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ESOPs and Surety Companies: Considerations for Contractors Requiring an Attractive Exit Option

Selling a company to employees combines stability and financial benefits for the contractor and the company.

BY PATRICE RADOGNA

A SMOOTH AND well-planned exit is imperative for construction company owners, and identifying the best option in a financially sound manner that ensures the longevity of the company is of paramount importance to contractors, as well as the surety companies that bond them. Employee Stock Ownership Plans (ESOPs) have become a hotly trending choice for the construction industry, as a way to satisfy the needs of both present and future stakeholders.

ESOP as an Attractive Exit Option

Typical exit options, such as sale to a third party, key management, or private equity fund, are often not a good fit or are not financially feasible for construction companies. An alternative is for shareholders to sell their company, in whole or in part, to an ESOP. This trend has caught the attention of sureties, which see the advantage of an employee-owned company, coupled with certain economic and tax benefits, as an attractive way for a selling shareholder to exit, while keeping the construction company operating for potentially years into the future with the same key people who have historically run the company.

Mechanics of an ESOP

An ESOP is initiated when a legal entity (a trust) is formed to hold the stock for the benefit of employees. An ESOP utilizes the resources of the company's own balance sheet to fund either a partial or a full buy-out from the exiting shareholder. The owner is able to access the desired liquidity from a "ready market" (the ESOP) that can back the purchase of stock for the exiting shareholder. Further, with this buyer, the legacy and successful culture of the firm stays with the people who have helped build it—the employees.

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Benefits of an ESOP

There are many positive non-financial reasons why ESOPs have proven to be a great exit option for selling shareholders. The most essential of these include the following:

- Allows owners to sell their company to their employees rather than an outside investor, competitor, customer, etc.
- Selling owners can remain in the company to implement a leadership succession plan.
- Employees will become owners and think like owners (a great retention tool in an industry plagued by labor retention issues).
- The company will not be dismantled by a third party who might lay off employees.
- The selling shareholder will leave a positive legacy in the community, with the company surviving the transition to new ownership.

One of the significant financial reasons why ESOPs make great economic sense for companies is that an ESOP provides significant tax benefits,[1] resulting in increased cash flows. As a sanctioned retirement plan, an ESOP is technically a tax-free trust; and ESOP-owned companies pay greatly reduced or no income taxes.

Financial Considerations for an ESOP-owned Company and its Surety

When the company buys shares of stock from the selling shareholder, it utilizes its balance sheet to fund the purchase. Thus, post-transaction, the company becomes a leveraged entity. This is an important consideration, as one of the most important concerns for construction companies that bid on public work is their bonding capacity. As discussed in an article by

Joseph Natarelli and James Miller[2] in the Fall 2019 issue of *Surety Bond Quarterly*, financial strength is, *prima facie*, an all-important factor to help contractors improve their bonding qualifications. Prudent financial planning, including financial benchmarking analysis and strong tax planning, are key factors in maintaining—or increasing—a contractor's bonding capacity.

The comprehensive planning of a multitude of factors is beyond the scope of this article. However, one aspect, leverage, is worth a closer look.

It is true that a company will often finance the purchase of shares from a departing shareholder. However, the economics underlying ESOP debt are very often more beneficial than other types of debt options. The benefits include the following:

- Enhanced cash flows to pay for ESOP-related debt. For S corporations, the pre-tax income of the company, attributed to the shares owned by the ESOP trust, is nontaxable. At its maximum benefit, an ESOP trust that owns 100% of the company stock pays no federal income taxes.[3] For S corporations where the ESOP does not hold 100% of the stock, there is a tax benefit related to ESOP leverage instead. With an ESOP in place, in addition to the interest, the principal payments (related to an ESOP loan) are also tax deductible.
- Lower risk resulting from tax-related cash flow. Experienced lenders in the ESOP field understand the significant tax-related cash flow benefits of an ESOP, which can lower its risk. In fact, the default rate for ESOPs is known to be significantly lower than default rates on commercial loans. A 2017 study by the National Center for Employee Ownership (NCEO) of 1,232 leveraged ESOP transactions at three large banks found that 1.3% of ESOP companies defaulted on their ESOP loans in a way that imposed losses on their creditors, for loans in effect between 2009 and 2013 (or an annual rate of 0.2%). Twenty-six (3.1%, or an annual rate of 0.6%) had to restructure their loans but had repaid or were repaying their loans at the time of the study.[4]
- Seller's notes in place of or in conjunction with commercial loans. Selling shareholders often choose to limit the debt from traditional senior debt lenders. Or, the senior debt, by formula, is only a portion of the total debt in a transaction. In these cases, the selling shareholder is often willing to accept a subordinated note (as opposed to cash) and delay the remainder of the payout over a course of years (anywhere from seven to 15 years could be seen as a reasonable range for seller's note terms). The bank considers the seller's note as "friendly debt," as it is subordinate to the senior debt and it has equity-like features. Seller's notes have become ubiquitous in 100 percent-ESOP transactions.

It is critical that surety companies examine and consider the above factors regarding the unique attributes of enhanced cash flows, along with the flexible, junior stature of seller’s notes. This should be considered when the bonding company is examining potential factors that impact the net worth of a contractor, which then heavily influences a contractor’s bonding capacity.

Why Sureties Like ESOPs as an Exit Option

In a potential transition, surety companies focus on the continuity of the company, looking for employees to be highly invested in the operation. Natarelli and Miller’s article mentions various aspects that are of utmost importance to the longevity and health of a construction company, for which an ESOP has a positive impact. Certain key factors include the following:

- Surety credit/bonding capacity is not a "one size fits all" formula; the calculation to determine the bonding capacity of a company is contractor-specific and is based on risks determined through review of a contractor’s reputation, experience, and organization. While working capital and net worth are critical factors, the longevity of the company and investment in key people (post-transition) are key factors that cannot be ignored.
- Regarding the financial scorecard (financial ratios, etc.), the enhanced cash flows (with up to 60% higher cash flows for tax-free ESOP companies than companies that pay income taxes) as well as the flexible nature of the seller’s notes must be taken into consideration regarding net worth.
- Elimination of any surprises. Timely meetings and planning to lay out a well-thought out exit plan and identifying the next generation of project managers and employees who will lead the company is a positive way for the surety to understand the mindset/commitment/morale of the employee-owned company.

ESOPs as a Strong Choice

Many construction companies are multi-generational, yet rising generations may not represent viable future ownership, as younger family members often opt for different career paths, or their skills and talents are not well suited to the construction industry. Top management may be interested but insufficiently funded to step up as buyers. At the same time, owners are often fiercely loyal to their families and long-time employees and have the desire to perpetuate the company. The construction industry’s intertwined culture of pride and longevity creates an ideal environment for employee ownership, while the economic benefits make this exit option much more financially feasible than is often understood and should certainly be considered.

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End Notes

1 A sale to an ESOP can provide significant tax benefits to the selling shareholder, as well as providing significant tax benefits to the company. A qualified sale can result in the deferral or avoidance of 1042 capital gains tax. The detail behind this tax treatment is beyond the scope of this article but is an important element for consideration.

2 "Increasing Bonding Capacity and Maximizing Surety Credit," Joseph Natarelli & James Miller, *Surety Bond Quarterly*, Fall 2019, p.32, **www.suretybondquarterly-digital.com/sbpq/0319_fall_2019/MobilePagedArticle.action?articleId=1520995#articleId1520995**.

3 For those S corporations where the ESOP owns a pro rata percentage of the company, the taxfree benefit is limited to the pro rata portion of the company owned by the ESOP. Thus, the optimal tax savings for an ESOP comes when the ESOP trust owns 100% of the company.

4 *See* **www.nceo.org/articles/default-rates-esoploans-2009-2013**, published by NCEO on March 8, 2017. Loan sizes ranged from $1-$50 million. Companies were in a variety of industries, including manufacturing, wholesale, and construction. The number of employees ranged from fewer than 50 to several thousand.