EXIT STRATEGIES: SELLING COMPANIES TO EMPLOYEES, PART 1 & PART 2
First Run Broadcast: January 30 & 31, 2019
Live Replay: July 11 & 12, 2019
1:00 p.m. E.T./12:00 p.m. C.T./11:00 a.m. M.T./10:00 a.m. P.T. **(60 minutes)**

Many closely held companies have only two potential sets of buyers – family members of the founding generation or managers and other employees of the enterprise. The market of third-party buyers for closely held companies can be very thin, so that when family members are not suitable buyers of a company, often the best solution is to sell to employees. But sales to employees are unlike sales to third-parties or family members, involving complex issues of how to finance the sale, transition management and control of the enterprise, retain key employees, and tax treatment. This program will provide you with a detailed discussion of the major issues of selling to employees, including valuation, how the sale price is financed, transition periods, retaining employees not in the buyout group, and tax treatment.

Day 1 – July 11, 2019:

- Long-range planning of sales to employees – and benefits over selling to third parties or family members
- Negotiating with employees over sales price and valuation issues
- Transitions of management control, including retaining seller/founder for a period of time
- Practical governance issues when employees are identified as potential buyers

Day 2 – July 12, 2019:

- Overview of alternative structures and the tradeoffs of each
- ESOPs – structural, practical and tax issues, including leveraged buyout options
- Use of company redemptions of founders to accomplish a transfer
- Crucial issues in drafting "earnouts" on sales to employees
- Seller financing options, including long-term notes and security interest in assets

Speakers:

Paul Kaplun is a partner in the Washington, D.C. office of Venable, LLP where he has an extensive corporate and business planning practice, and provides advisory services to emerging growth companies and entrepreneurs in a variety of industries. He formerly served as an Adjunct Professor of Law at Georgetown University Law Center, where he taught business planning. Before entering law practice of law, he was a Certified Public Accountant with a national accounting firm, specializing in corporate and individual income tax planning and compliance. Mr. Kaplun received his B.S.B.A., *magna cum laude*, from Georgetown University and J.D. from Georgetown University Law Center.

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Exit Strategies: Selling Companies to Employees, Part 1 Teleseminar

July 11, 2019

1:00PM – 2:00PM

1.0 MCLE General Credits

VBA Members $75
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CERTIFICATE OF ATTENDANCE

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Date:	July 11, 2019
Seminar Title:	Exit Strategies: Selling Companies to Employees, Part 1
Location:	Teleseminar - LIVE
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Comparison of
Sale of Closely Held Company to Employees
Versus
Sale to Family or Outsiders

Paul T. Kaplun, Esq.

John A. Wilhelm, Esq.

Venable LLP

A. Preparation for Sale

- Make sure governance documents (such as Articles, Bylaws, Minutes) are in order.
- Review history of company ownership documents to confirm ownership.
- Review legal documents to assure in order.
- Review any outstanding claims or litigation to assess.
- Obtain a valuation.
- Discuss sale with investment banker or business broker, as applicable, to assess outside market.
- Assess Company's business, operations and books and records
- Create 3 to 5 year business plan.
- Explore financing with one or more financial institutions.
- Assemble other professional advisors.
- Understand the sale process; maintain normal conduct of business during sale.
- Consider pre- and post-sale implications regarding customers, competitors, employees, banking relationships and vendors.
- Determine role of owners and employees post-sale in the Company's business and operations.
- Consider pricing, including fixed versus contingent; payment terms; use of escrows, earnouts.

B. Critical Documents and Matters

- Financial Advisor Agreement.
- Trustee, Trustee legal counsel and Trustee legal counsel engagement letter (if an ESOP Trustee purchaser).
- Nondisclosure Agreement (if an ESOP trustee purchaser)
- Document Data Room (if an ESOP trustee purchaser).
- ESOP Plan and Trust Documents (if an ESOP Trustee purchaser).
- Letter of Intent (if an ESOP Trustee purchaser).
- Acquisition agreement.
- Employment/Consulting agreements.
- Non-competition agreement.
- Stockholder, Operating or partnership agreement.
- Governance and management; vote pooling arrangements.
- Inspection rights.
- Buy-outs – mandatory or optional.
- Events triggering buyouts.
- Take me along; drag along rights.
- Other minority ownership issues.
- Restrictive covenants – nondisclosure; noncompete and nonsolicitation.
- Resolution of disputes/conflicts.

C. Sale to Family

- Sale to family generally entails passing on benefits of business to next generation.
- Favorable only if donative intent as to next generation and interested capable heirs.
- Could create friction within family.
- Generally involves financing sale through business receivables.
- Involvement of selling owner with business.
- Receipt of payment at risk of business success.

D. Sale to Employees

- Need to identify key employees to assume control.
- Will not likely have independent financing.
- If obtaining outside financing, will have to secure loan for purchase price with assets and accounts receivable of business.
- Selling owner may have to guarantee loan.
- Financing could be through a take-back promissory note to seller.
- Payments may be made through payroll withholding from employees.
- Seller will need to stay involved with business to protect interest.
- Consider staged sale: 51% in initial sale (to capture control premium) and 49% later.
- Seller will want to retain certain authority over company with shareholder agreement to protect interest until sell out entirely.
- Consider hybrid sale with part to core management and part to ESOP.

E. Sale to Unrelated Third Party

- Frequently the best option, if available.
- May pay premium if a strategic buyer as opposed to a financial buyer.
- Will obtain own financing.
- Except as to earnouts, payment would not depend on future success of business.
- Any future involvement with business would likely be minimal and/or limited to a short period of time.
- Provides complete exit.
- Will allow seller to reinvest proceeds and move on to other endeavors.
- Strictly a business deal.
- No emotional component (except as to departing from the business).

F. Sale to an ESOP

1. What is an ESOP?

- An Employee Stock Ownership Plan is a retirement plan in which the assets are invested in company stock.
- A Trust is established under the ESOP to purchase and hold shares.
- Consideration should be given to appointing an independent trustee to represent the ESOP in the sale
- The trust typically loans money from a financial institution to purchase shares.
- However, take-back financing from the seller(s) is also possible.
- The purchased shares are held as collateral for the acquisition loan.
- The ESOP provides for allocation of the shares to employee accounts as the loan is repaid.
- Employees vest in their accounts under a vesting scheduled.
- Employees become entitled to distribution of vested account balance following termination.
- Company must offer to repurchase the shares.

2. Pros and Cons of ESOP Sale.

- Establishes an employee ownership culture.
- If bank financing is obtained, may provide upfront cash to selling shareholder.
- However, financial institution may require guarantee from selling shareholder.
- Company gets a deduction for loan payments.
- No taxation of employees until distribution from ESOP.

- Selling shareholder of a C corporation may be able to defer taxes on sale under IRC 1042 if ESOP holds over 30 percent of company and timely election and reinvestment is made.

- ESOPs holding S Corporation shares may exempt the ESOP's share of business income from federal income taxation

- The ESOP is governed by ERISA, which imposes numerous rules on the operation of the ESOP and fiduciary duties on the trustee and administrator of the ESOP.

- A valuation by an appraiser is required for the sale transaction and annually thereafter.

- Prohibited Transaction penalties may apply if ESOP pays more than "adequate consideration" or if the terms of the purchase loan are not fair to the ESOP and its participants.

3. When is an ESOP appropriate?

- Generally, an ESOP would be appropriate only for a company which has potential for growth by incentivizing employees and which has a value that justifies the expense of the transaction.

- Provides opportunity for current stockholders to sell a portion of their equity and still maintain control.

- Further, there would need to be management employees capable of running the company when the selling shareholder(s) depart.

- Because shares must be allocated uniformly under the ESOP to all participating employees based on compensation levels (up to the maximum permitted by tax law), in many instances additional equity is granted or sold to the key management employees.

G. Tax Considerations

- Tax Treatment of Owner Selling to Employees: Partnership or LLC; S-Corporation; C-Corporation.

- Tax Treatment of Employees Purchasing Interests: Bargain Purchase; Substantial Risks of Forfeiture; Section 83; Section 83(b) Election.

- Tax Treatment of Redemption of Owner Interests.

- Tax Treatment of Owner Selling to ESOP: Section 1042.

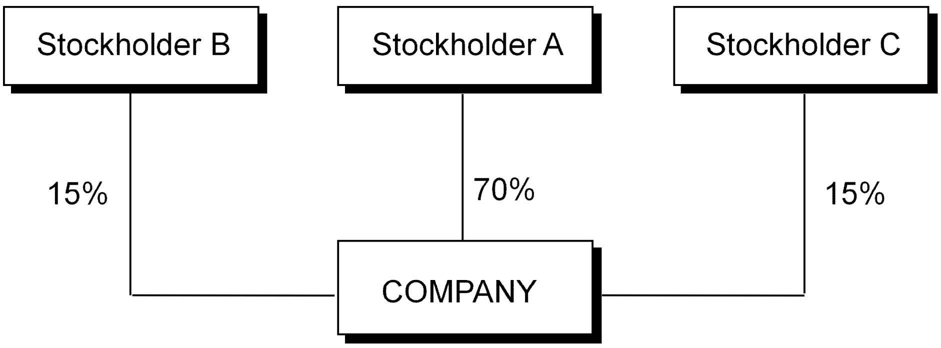
H. Sample Sale Structures for Discussion

- See Exhibit A attached.

- See Exhibit B attached.

EXHIBIT A

PURCHASE (REDEMPTION) OF OWNER'S STOCK BY CORPORATION



<u>Facts</u>: Stockholder A is the President, CEO and 70% stockholder of Company, which is a mechanical contractor. Company is an S corporation. Each of Stockholders B and C is a key employee of Company and owns 15% of its common stock, having purchased such stock 5 years ago for a bargain purchase price.

<u>Proposal</u>:

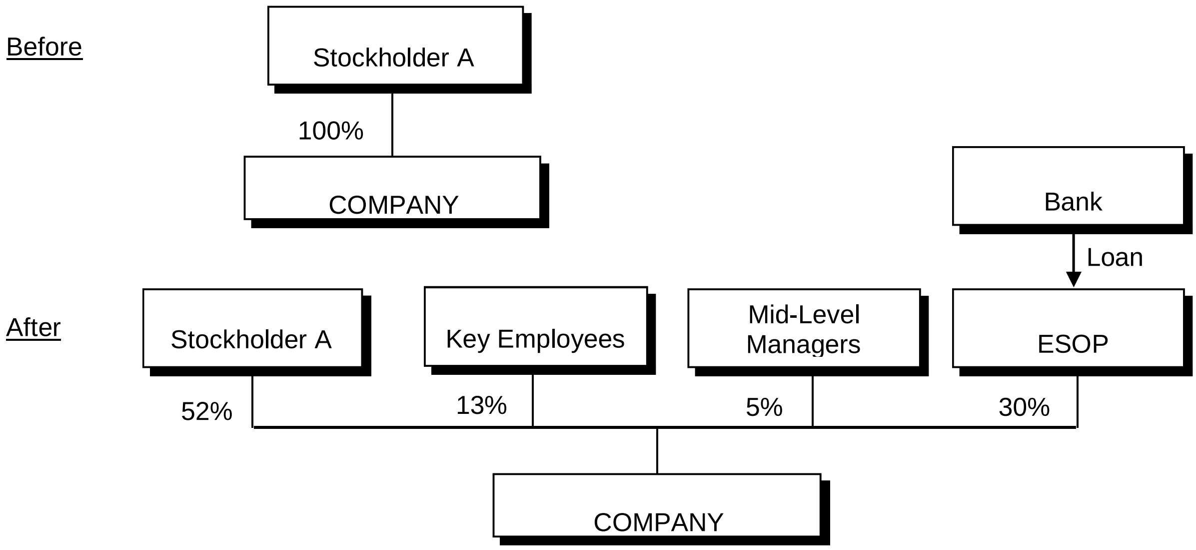
Purchase (redemption) by Company of Stockholder's A common stock for $10 million. Company makes a down payment of $3 million, with the balance payable under a 7-year promissory note of Company.

The promissory note will be secured by the stock purchased, and $1 million of the note will be guaranteed by B and C.

Stockholder A will continue as Chairman of the Board, B will become CEO, and C will become President.

EXHIBIT B

SALE OF STOCK TO MANAGEMENT AND ESOP



<u>Facts</u>

A is the 100% Stockholder of Company, an S corporation.

A wants to start shifting his equity interest to employees, but wants to retain control.

<u>Proposal</u>

A newly-formed ESOP obtains a bank loan and purchases a 30% stock interest from A.

A group of key executive employees purchases a 13% stock interest in Company for a FMV purchase price, paying for the stock on a deferred basis. Such stock is subject to forfeiture restrictions; that is, the employees must continue to be employed by Company for a period of years before they will realize the full value of the stock upon repurchase by Company.

A group of mid-level management employees are granted stock options to purchase a 5% stock interest. Such options are exercisable gradually over a period of years.

This could be the first step in a succession plan in which stockholder A will eventually become divested of all stock ownership.

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Using ESOPS to Fund Owner Buyouts and Provide Business Capital

Paul T. Kaplun
John A. Wilhelm

VENABLE LLP

What Is An ESOP

- An ESOP is a tax-qualified employee retirement plan (similar to a 401(k) plan).
- Instead of mutual funds, etc., employee accounts are primarily invested in the employer's stock.
- A trustee is the legal owner of the stock and votes the stock (although participants can direct the vote on mergers, recaps, etc.)
- Growth of accounts is tax-deferred.
- Employees vest in their accounts over time
- Upon termination of employment, employees receive distributions of their vested accounts.

Why Your Clients Might Have Interest in Establishing an ESOP

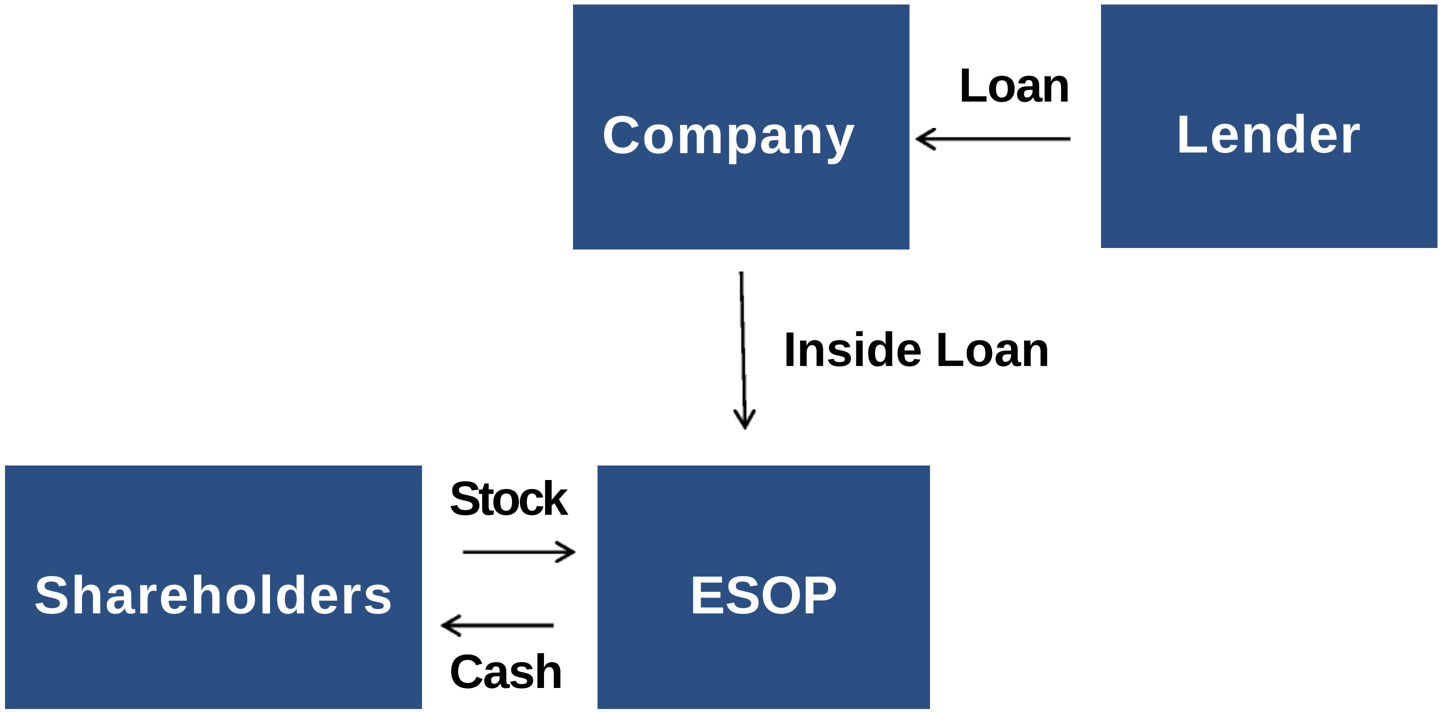
- An ESOP can provide a market for acquiring a founder's stock.
  - In a C Corporation, the sale to the ESOP can be on a tax-deferred basis with a so-called 1042 election.
  - In an S Corporation, income of the business on shares held by the ESOP is tax-exempt.
- ESOPs can be part of a succession plan.
- An ESOP could also be established to acquire newly issued shares on a tax favored basis from the company to provide capital.
- ESOP's incentivize employees to act like owners.

Overview of How to Establish a Leveraged ESOP

- ESOP borrows from a bank, either directly or in a "back-to-back" loan via the company.
- ESOP uses loan proceeds to purchase employer stock
  - o Can purchase newly issued or treasury stock from the employer, to provide a source of capital for the company.
  - o Can purchase stock from an owner, to serve as a liquidity source for buyout of the owner.

Overview Cont'd

- **Summary of "Back to Back" Leveraged ESOP Transaction**



Overview Cont'd

- The purchased stock is collateral for the bank loan.
  - ESOP maintains the purchased stock in an “unallocated” account. Each year, the employer makes contributions to the ESOP for the benefit of its employees.
  - The ESOP uses the employer contributions to repay the loan. As the loan is repaid, shares are removed from the “unallocated” account and allocated to participants.

Non-leveraged ESOPs: An Overview

- Non-Leveraged ESOP: not a capital raising or owner buyout device.
  - ESOP does not borrow funds, and does not make an upfront acquisition of employer stock.
  - The employer issues and contributes stock each year. The stock is allocated to participant accounts as it is contributed.

Leveraged ESOPs: List of Players

- Company, ESOP consultants, legal counsel and valuation adviser.
- ESOP institutional trustee, with appointed ESOP counsel and appraiser.
- ESOP record keeper.
- Company legal counsel.
- Lending bank and its legal counsel.
- Need to determine allocation of costs of transaction between employer, selling shareholder (if applicable) and ESOP.

Leveraged ESOPs: A Closer Look

- Employer adopts ESOP.
- Employer appoints ESOP institutional trustee to negotiate stock purchase.
- ESOP institutional trustee appoints appraiser and counsel.
- ESOP uses bank debt, and often a note to the selling entity, to purchase Employer stock from the employer or its owners.
- Effective after the transaction, the Employer appoints new “internal” ESOP trustee or continues institutional ESOP trustee on an ongoing basis to hold shares.

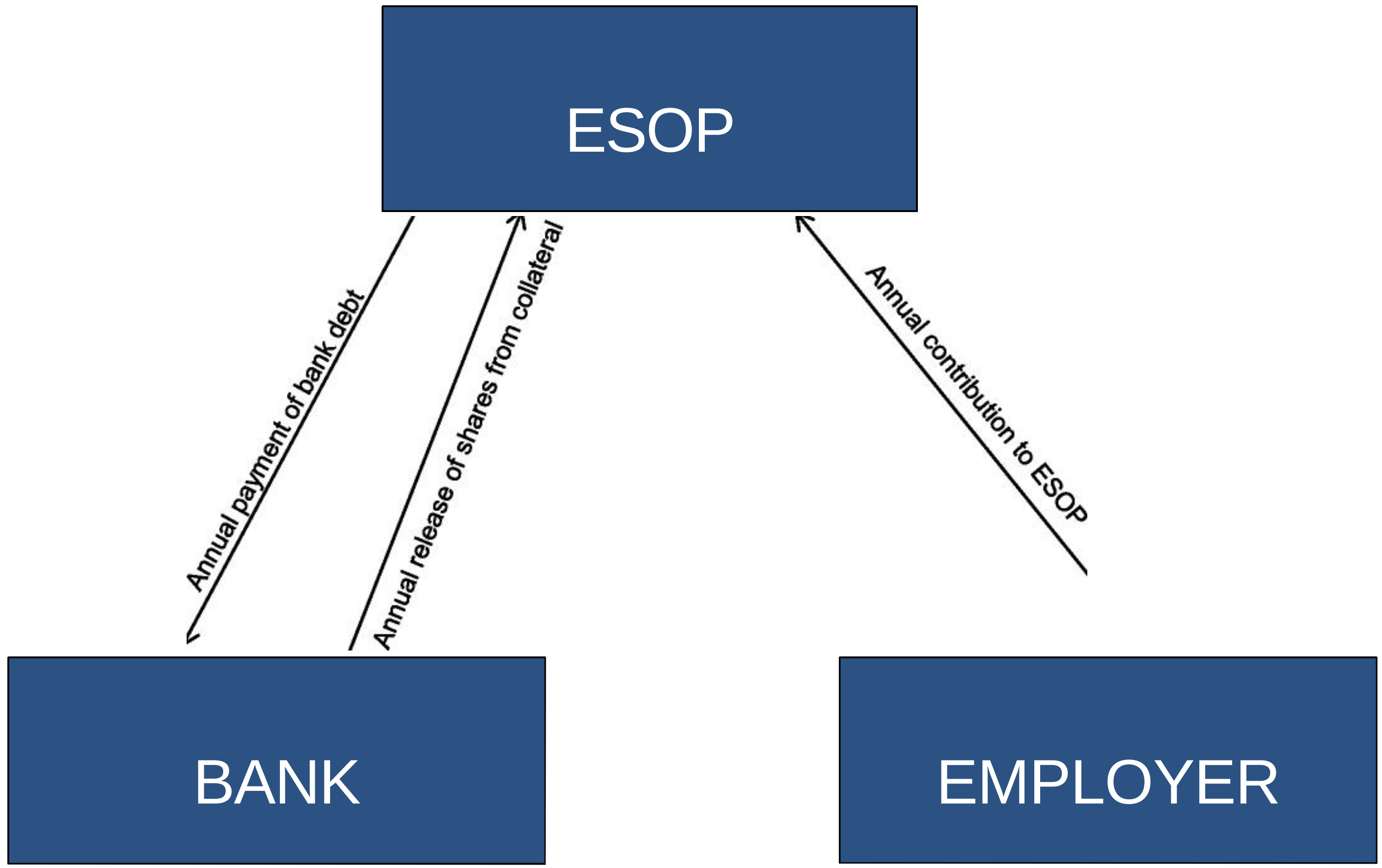
A Closer Look Cont'd

- Bank loan may be directly to the ESOP, or a back-to-back loan to the employer (which loans to ESOP).
  – The Bank may require a guaranty from employer and possibly selling shareholder (if applicable).
  – In a back-to-back loan, the Bank may also require a security interest in the employer's assets.
- Instead of purchasing 100% of the stock, the ESOP could purchase only a portion of employer's stock. However, to qualify for Section 1042 nonrecognition treatment, the ESOP must purchase at least 30%. To avoid a minority discount, the ESOP must purchase at least 50%.

A Closer Look Cont'd

- Pledge of Shares: Shares purchased with loan proceeds are pledged as collateral for the loan.
- Sources of Loan Repayment
  - Typically, annual contributions are used to make loan payments.
  - Dividends may also be used by the ESOP to make payments on the loan.
  - In the case of a C Corporation, Employer receives preferential deduction treatment for such dividends.

A Closer Look Cont'd



A Closer Look Cont'd

- Stock purchased with loan proceeds will be pledged to lender as collateral for shares.
  - Each year a portion of pledged shares will be released from collateral by lender based on portion of loan payments paid that year.
  - Two possible release formulas: one based solely on principal paid and the other based on principal plus interest paid.

A Closer Look Cont'd

- Shares released are generally allocated annually to ESOP participant accounts based on pro-rata amount of compensation. However, if loan payments are made with dividends on stock allocated to participant accounts, released shares are allocated to those accounts.
- ESOP can require a year of service and age 21 to participate
- ESOP can also require up to 1000 hours of service and/or employment at year end to participate that year.

Non-Recognition of Gain under Section 1042 of the Internal Revenue Code (C Corporation ESOPs)

- Shareholder sells appreciated C corporation stock to an ESOP.
- After the sale, the ESOP must own at least 30% of the outstanding common stock of the C corporation.
- Shareholder uses proceeds to purchase “qualified replacement property” within 3 months before or 12 months after the sale to the ESOP.
- Section 1042 defers recognition of long-term capital gain until disposition of the qualified replacement property.

Non-Recognition of Gain under Section 1042 of the Internal Revenue Code (C Corporation ESOPs)

- Qualified replacement property must be a security (equity or debt) issued by an operating common, not a passive investment vehicle such as a mutual fund.
- Basis in qualified replacement property is reduced by the amount of deferred gain.
- Shareholder files Section 1042 election by tax return due date (including extensions) for the year of sale.

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Non-Recognition of Gain under Section 1042 of the Internal Revenue Code (C Corporation ESOPs)

- The employer must agree to the 1042 election, because the employer is subject to an excise tax if the ESOP holds the acquired stock for less than 3 years.
- An excise tax also applies if shares purchased by the ESOP are allocated to the selling shareholder or a family member within 10 years following the sale (or if later, before any loan used to acquire the stock is repaid in full).

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S Corporation ESOP Anti-Abuse Rules

- S corporation ESOPs are subject to anti-abuse rules designed to prevent owners from avoiding taxes (through use of ESOP) while maintaining control (indirectly through their ESOP account).
- If “disqualified persons” own at least 50% of the S corporation stock during a plan year, no S corporation stock may be allocated to disqualified persons during the plan year.
- “Ownership” includes shares held through the ESOP (whether allocated or unallocated), and “synthetic equity.”

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Corporate Governance

- ESOP Trustee is in same position as shareholder in a corporate structure:
  - Legal owner of the ESOP held shares in Employer.
  - Votes on issues requiring shareholder approval such as election of directors and officers, mergers, reorganizations, etc.
  - Participants must be permitted to anonymously direct the Trustee as to the vote on mergers, reorganizations, and similar transactions.
- Board of Directors sets corporate policy on Employer and Officers carry out corporate policy.

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Effect of ESOP Transaction on Valuation

- Leveraged ESOP transactions have a substantial effect on the company's valuation.
- Debt incurred in a leveraged ESOP transaction typically must be recorded on the company's balance sheet (whether the company incurred or guaranteed the debt, or is expected to satisfy the debt through future contributions to the ESOP).
- Therefore, the ESOP loan usually causes the per-share value of the company to decline, often substantially below the per-share amount paid by the ESOP.
- This will dilute any owners who do not sell to the ESOP until the loan is substantially repaid.
- Floor-price protection can be used to protect existing ESOP participants from diminishment in valuation upon second-stage purchases.

Distributions

- ESOPs must generally provide terminating participants a right to have account distributed in stock.
  - However, solely cash can be distributed by ESOPs of S corporations and companies whose governing documents limit ownership substantially to employees.
- Non-publicly traded companies must permit diversification of a portion of accounts, either by distribution or transfer to other investments, by participants who are over age 55 with 10 years of ESOP participation.

Distributions, cont'd.

- Non-publicly traded companies must provide a put right under which a participant can choose to sell the stock back to the company. (The ESOP often elects to purchase the stock, instead of the company doing so.)
- Whether an ESOP is sponsored by a C corporation or an S corporation, consideration must be given to ensure that there will be sufficient future liquidity to handle payments to departing participants.