative to these benchmark char-

acteristics in order to determine if the company is a reasonable candidate for an ESOP formation. This initial feasibility analysis may be performed internally within the company—that is, without the company having to spend large amounts of time and money.

That is, if the private company, the selling shareholders, and the company management do not "pass" these threshold characteristic "tests," then the company may not be a particularly good candidate for an ESOP formation. The company stockholders and management do not need to proceed to the financial, valuation, or administrative "tests" associated with an ESOP formation.

The next procedure of the feasibility analysis is for the company shareholders and company management to become more familiar with the ESOP installation process. This procedure should include familiarity with the financial, legal, administrative, and regulatory aspects of an ESOP formation. The ESOP Association and the National Center for Employee Ownership are useful resources for this type of information.

This "process familiarity" procedure should allow the parties in interest to address questions such as the following:

- Can the differing goals and objectives of the various company shareholders—and of the other parties to the proposed transaction (e.g., management team, employees, nonselling shareholders, etc.)—be achieved through the formation of an ESOP?
- Would a company merger or a sale to a strategic buyer—or some other type of company liquidity event—be better suited to achieve the objectives of the company shareholders, management, or other parties?
- What percentage of the company stock will the to-be-formed ESOP own after the stock purchase transaction? And, which shareholders will sell or redeem their shares as part of the ESOP sponsor company stock purchase transaction?
- How will the company management—and the current controlling shareholder(s)—react to the inevitable changes in voting/control rights and in corporate governance?
- How will the current management succession planning be addressed in relation to the stock ownership change transaction? How long will the selling shareholders (assuming they are also company managers

or directors) remain in their current management roles? How will the successors to the current executive management or board of directors be identified and transitioned in order to maintain operational management continuity on a going-forward basis?

- Is it desirable for the company to merge the to-be-formed ESOP with the company's existing 401(k)—or other employee benefit—plan?
- What happens to any existing management incentive (compensation) plans? Will a new management compensation plan be introduced at the same time as the ESOP stock purchase transaction?
- Which of the company employees will (and will not) be eligible to participate in the to-be-formed ESOP?

Consideration of these questions may help to clarify the strategic objectives (and the personal objectives) of all interested parties to the company ownership transition. In order for the ESOP formation to be successful, the means of achieving these strategic objectives (and these personal objectives) should be evaluated as part of the ESOP feasibility analysis.

If these initial procedures indicate that financing an ESOP stock purchase transaction is a reasonable alternative for achieving the objectives of most of the interested parties, then it may be time for the company to retain experienced ESOP advisers. These ESOP advisers should address some of the more technical (and complex) ESOP formation feasibility issues. These ESOP advisers typically include a trustee, legal counsel, an independent financial adviser, and perhaps others.

TYPICAL COMPONENTS OF AN ESOP FINANCIAL FEASIBILITY ANALYSIS

A comprehensive ESOP feasibility analysis typically includes several transaction planning, pricing, structuring, administrative, and legal considerations. These considerations typically include the following:

- A preliminary valuation of the sponsor company stock to determine the approximate fair market value price that the to-be-formed ESOP could or may pay

- A quality of earnings (or stockholders' equity) analysis to determine how the to-be-formed ESOP would affect (1) the existing company shareholders and (2) the company's future financial performance
- A plan design study to determine the most beneficial stock ownership transition transaction structure and which plan features to incorporate in the to-be-formed ESOP
- A liquidity study to assess the future demands that the ESOP stock repurchase obligation may eventually make on the sponsor company

THE PRELIMINARY VALUATION ANALYSIS

A sponsor company stock preliminary valuation analysis is an important component of the ESOP financial feasibility analysis. It is one of the procedures that should be performed early in the process. Accordingly, this preliminary valuation analysis may be performed by an analyst without undertaking a comprehensive due diligence investigation.

Therefore, the analyst typically cannot provide a final opinion of the fair market value of the sponsor company. Rather, the analyst provides an opinion of a reasonable—but not final—range of fair market value indications for the sponsor company stock.

The estimation of the sponsor company stock value is complex—and important to the ESOP formation decision. Accordingly, the parties usually retain an analyst who is experienced in performing ESOP—and ERISA-related—stock valuations.

Typically, the selling shareholders (and/or the company) and the trustee to the to-be-formed ESOP each retain their own independent analyst at this stage of the feasibility analysis. Regardless of whether the analyst is retained by the selling shareholders or by the to-be-formed ESOP trustee, the analyst's preliminary value conclusion is typically expressed as a range of fair market values for the sponsor company stock.

At this stage of the feasibility analysis, an analyst experienced in performing ESOP—or ERISA-related—stock valuations will typically estimate a reasonable range of stock values without preparing a narrative valuation report. Consequently, the expense associated with this preliminary valuation analysis is usually less than the expense associated with the analyst's final stock valuation analysis (and the preparation of a written narrative valuation report).

“[T]he preliminary range of fair market values for the company stock should be concluded as early as possible in the ESOP feasibility process.”

The estimation of the preliminary range of company stock fair market values is often considered on the “critical path” of the ESOP formation process. It is important for the parties to find out early if:

1. the preliminary stock value range is less than the per-share stock price desired by the selling stockholders and
2. structuring alternatives, such as earn-outs or warrants, cannot be used to encourage the selling stockholders to accept the preliminary stock price.

In such an instance, other strategies may have to be considered to increase the ownership transaction attractiveness to the selling shareholders.

Such “other” strategies may include waiting until the subject company’s financial performance improves, reducing company operating expenses, and the like.

If the company’s principal shareholders are not willing to sell their stock to the ESOP, or to permit the company to issue new shares of stock at a price within the preliminary range of fair market values estimated by the analyst, then the ESOP formation process may be abandoned.

Therefore, the preliminary range of fair market values for the company stock should be concluded as early as possible in the ESOP feasibility process. That way, the shareholders can change direction and evaluate other liquidity alternatives—while still minimizing the expense incurred to pursue an ESOP formation strategy that will ultimately be unsuccessful.

THE QUALITY OF EARNINGS ANALYSIS

The following components of the financial feasibility analysis can all be performed concurrently:

1. The quality of earnings analysis (which includes what is often called a stockholders’ equity analysis)
2. The company liquidity study
3. The ESOP design study

In fact, these financial and administrative analyses can be performed at the same time that the

preliminary stock valuation analysis is being performed.

The quality of earnings analyses should address several of the important questions typically asked by the company’s principal shareholders. These principal shareholders are typically interested in the following considerations, particularly for the time period during which the ESOP stock purchase loan will be outstanding:

- How will the ESOP affect the fair market value of their (retained) stock?
- How will the ESOP affect the company’s expected cash flow and the company’s expected profitability?
- What dilution effect will the ESOP-owned shares have on the company stock fair market value?

If the company already has an existing pension and/or profit sharing plan, the quality of earnings analysis may also compare:

1. the effects of the ESOP stock ownership in contrast to
2. the effects on the stock ownership (without the ESOP formation) of the existing plans.

The quality of earnings analysis typically applies management-prepared financial projections—projections with alternative growth and profitability assumptions and other ESOP transaction variables—to create several alternative scenarios. The analyst performs this scenario analysis to illustrate the resulting impact of the to-be-formed ESOP on:

1. the sponsor company cash flow and
2. the sponsor company stock value.

The cash flow component of the quality of earnings analysis can also be used as a structuring tool to help evaluate a mixture of stock purchase financing options. The alternative ESOP stock purchase financing options may include varying levels of bank debt versus seller financing—as well as the assorted terms and conditions of the proposed financing structure.

In the quality of earnings analysis, some of the analysis variables that are typically adjusted (or “stress tested”) in order to construct alternative scenarios include the following:

- Revenue growth rate
- Profit margin
- Amount of the sponsor company operations-related bank financing

- Amount of—and terms of—the ESOP stock purchase bank financing
- ESOP stock purchase bank financing terms (interest rates, covenants, maturity, required prepayments, guarantees, etc.)
- Amount of any selling stockholder-provided financing
- Selling stockholder subordinated debt terms (interest rates, maturity, required prepayments, warrants, etc.)
- Refinancing of the company's existing bank debt
- Expected future capital expenditure investments
- Expected future working capital investments



Often, the analyst applies the management-prepared financial projections as a “base case” scenario in the quality of earnings analysis. The analyst then adjusts (or “stress tests”) the revenue, expense, investment, and income variables in order to create alternative financial scenarios. These alternative scenarios may include financial projections that reflect prospective operations under optimistic, pessimistic, and zero growth conditions.

These alternative scenarios typically hold all other company operational variables constant across the various sets of conditions. The goal of stress testing the operational variables in these alternative scenarios is to illustrate how the sponsor company could fare under alternative sets of operating circumstances.

THE LIQUIDITY ANALYSIS

The liquidity analysis component of the ESOP feasibility analysis is intended to estimate the amount of the ESOP stock repurchase obligation that the sponsor company may incur over the next, say, 10 to 15 years. This ESOP stock repurchase obligation results from the employee expected terminations of service due to death, disability, retirement, and so forth.

The liquidity analysis typically does not address the source of funding for the ESOP stock repurchase obligation. Nonetheless, this liquidity analysis is a valuable tool that can help sponsor company management estimate the timing of—and the amount of—the funding that may be needed for repurchasing the allocated shares from departing employees.

This information allows the sponsor company management to make the appropriate financing, insurance, or other liquidity plans.

THE PLAN DESIGN STUDY ANALYSIS

The greater the flexibility included into the design of the ESOP documents themselves, the more effectively the ESOP will be able to accomplish its objectives.

The ESOP design study will typically address the following issues:

- Participant eligibility
- Vesting schedules
- Timing of the benefit distributions
- Forfeitures
- Contribution levels
- Allocation formulas
- Past service credit
- Early retirement policies
- A charter or bylaw provision that restricts the stock ownership to the employee group

The use of one or more special classes of stock (e.g., nonvoting stock, preferred or convertible preferred stock, etc.) may also be addressed in the ESOP design study.

Some of the other questions that may need to be considered in the ESOP design study include the following:

- Who will (and will not) be able to participate in the to-be-formed ESOP?
- Must the sponsor company distribute shares of stock to employees at retirement—or at other required distribution dates—if the employees demand it, or can the sponsor

company limit the form of distributions to cash?

- What company divisions or subsidiaries may be excluded from the plan?
- Who will (and who will not) be able to vote the shares of the ESOP-owned sponsor company stock—and under what circumstances?
- Should the sponsor company combine other benefit plans, such as a 401(k) plan, with the ESOP?
- What will happen to the sponsor company's existing pension or profit sharing plan?
- Is the existing company pension plan overfunded, underfunded, or adequately funded?
- What about the selection of the ESOP fiduciary/trustee, and of any possible administrative and/or advisory committee(s)?

The consideration of income tax issues should also be part of the plan design phase of an ESOP feasibility analysis. The relevant income-tax-related issues may include the tax implications of ESOP-related legislation, regulations and administrative rulings, and judicial precedent.

In addition, all of the interested parties should consider the implications of the following issues:

1. The “tax-deferred reinvestment” or “tax-free rollover” election available for the selling shareholders with regard to the sale proceeds of the company stock to an ESOP
2. The tax deductibility to the sponsor company of dividend payments if paid to the ESOP participants or used to repay the ESOP stock purchase loan
3. Compliance considerations for an S corporation sponsor company owned by an ESOP
4. Any new or currently proposed tax regulations or legislation

If a deferred profit sharing or money purchase pension plan already exists at the sponsor company, it is normally “frozen.” The assets of the existing benefit plan will typically remain invested in a diversified securities portfolio.

However, the employees can be given the option to invest a portion—or all—of their assets from a profit sharing, money purchase, or 401(k) plan into either (1) the company stock or (2) part of the ESOP stock purchase transaction.

Almost all ESOP sponsor companies either maintain or establish a diversified 401(k) plan that is not

invested in the company stock. However, in some cases, a sponsor company may decide to merge its existing 401(k) plan with the ESOP.

In these situations, employees that are invested in the sponsor company's 401(k) plan are given the opportunity to invest their money into the ESOP. These funds are considered part of the stock purchase transaction financing. These funds are used to purchase the sponsor company shares from the selling shareholder(s).

All federal and state securities laws should be complied with, and “full disclosure” should be provided to, the company employees. Full disclosure can be a fairly burdensome requirement for a private company.

As mentioned above, there are both expenses and risks associated with a new ESOP formation. For example, the sponsor company will be required to create a disclosure memorandum.

The disclosure memorandum typically describes the following:

1. The nature of the company business operations
2. The company's historical financial performance
3. Management expectations for the company's future financial performance
4. The risks associated with investing in the company stock
5. Other information that an investor may require in order to make an informed investment decision

The disclosure memorandum is then distributed to the company employees. The employees are typically given 20 to 30 days to make their decisions about investing in the company stock. The distribution of this disclosure memorandum may be considered a risk to the ESOP formation process. This is because, often, the company employees may not have the financial sophistication—or the desire—to evaluate all of the information provided in the disclosure memorandum.

Therefore, some employees may simply elect not to invest in the sponsor company stock. As a result, the company may not receive the level of employee participation that was expected for the ESOP formation.

In some cases, the company may make financial advisers available at no cost to the employees. These financial advisers may be provided in an effort to give the company employees the resources they need to make an informed investment decision. However, due to the expense associated with

giving employees the option to invest their 401(k) or profit sharing assets in the company stock, the company management should carefully weigh the risks versus the probability of success before pursuing this option.

If the management determines that this option will be pursued, then a temporary “floor price” is usually attached to the sponsor company stock acquired with assets from other benefit plans. This temporary floor price often remains in effect until the ESOP’s stock purchase loan is completely repaid.

In most cases, this “floor price” is calculated as the fair market value of the company stock without taking into account the impact of the ESOP’s stock purchase loan.

The ESOP design features should also allow for factors that will positively influence employee motivation. For example, an accelerated vesting schedule may serve to motivate employee participation in the ESOP. However, as a means to prevent vested employees from terminating their employment prematurely in order to receive large account balances, the sponsor company may postpone the distribution of accounts to terminated employees for a certain time period.

The transfer of voting rights is also a concern for many shareholders of a private company. However, this issue has not actually resulted in a problem for ESOP-owned sponsor companies. The requirement to “pass through” voting rights to employees of private sponsor companies is a function of state law.

However, the voting rights “pass through” is usually only required for issues such as mergers, consolidations, recapitalizations, sale of the business, liquidation, dissolutions, and similar types of transactions.

When a trusted, experienced management team has a proven track record of successfully operating the business to achieve growth and profitability, the employees are generally content to not be involved in the management of the sponsor company.

SUMMARY AND CONCLUSION

Upon the completion of the ESOP financial feasibility analysis, the findings are typically presented to the company board of directors or to the ESOP formation committee.

The professionals involved in conducting the ESOP financial feasibility analysis may include the analyst, an ESOP consultant, investment bankers, lenders, the senior management team, legal counsel, and the selling shareholders. It is important for all of these parties to:

1. anticipate potential ESOP formation obstacles and
2. have reasonable solutions to each of these obstacles.

Based on such anticipatory consideration, any last-minute obstacles or issues can be evaluated as part of the decision-making process of the company board of directors and of the ESOP formation committee.

Further, the evaluation of the ESOP feasibility is an ongoing part of the ESOP formation process. As valuation, structuring, and financing decisions are made, circumstances (both for the company and for the selling shareholders) may change. In such instances, various alternative ownership transition opportunities may be considered.

Ultimately, the different aspects and considerations of the ESOP financial feasibility analysis should be updated. This updated analysis should reflect the most current set of facts related to the sponsor company—in order to confirm the continued financial feasibility of the ESOP formation.

Finally, the decision to enter into a transaction to buy the company’s shares and to pay a fair market value price for those company shares is made (on behalf of the to-be-formed ESOP participants) by the ESOP fiduciary.

ESOP sponsor companies (and the company’s selling shareholders) sometimes face litigation claims and regulatory challenges related to the new ESOP formation.

Sometimes, the ESOP trustee, the financial adviser to the ESOP trustee, and other parties may become involved in these litigation claims or regulatory challenges. And, sometimes the sponsor company noncontrolling shareholders may also raise issues with regard to the ESOP stock purchase transaction.

A comprehensive ESOP financial feasibility analysis will not eliminate the potential of litigation or regulatory challenges. However, the ESOP financial feasibility analysis does provide evidence of the due diligence and business judgment that was exercised by the various parties to the ESOP formation process.

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