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Strategic Business Perpetuation – A Look at ESOPs from the Surety's Perspective

Alec Gumpfer | Account Executive

Inevitably, every business owner will have to address the question of, "What's next?" This can be a complicated and difficult question to answer when it comes to perpetuating a business. Business owners these days have enough on their plates as they navigate an ever-changing and demanding business landscape. Complicating things further are myriad potential perpetuation strategies that include gifting shares, selling outright to a third party, or the creation of an employee stock ownership plan (ESOP), to name a few. There is no one-size-fits-all solution; each perpetuation strategy has its own respective advantages and limitations.

ESOPs, specifically, have gained significant traction in recent years as a popular solution. When properly structured, an ESOP can provide several benefits for all parties. But when improperly structured, an ESOP could strain ongoing operations and be detrimental to the company's surety bonding program. In this article, we will walk through the general structure of leveraged ESOPs, the potential benefits, and the challenges they present from the surety company's perspective.

ESOP STRUCTURE AND MECHANICS

An ESOP is a qualified retirement plan subject to ERISA regulations in which employees will purchase company stock from the current owner via an established trust. To assess the viability of an ESOP, a company will conduct a general feasibility study, relying on rough estimates of stock value, to establish a buyout timeline and determine whether the company will have adequate cash flow to support the plan.

If an ESOP is viable based on financial projections, the next step is to conduct a formal valuation of the company's stock and establish the overall ESOP structure. Once a plan is formalized, the company will create a trust operated by a trustee (or trustees) appointed by the company.

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In a leveraged ESOP, the most common form, the company borrows money from either a bank or the selling shareholder(s) and re-lends the loan proceeds to the ESOP trust. The ESOP trust uses those funds to purchase shares from the existing shareholders. The buyout process can be completed either all at once or over a specific period of time, where shareholders sell certain percentages of their shares on a schedule tailored to their needs.

For the ESOP trust to pay back the company and the company to pay back the lender(s), the company will make cash contributions to the ESOP trust from earned profits. The ESOP trust then uses those funds to pay down its loan from the bank or other lender, and so on and so forth, until the loan is paid in full.

ESOP BENEFITS

Finding the right buyer for a closely held company isn't always easy, even if the company is highly profitable. An ESOP, however, can help shareholders create a market in which to sell their ownership interest and provide long-term employees with the benefit of equity in the company. In a tight labor market where many companies are struggling to hire and retain quality employees, an ESOP could provide an attractive incentive for key employees.

In addition to the ownership incentives, there are many tax benefits for both seller(s) and the company. Owners that sell shares to the ESOP can defer and potentially avoid capital gains taxes. Furthermore, the portion of the company owned by the ESOP trust could be exempt from federal or state income taxation. An ESOP's tax benefits hinge on a number of factors, but a tactfully structured plan can yield impactful tax savings.

ESOP SURETY CHALLENGES

As with any business perpetuation plan, an ESOP presents challenges, especially in the eyes of a surety company. The creation of additional leverage combined with a change in ownership can lead to serious concerns regarding the company's ability to fulfill debt obligations and continue profitable operations. Leveraged ESOPs can be structured in a way that satisfies a surety's requirements, but that planning should begin in the early stages of forming an ESOP – starting with the company's stock valuation.

The valuation is a pivotal step and often the root problem of unsuccessful ESOPs. With different valuation methods and several variables, there is significant flexibility in determining the final value of a company's stock. This can lead to an inflated valuation, resulting in a substantial amount of corresponding debt to finance the ESOP, and consequently, significant pressure on the company and ESOP participants.

It's important to note that ESOP participants are interested in future earnings of the business, not historical profits. With the construction industry's cyclical nature, can you accurately and confidently predict profits three, five, or even ten years from now? Ultimately, successful ESOPs are driven by a fair valuation that provides the selling shareholders with adequate compensation for their equity while ensuring that the company and ESOP participants can properly service the associated debt without excessive pressure.

The other primary hurdle to overcome is indemnity. ESOP trusts are unable to indemnify because they are exempt from creditors per ERISA regulations. In most ESOPs, the surety is left looking at a heavily leveraged entity, a trust that cannot provide indemnity, and key members soon exiting the company. This is an uncomfortable position for the surety, which will look to bridge the financial gap to continue providing bonding support.

The first way to mitigate concerns lies in the ESOP's financing structure. Surety companies will always prefer

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the ESOP to be financed by the seller(s) instead of a bank due to increased flexibility and limited third-party involvement in the transaction. The surety will then look to subordinate the note payable for the stock purchase so that they can add that amount to the company's equity in their financial analysis, helping to mitigate debt obligation concerns. In some cases, a surety will also look for the seller(s) to provide personal indemnity for a period of time after the initiation of the ESOP. The selling shareholders' personal indemnity serves both as a confirmation of their commitment to the company's success after their departure and an additional financial cushion.

NEXT STEPS

Though ESOPs have recently gained more traction, they remain complex continuity vehicles that can pose numerous problems when securing surety bonds. Every company is different and without any clear-cut rules for a successful ESOP, securing the proper guidance and intellectual capital to make an informed business decision and mitigate surety concerns is paramount. Whether you're considering an ESOP or just starting to develop any continuity plan, please reach out to **Parker, Smith & Feek's Surety Department** for counsel to make informed decisions and protect your surety credit program.