What You and Your Clients Need to Know

Speakers

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Agenda

- Overview of Employee Stock Ownership Plans
- Basic Structure of an ESOP
- Market Observations
- Is an ESOP right for your client?

- Planning for the Sale
- Preparing Owners & Businesses
- Scope & Timeline
- Transaction Prep

- Structuring the Transaction
- Financing
- Documentation & Legal Considerations
- Closing & Immediate Post Close

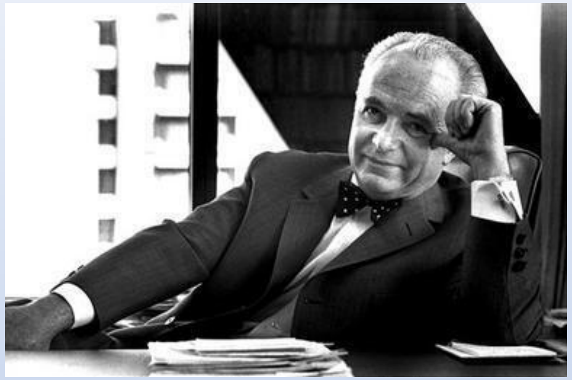
- Later Years

ESOP Overview

- ESOP Defined: An “employee stock ownership plan” or “ESOP” is a type of qualified defined contribution retirement plan as defined in Section 4975(e)(7) of the Internal Revenue Code (“Code”).
  - Designed to primarily invest in qualified employer securities of the plan sponsor.
  - An ESOP is not a stock option program.

ESOP Overview

- Louis Kelso is credited for the concept of ESOPs in the 1950s-1960s.

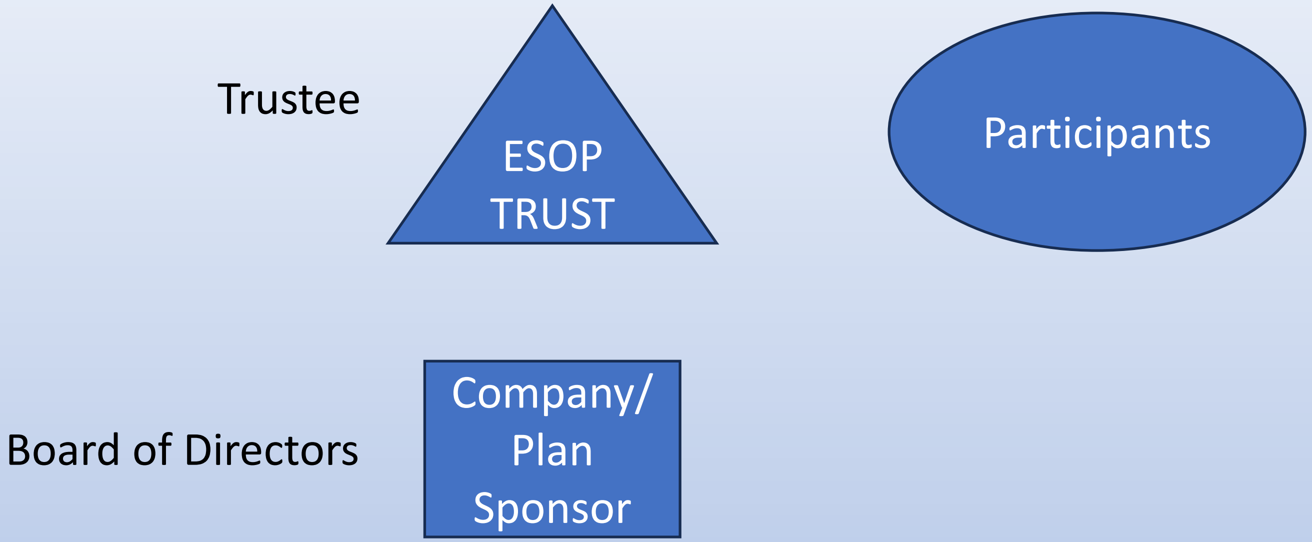


- Russell Long, son of Populist Governor Huey Long, was a U.S. Senator and Chair of the Finance Committee.
  - Russell was the key legislator promoting these "second income" or "Kelso Plans".
  - Incorporated ESOPs into the Employee Retirement Security Act of 1974 ("ERISA")

ESOP Overview

- Tax Reform Act of 1986 enacted Code Section 1042.
  - Owners of a C-Corp who sell at least 30% of a company's shares to defer recognition of the capital gain realized on such sale.
- The Small Business Job Protection Act of 1996 introduced S-Corp ESOPs as a tax preferred vehicle for owning a corporation.
  - Code Section 512(e)(3) allows for an ESOP trust owning an S-Corp stock to NOT be subject to income tax on profits allocated to the shares it owns of the S-Corp.
- The Economic Growth & Tax Relief Reconciliation Act of 2001 enacted major anti-abuse rules for S-Corp ESOPs.
  - Section 409(p) of the Code
  - Limits to at least 11 employees

Basic ESOP Structure



<u>CIRCULARITY OF CONTROL</u>

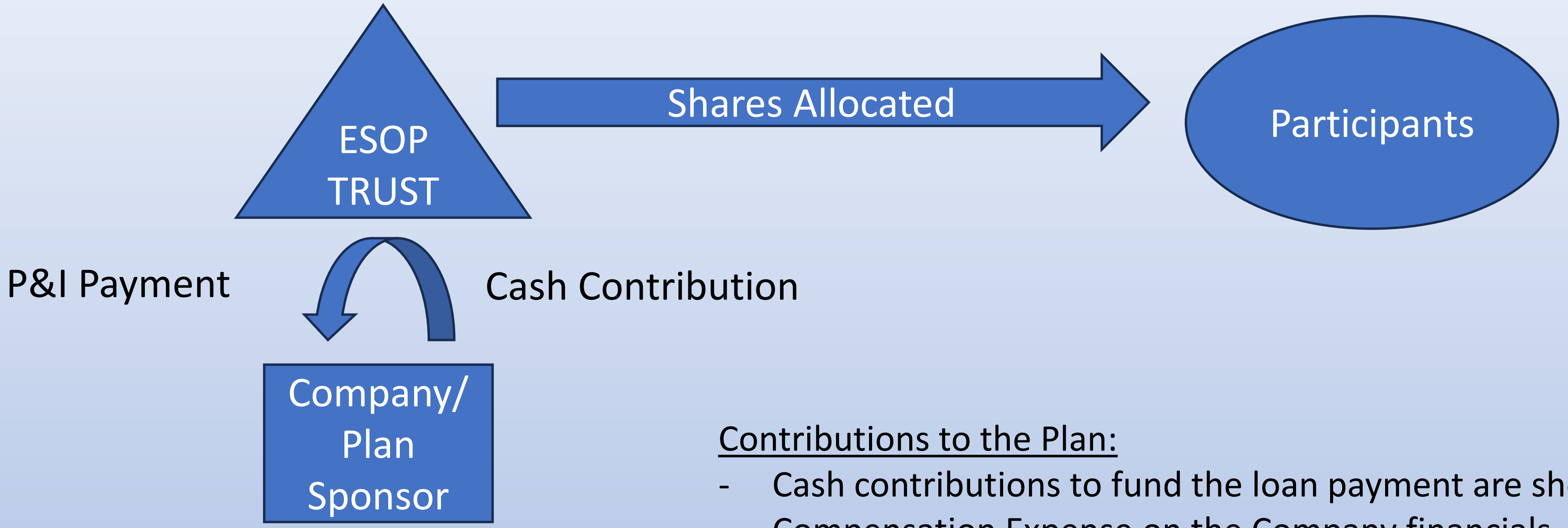
ESOP Trustee:

- Appointed by ESOP Committee or Board of Directors
- Acts on behalf of ESOP as sole shareholder (100%)
- Votes on shareholder matters and establishes valuation of ESOP Shares
- Retains fiduciary responsibility for trust assets

Board of Directors:

- Elected by the shareholders (the ESOP Trustee)
- Fiduciary responsibility to maximize shareholder value, appoint and oversee management, duty to monitor the trustee.
- May appoint an ESOP Committee to direct the Trustee

Basic ESOP Structure



<u>Internal Loan:</u>

- The ESOP Trust does not have cash at inception to purchase the shares.
- The ESOP trust issues a note to the company
- The note does not appear on the Company financials as a liability, rather it is a contra-equity account.
  - "unearned/unallocated ESOP Shares"
- The note shows as a liability on the ESOP Trust financials.
- The amortization sets the release of the shares.
  - For example, 30 year amortization would be 1/30 of the shares released annually.

<u>Contributions to the Plan:</u>

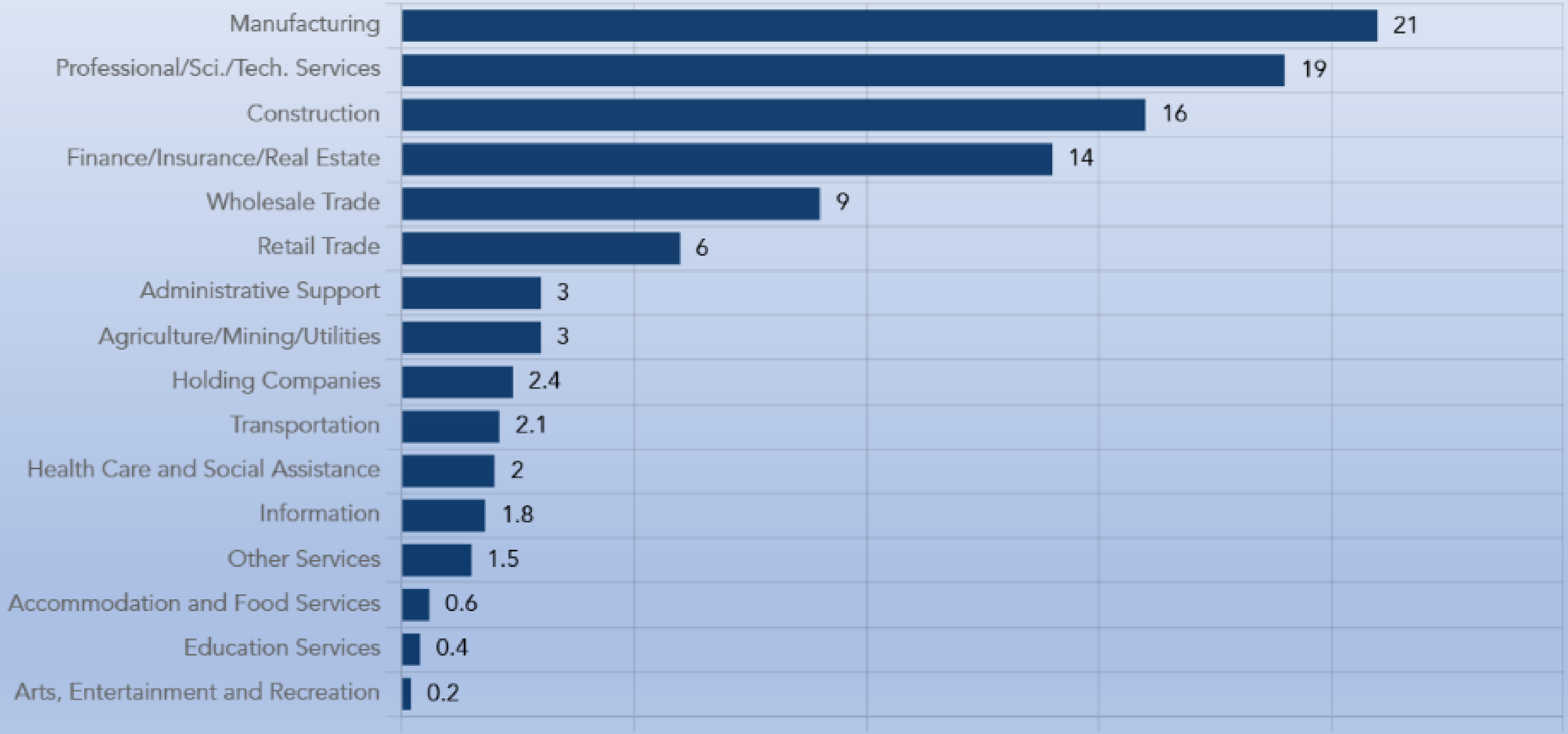
- Cash contributions to fund the loan payment are shown as ESOP Compensation Expense on the Company financials.
- It is a non-cash expense and added back on the SCF.
- Contributions to the plan are capped by the deduction limitation of Section 404(a)(3) and indirectly by the limitation on annual additions under Section 415(c)
- The maximum annual deductible contribution to defined contribution plans is 25% of eligible compensation
- The maximum annual addition is the lesser of 100% of a participant's compensation or $70,000 for 2025.

ESOP Demographics

- Adequate number of employees.
  - 20-50 is the practical minimum.
- Minimum EBITDA
  - Range can vary upon several factors, in general $2mm is a guideline.
- Stable earnings and cash flow / strong balance sheet
- Collateral Support
- Lower Turnover
- Non-Union workforce
- Bench strength
- Strong Corporate Governance, Records, Financials
- Empowering Company Culture /Social – Community Awareness

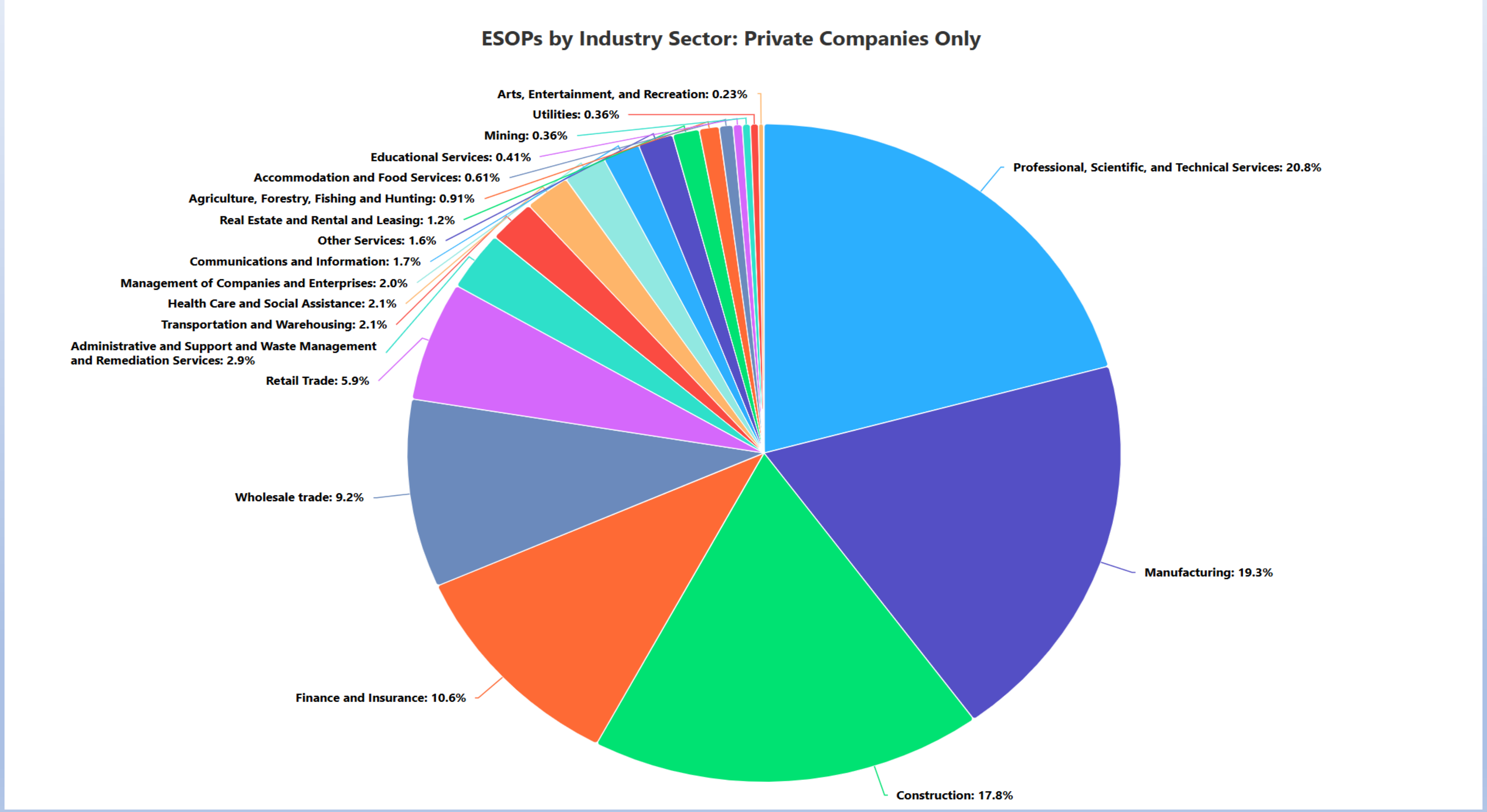
ESOP Demographics

NCEO By The Numbers 2022 (rounded percentages)



ESOP Demographics

NCEO Breakdowns by Industry Update 2025 National ESOP Database – 2023 Form 5500 filings



THE 60TH ANNUAL SOUTHERN FEDERAL TAX INSTITUTE

Market Observations

- Larger companies are considering and executing ESOP transactions now more than ever before
  - BDO, Vortex Optics, Room and Board

- ESOP transactions are being looked at as an equal and viable alternative to other types of M&A transactions
  - Due to increased sophistication in deal structuring (warrants, longer internal loans, management incentive plans, etc.)
  - Institutional acceptance by senior and non-traditional lenders
  - Government support and subsidies
  - Tax advantages for seller and company
  - ESG considerations

- Projects are shifting from ESOP Feasibility Study to Review of Strategic Alternative Studies and ESOP Execution Transactions to Dual Track Transactions are becoming the “new normal” for our team as companies are looking to appropriately consider all strategic alternatives

Benefits of an ESOP

SELLER

- Receive fair market value
- Favorable tax treatment on sale (§1042 Capital Gain Deferral – C corporation)
- Flexibility; can sell any percent of company
- Preserve legacy as independent company
- Retain operating control
- Reward management and employees who helped grow the business

COMPANY

- Tax-advantaged financing
- Potential for income tax-free entity (100% ESOP-owned S corporation)
- Repay debt more quickly with enhanced cash flow
- Potential for productivity gains and reduced turnover

EMPLOYEES

- Valuable retirement benefit
- Ability to participate in value they help create
- Ensure continued employment
- Incentive for management through Management Incentive Plans

Assessment of Options

- Determine which type of transaction works best through a Review of Strategic Alternatives Analysis
- If an ESOP is the chosen alternative, perform an ESOP Feasibility Study
  - Feasibility study will determine whether an ESOP is the best option given the goals of the company and selling shareholders
  - Study will review financial performance of the company, analyze debt capacity, cash flow, include a series of valuation models and model the implications and transaction structure if an ESOP is implemented
  - Model pre- and post-tax proceeds to the selling shareholders
  - Estimate ESOP share allocation and benefit levels and management incentive payouts outside of the ESOP (i.e., stock appreciation rights)
  - Provide a proposed transaction structure
  - Identify any potential tax restructuring as needed.
- Timeline – 6 to 8 weeks to conduct diligence and feasibility study
- Results should determine path, valuation, and capital structure expectations

Preliminary Planning for a Sale to an ESOP

- Clarify selling shareholders' long-term goals
  - Preserve culture and independence
  - Retain control
  - Future involvement in management
  - Tax-advantaged sale under Code Section 1042
- Determine the type of sale
  - Partial sale provides some liquidity but allows selling shareholders to retain control
  - Full sale provides maximum liquidity and allows selling shareholders to make a full exit
  - Typically, selling shareholders will stay involved in management after the sale (ESOP trustee may require continued involvement)
- Communicate with Key Family Members and Align Interests
  - Preserve family relationships and ensure that the sale meets all parties' goals, whether family members are active in the business or not
  - Lack of transparency can lead to disputes and governance issues after the sale
  - Resolve any existing conflicts of interest before the sale occurs

Preliminary Planning for a Sale to an ESOP

- Consider Possible Succession Plan Post-Sale
  - Plans for company management should be communicated clearly to family members
  - Roles assigned to family members based on competence and leadership ability
  - Establish clear board roles, voting rights and oversight responsibilities
- Financial Planning for Windfall
  - Selling shareholders should discuss their estate plan with their heirs to avoid any surprises
  - Selling shareholders and heirs should retain personal advisors with ESOP expertise – particularly if Section 1042 is in play

Preliminary Planning for a Sale to an ESOP

- Selling shareholders should review and update relevant legal documents to ensure their intentions are reflected
  - Wills and trust documents
  - Beneficiary and asset title designations
- Selling shareholders should understand the financial implications of the sale both for the company and them personally
  - Effect of seller financing on selling shareholders' risk exposure
  - Effect of ESOP repurchase obligation on company's cash flow and valuation
  - Requirements for a Section 1042 election

Preliminary Planning for a Sale to an ESOP

- Review real estate holdings
  - Determine whether real estate will be included in the sale of the company
  - Prepare separate financials for real estate and perform fair market rent studies
- Engage key stakeholders
  - Notify banks, insurers, bonding companies and major clients to avoid any potential surprises or issues
  - Review contracts for change in control clauses, consent requirements or other contractual covenants that may be triggered by a sale
- Address industry specific regulations
  - Consider ownership and state licensure requirements
  - Consider potential state filing requirements

Determine the Appropriate Capital Structure

Cash Needs and Liquidity

- Immediate cash requirements at closing impact liquidity strategies and the level of leverage adopted in the capital structure.
  - For example, for 1042 election
- Higher cash at close expectations may require uni-tranche or mezz debt; however, for common ESOP candidates with little debt experience, proper education is required

Cash Flow Capacity and Debt Service

- A company's ability to generate cash determines debt service coverage and requires comprehensive forecasting and stress testing for financial stability.
- Banks utilize various testing metrics such as Fixed Charge Coverage Ratio to assess the company's ability to cover minimum debt payments → stress testing is critical during debt capacity analysis
- Use of warrants to minimize ongoing interest expense

Valuation and Seller Objectives

- Valuation, purchase price, and seller goals like liquidity and involvement shape structural choices such as use of synthetic equity instruments.
- Higher valuation results in inevitably higher gap in financing > larger seller notes as % of deal

Trustee and Lender Requirements

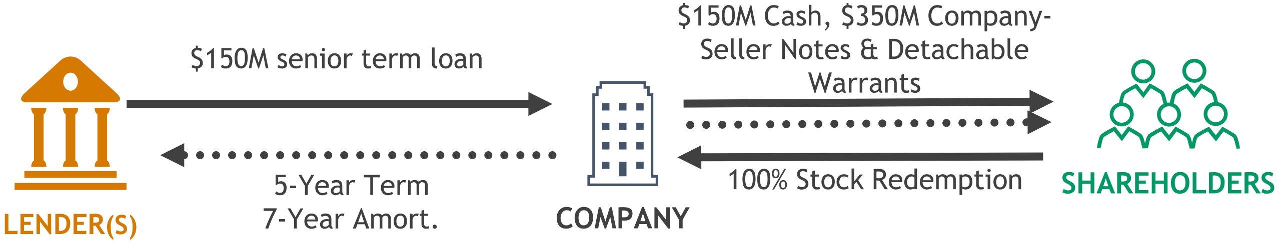
- Trustees and lenders require fairness opinions and coverage ratios, playing a crucial role in structuring the deal.

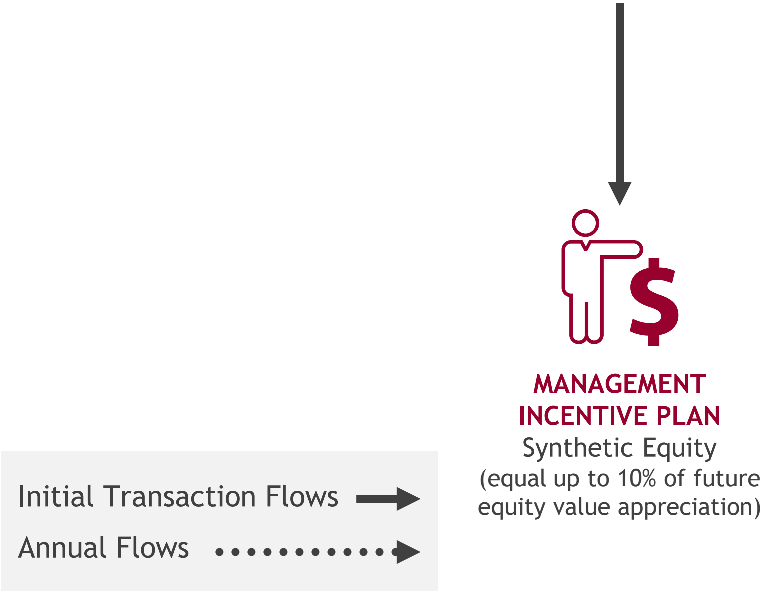
Possible Output100% ESOP Structure (NO 1042)

$500M SALE EXAMPLE

Step 1 - Financing *(Optional)*

Step 2 - Stock Redemption

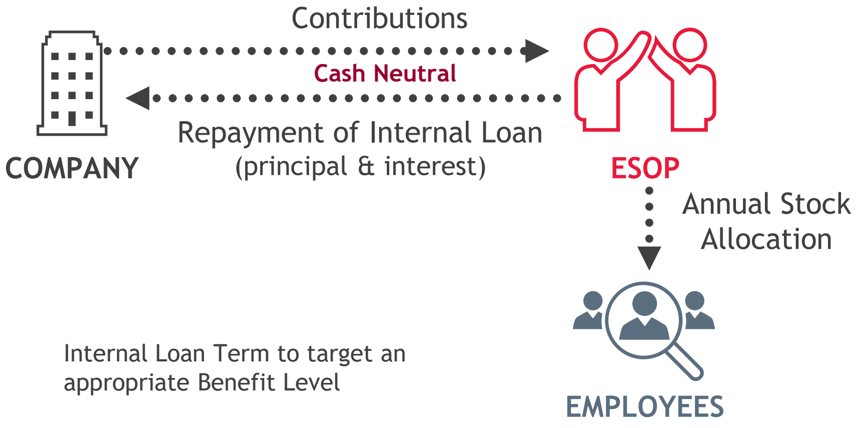




Step 2 - Explained
Company redeems 100% of stock worth $500M, in exchange for $150M in cash from a senior lender, $350M in subordinated unsecured seller notes and warrants representing up to 25% of the future appreciation of the company value.

Step 3 - Loan/Sale to ESOP

Step 4 - Annual Stock Allocations



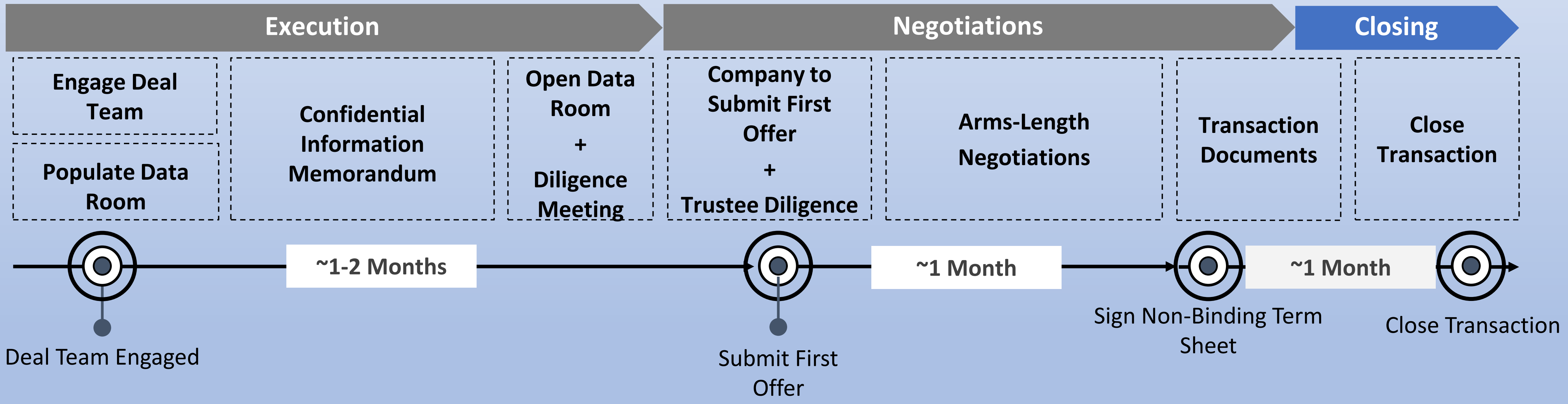
OPTION TO 100% SELLER FINANCE: If the shareholder would prefer to seller finance the entire transaction, the above references to Lender(s) and Cash will not exist, and corresponding notes will be increased as such.

Preparing Business for a Sale-Early Steps

- Continue to evaluate selling shareholder goals and leadership/succession planning
  - Confirm goals for future involvement, impact on employees and buyer selection
  - Strong, informed management team is critical – particularly due to institutional knowledge
- Strengthen financial reporting/position for strong valuation
  - Accurate well-maintained financials are key to valuation
  - Assess internal systems, reporting capabilities and the strength of the internal finance team
  - Minimize nonrecurring expenses and personal add-backs to EBITDA to improve perceived value
- Assess compensation structure
  - Perform a compensation study to assess market alignment
  - Compensation-related adjustments may affect EBITDA and valuation

Structuring the Transaction

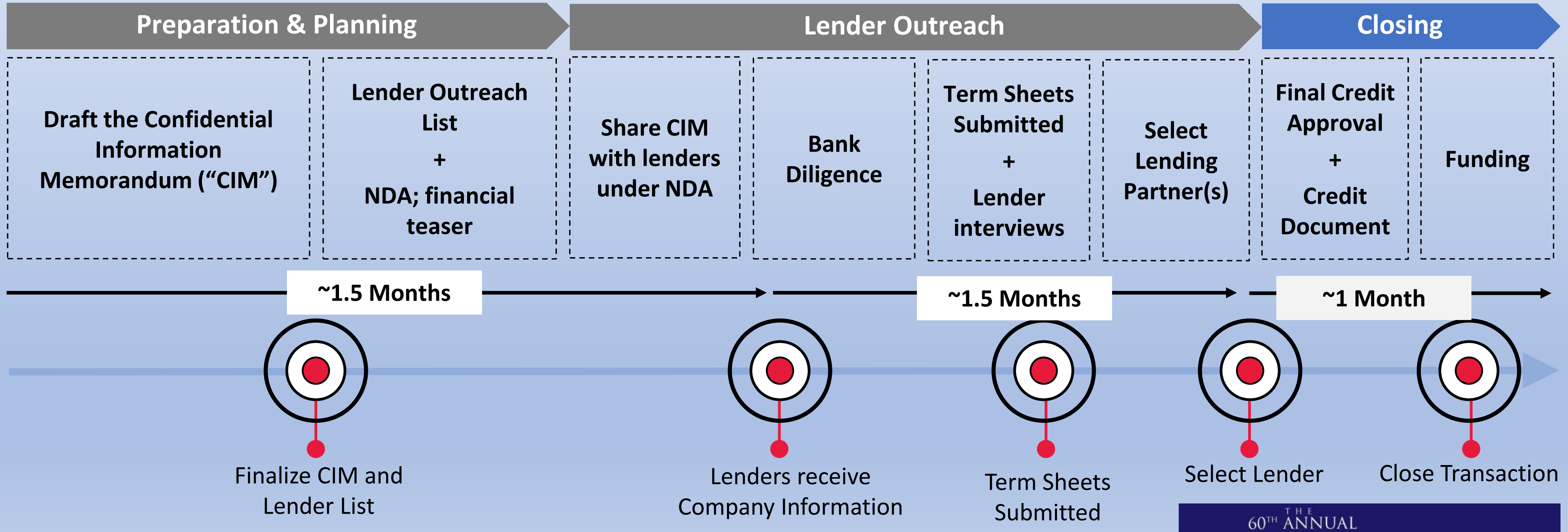
Phase II – Timeline



Financing

Capital Raise Process

Similar to the Transaction Execution process, it is necessary to have a project plan to solicit, coordinate, negotiate and select a lending partner for an ESOP transaction, if desired by selling shareholders and the company. Alignment between the Debt Capital process and Transaction Execution process are critical.



Later Years

- Sustainability and Repurchase Obligation Studies
  - Begin 3-5 years post close.
  - Very important to plan for future budgeting and plan testing requirements.
- Policy for Acquisition Offers
  - Board should adopt a written policy regarding how to address unsolicited offers and document relevant decision factors
  - Policy should address management and board responsibilities upon receipt of an offer
  - Board has the obligation to treat all bona fide offers seriously and should immediately engage the ESOP trustee
  - In consideration of an offer, the board should consider value to shareholders, employees, culture, continuity of the business and whether the offer is serious and reliable
  - "Business judgment rule" is the typical standard for Board decisions by disinterested directors – unless the Board was grossly negligent or there was a conflict of interest
- Maintain the independent trustee
- Develop a consistent schedule of board meetings and documentation of meeting minutes for the Company and each subsidiary.
  - Additionally, a consistent schedule for participant distributions and communication.
- Have a well-qualified controller or CFO
- Continuous engagement of ESOP Ecosystem partners
  - TPA, ERISA Counsel, Valuation, Trustee