CONSIDER THE SALE OF THE COMPANY TO AN EMPLOYEE STOCK OWNERSHIP PLAN

This article outlines the factors that private construction company owners should consider — and the feasibility analysis that their advisors should perform — to assess whether a sale of the company stock to an ESOP makes sense as an ownership transition strategy.

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Owners of a private construction company who are looking for an exit strategy may consider the sale of all (or part) of the company to an employee stock ownership plan (ESOP). Such a strategy may be particularly attractive to baby boomer construction company owners who are seeking retirement and liquidity and who would prefer to see their loyal employees retain a stake in the company ownership. This article introduces the factors that such private construction company owners should consider — and the feasibility analysis that their advisors should perform — to assess whether a sale of the company stock to an ESOP makes sense as an ownership transition strategy.

When it is time for the owners of a private construction company to consider an ownership transition (i.e., a sale of the company on the path to retirement), a sale to the company employees may be one option to consider. This ownership transition exit strategy is often implemented through the formation of an ESOP. The private construction company sponsors (i.e., arranges) the formation of the ESOP, and the ESOP trust buys the company stock, often through a leveraged stock acquisition transaction. As will be discussed, the selling stockholders may or may not provide seller financing to make the stock acquisition transaction more attractive to the employees.

Through the ESOP's acquisition of the company stock, the selling stockholders

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receive liquidity — usually in a tax-advanced structure. The selling stockholders achieve the ownership transition objective that they are seeking, and the loyal employees enjoy a stake in the ownership of the construction company on a going-forward basis.

Obviously, an ESOP formation and a leveraged stock acquisition is not the appropriate ownership transition strategy to satisfy every construction company owner's exit plan. This article discusses the factors that the current company shareholders should consider before the company sponsors an ESOP formation. This article also describes the ESOP financial feasibility analysis (and the other issues) that the company advisors should consider before the current owners implement a sale of the construction company to an ESOP.

Before a private construction company proceeds with the formation of an ESOP, that company should perform an ESOP formation feasibility analysis. The purpose of a feasibility analysis is to give both the selling shareholder(s) and the construction company management/directors the information they need to determine whether to move forward with the ESOP formation and with the ESOP's purchase of the company stock.

The results of the feasibility analysis should enable the construction company, the trustee to the to-be-formed ESOP, the selling shareholder(s), and the legal counsel to all parties to structure a transaction that is beneficial to all the parties. Of course, to comply with federal laws, such a stock purchase transaction must be fair to the to-be-formed ESOP from a financial point of view. This discussion summarizes the process of the ESOP financial feasibility analysis and how the parties to the ESOP formation may use the information developed in the financial feasibility analysis to decide if (and how) they need to structure the ownership transition transaction.

In the decision to implement an ESOP purchase of the construction company stock, the selling shareholders have to consider whether (and at what price) to sell their company shares to the ESOP. The selling shareholders also have to decide whether they are willing to give up ownership control of the construction company to a new owner (i.e., to the ESOP). This transfer of ownership control consideration is also relevant in an ESOP formation where the construction company itself (and not the current shareholders) sells treasury shares to the ESOP.

The construction company managers and directors have to consider whether the company can afford to finance the ESOP stock purchase transaction — particularly if the ESOP transaction is to be a leveraged stock purchase. The company managers and directors also have to consider the other (nondebt service) ESOP-related costs (e.g., 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 the current shareholders' ownership transition and liquidity objectives. Each ESOP feasibility analysis will be different — depending on the potential construction company's situation. However, most ESOP feasibility analyses include certain basic considerations to (1) provide meaningful information to all parties involved in the ESOP formation and company sale decision and (2) avoid costly mistakes that could impair the long-term success of the ESOP (and of the company itself).

BEFORE A PRIVATE CONSTRUCTION COMPANY PROCEEDS WITH THE FORMATION OF AN ESOP, THAT COMPANY SHOULD PERFORM AN ESOP FORMATION FEASIBILITY ANALYSIS.

The ESOP financial feasibility analysis

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

- What parties will actually sell the construction company shares to the to-be-formed ESOP?
- How will the to-be-formed ESOP finance the purchase of the construction company stock?
- How will this new stock acquisition financing (if any) affect the cash flow of the construction company?
- What is the best plan design for the construction company? For example, should the construction 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 construction company management and the selling shareholder(s) should know about?
- What if the actual construction company future results of operations vary — positively or negatively — from any financial projections prepared at the time of the construction company stock purchase transaction?
- How does the selling shareholders' desired sale price for the construction company stock compare to the range of company stock fair market values estimated by the valuation analyst (hereafter, the analyst) working for the to-be-formed ESOP trustee?

THE ESOP FEASIBILITY INITIAL CONSIDERATIONS MAY BE DETERMINED WITHOUT RETAINING AN INDEPENDENT FINANCIAL ADVISER OR LEGAL COUNSEL.

Initial considerations

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

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

- 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 company operating history.
- Report at least $20 million in company annual revenue.
- Have one or more company owners who are interested in investment liquidity and in a diversification of their personal wealth.
- Have one or more company owners who are interested in ownership/management succession planning and in the transition of the company ownership to the employees.
- Have one or more owners who would consider accepting a reasonably conservative stock value (i.e., a price that is at the lower end of the range of corporate acquirer transaction prices).
- Have a senior management team that supports the concept of an ESOP formation (and of the employee ownership of the construction company).

The controlling shareholder(s) should assess the company relative to these benchmark characteristics to determine if the company is a reasonable candidate for an ESOP formation. This initial feasibility analysis may be performed internally within the company (i.e., without the company having to spend large amounts of time and money).

If the private construction company, the selling shareholders, and the company management do not "pass" the aforementioned threshold characteristic tests, then the company may not be a particularly good candidate for an ESOP formation. The company stockholders and the company 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 developing a 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 construction company shareholders — and of the other parties to the proposed stock sale 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 acquirer — or some other type of company liquidity event — be better suited to achieve the objectives

of the company shareholders, management, and other parties?
- What percentage of the company stock will the to-be-formed ESOP own after the stock purchase transaction? Which shareholders will sell or redeem their shares as part of the ESOP's stock purchase transaction?
- How will the current company management — and the current controlling shareholder(s) — react to the inevitable changes in voting/control rights and in corporate governance?
- How will the company's 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 to maintain operational management continuity on a going-forward basis?
- Is it desirable for the construction 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's 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 construction company ownership transition. 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 will 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 construction 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; and
- a liquidity study to assess the future demands that the ESOP stock repurchase obligation may eventually make on the construction company.

A preliminary valuation analysis

A preliminary valuation analysis of the company stock is an important component of the ESOP financial feasibility analysis, and 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 construction company. Rather, the analyst provides an opinion of a reasonable — but not final — range of fair market value indications for the construction company stock.

The estimation of the construction company stock value is a complex process, and

A PRELIMINARY VALUATION ANALYSIS OF THE COMPANY STOCK IS AN IMPORTANT COMPONENT OF THE ESOP FINANCIAL FEASIBILITY ANALYSIS.

it is important to the ESOP formation decision. Accordingly, the parties usually retain an analyst who is experienced in ESOP — and ERISA-related — stock valuations.

In fact, the selling shareholders (and/or the company) and the trustee to the to-be-formed ESOP typically retain their own independent analysts at this stage of the feasibility analysis. Regardless of whether the analyst is retained by the company's 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 construction company stock.

At this stage of the feasibility analysis, an analyst experienced in 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).

THE 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 all the parties to find out early if (1) the preliminary stock value range is less than the per-share stock price desired by the company's selling stockholders and (2) structuring alternatives, such as earn-outs or warrants, can be used to encourage the company's selling stockholders to accept the preliminary stock price.

In such an instance, other strategies may have to be considered to increase the ownership transition attractiveness to the company's selling shareholders. Such other strategies may include waiting until the construction company's financial performance improves, reducing company operating expenses, and the like. In other words, what can the selling shareholders do to increase the value (i.e., the selling price) of the construction company?

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 selling 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 (or cash flow test) study; and
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 that are typically asked by the company's principal shareholders. These principal shareholders are usually 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 ownership?
- 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 construction company cash flow and (2) the construction 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 financing versus seller note 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") to construct alternative scenarios include the following:

- revenue growth rates;
- profit margins;
- amounts of the construction company operations-related bank financing;
- amounts of — and terms of — the ESOP stock purchase bank financing;
- the ESOP stock purchase bank financing terms (interest rates, covenants, maturity, required prepayments, guarantees, etc.);
- amounts of any selling stockholder-provided financing;
- any selling stockholder subordinated debt terms (interest rates, maturity, required prepayments, warrants, etc.);
- the refinancing of the company's existing bank debt;
- any expected future capital expenditure investment requirements; and
- any expected future working capital investment requirements.

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 projection variables to create alternative financial projected 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 of the 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 construction company could fare under alternative future 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 construction company may incur over the next, say, 10–15 years. This ESOP stock repurchase obligation results from the employees' expected future 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 the construction company management to estimate the timing — and the amount — of the funding that may be needed in the future for repurchasing the allocated shares from any departing employees. This information allows the construction company management to make the appropriate financing, insurance, or other liquidity plans.

The plan design study analysis

The greater the flexibility included in the design of the ESOP documents themselves, the more effectively the ESOP will be able to accomplish its objectives. The ESOP plan design study will typically address the following issues:

- plan participant eligibility;
- employee vesting schedules;
- timing of the benefit distributions;
- forfeitures of departing employees;
- company contribution levels;
- employee account allocation formulas;
- past service credit;
- early retirement policies; and
- a corporate 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

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

- Who will (and who will not) be able to participate in the to-be-formed ESOP?
- Must the construction company distribute the shares of stock to employees at retirement — or at other required distribution dates — if the employees demand it, or can the company just limit the form of the 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 construction company stock and under what circumstances?
- Should the construction company combine other benefit plans, such as a 401(k) plan, with the ESOP?
- What will happen to the construction 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)?

THERE ARE BOTH EXPENSES AND RISKS ASSOCIATED WITH A NEW ESOP FORMATION.

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 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 construction 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 construction company that will be owned by an ESOP; and
4. any new or currently proposed tax regulations or tax legislation.

If a deferred profit sharing or money purchase pension plan already exists at the construction company, it is normally "frozen." The assets of the existing benefit plan will typically remain invested in a diversified portfolio of publicly traded securities. 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, the construction company may decide to merge its existing 401(k) plan with the newly formed ESOP. In these situations, employees who are invested in the construction 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 construction company's 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 previously, there are both expenses and risks associated with a new ESOP formation. For example, the construction company that forms an ESOP will be required to create a disclosure memorandum. The disclosure memorandum typically describes the following:

1. the nature of the construction company's business operations;
2. the company's historical financial performance;
3. management's expectations for the company's future financial performance;
4. the risks associated with investing in the company stock; and

5. other information that an investor may require to make an informed investment decision.

The disclosure memorandum is then distributed to the company employees. The employees are typically given 20–30 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 fairly common because the company employees may not have the financial sophistication — or the desire — to evaluate all the information provided in the disclosure memorandum. Therefore, some employees may simply elect not to invest in the construction 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 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 company management determines that this option will be pursued, then a temporary "floor price" is usually attached to the construction 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 considering the impact of the ESOP's stock purchase loan.

The ESOP plan 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, to prevent vested employees from terminating their employment prematurely to receive large account balances, the ESOP 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 major corporate issues (e.g., 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 ESOP sponsor company.

Summary and conclusion

Upon the completion of the ESOP financial feasibility analysis, the findings are typically presented to the construction company's board of directors or to an ESOP formation committee. That committee could include board, management, and employee representatives. 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 company's selling shareholders. It is important for all 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 construction company's board of directors and of the ESOP formation committee.

Additionally, 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. As the consideration of the company sale transactions progress, the different aspects and considerations of the ESOP financial

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feasibility analysis should be updated. This updated analysis should reflect the most current set of facts related to the construction company 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.

For private construction company owners considering a sale of all (or part) of the company, an ESOP formation is one possible ownership transition structure. However, a comprehensive ESOP formation and financial feasibility analysis is appropriate to assess whether the sale of the construction company stock to the ESOP makes sense to the selling shareholders, to the to-be-formed ESOP employee participants, and to the construction company itself. ■