EMPLOYEE STOCK OWNERSHIP PLANS FOR CONSTRUCTION COMPANIES

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In recent years, a growing number of construction companies have established employee stock ownership plans (ESOPs).[1] The interest in an ESOP is often generated by the need for an exit strategy for one or more of the owners of a closely held business, a common scenario in the construction industry. Because private equity buyers are rarely interested in construction companies and because construction companies seem less likely to sell to competitors than companies in other industries, the construction industry seems particularly drawn to ESOPs. In circumstances where the business is not easily sold to a third party and/or the owners have a desire to provide for continuity, an ESOP can be a great solution.

ESOPs provide a tax-advantaged path for an exit strategy, and they can provide liquidity for owners that may not be easy to obtain in a sale to a third party. ESOPs help build an ownership culture and incentivize employees to grow the company. As a related matter, they can be a useful retention tool. The increased cash flow generated by reducing or eliminating taxes can be critical to the sustainability of the company.

There are unique issues that construction companies need to address in implementing an ESOP, particularly with regard to sureties and any new debt that is incurred by the company to complete the ESOP transaction. The following provides a background on ESOPs and an analysis of issues affecting construction companies.

BACKGROUND

An ESOP is a type of tax-qualified retirement plan that primarily invests in employer stock. Like other retirement plans, the ESOP is governed by the terms of a formal plan and trust documents. The ESOP buys shares from selling shareholders, the company, or some combination of both. In a leveraged transaction, the shareholders typically sell their stock to the ESOP. The ESOP will usually purchase the stock through a combination of seller notes and

cash borrowed from the company, which in turn will often borrow money from a bank.

Employees are usually allowed to participate in an ESOP after completing a year of service and will have shares allocated to their account for each year of service they continue to provide. Through additional allocations of stock and increases in share value, employees can accumulate significant tax-favored retirement savings over time. Employees are able to access their retirement savings in an ESOP after they retire (or, with some limitations, terminate their employment) and can generally roll over these funds to another retirement plan or IRA. The company has the flexibility to tailor the ESOP and its distribution policy to the needs of the company and employees through different eligibility, vesting, and distribution options.

There are several tax advantages to an ESOP. One such advantage is that contributions by the company to the ESOP to enable the ESOP to repay the promissory note are tax deductible (up to certain limits); thus, a loan used to finance an ESOP transaction can be repaid with pre-tax dollars. Additionally, a selling shareholder of a C-corporation may be able to elect Internal Revenue Code Section 1042 tax-deferral treatment of the capital gains associated with the sale of his or her shares, subject to certain requirements. Finally, for companies that elect S-corporation status, the ESOP's share of recognized earnings is ordinarily exempt from income taxes. The goal for most ESOP-owned companies is to eventually become a 100 percent ESOP-owned S-corporation, thereby achieving the best possible tax status.

To start the ESOP process, companies will usually obtain a feasibility study that considers valuation, transaction size, financing, surety program impact, and the expected benefits delivered to employees over time. The ESOP process will also ordinarily consider the long-term goals and related incentives for management, including any management transition issues.

ISSUES UNIQUE TO CONSTRUCTION COMPANIES

Maintaining Continuity

Many construction companies are closely held companies that do not have a business continuity plan. They may be owned by the founder or a small number of shareholders who are not working for the company. An ESOP can provide continuity by establishing a market for the purchase of shares.

Incentivizing Employees

An ESOP is designed to provide employees with "skin in the game," thereby incentivizing them to increase the value of the company stock and their beneficial ownership. As the number and value of shares allocated to an employee's ESOP account grows, employees will see the dollar value of their account grow as well. It is not uncommon for long-term employees to be able to accumulate significant wealth in an ESOP. Given labor shortages in the construction industry, an ESOP can provide an important retention tool and incentive for employees to remain employed with the company and pursue long-term growth. Also, because union employees can be excluded from participating in an ESOP, an ESOP may also reduce employee interest in unionization.

Increasing Cash Flow

In certain settings, an ESOP can be an effective tool for increasing a company's cash flow. A contractor can reduce its corporate income taxes and increase its cash flow and thereby its net worth through an ESOP structure. For the first few years, this increase in cash flow will likely be used for repayment of any bank debt. If the contribution to the ESOP is made in lieu of contributions to a 401(k) plan, the cash flow savings are even greater. The additional cash can be used to finance projects and the growth of the business.

Satisfying Surety Bond Requirements

Construction companies are often required to obtain surety bonds to guarantee a project owner that the contractor will comply with the terms and conditions of the contract. Surety companies will ordinarily

conduct an extensive underwriting review of the contractor and continue to do so periodically while the bond is in place. The underwriting review will consider the contractor's financial condition, structure, experience, and capacity to meet the requirements of the contract. The surety company will typically focus on the maintenance of a certain amount of working capital and sufficient net worth to support the construction company's business. Sureties may require financial statements from a construction-oriented accounting firm on a reviewed or audited basis. They will be interested in work in progress and the status of projects. A construction company will usually be required to execute an indemnity agreement in favor of its surety, which may include a personal indemnity/guaranty by one or more of the company's owners that obligates the indemnitors to protect the surety from losses.

Because surety bonds typically contain financial covenants or provisions stating that a change of control is a default, existing surety bonds will likely require the consent of the surety for change of control. Construction companies considering an ESOP should begin discussions with their surety in the early stages of the transaction. Depending on the surety's familiarity with ESOPs, this education process can take time and is best done with the help of professionals who specialize in ESOPs and can adequately communicate the ESOP deal structure and the benefits of ESOPs.

Cons

If a company borrows money and then lends this money to the ESOP to purchase company stock, the loan will be a liability that will reduce the company's net worth, and this loan could also affect surety bond requirements. However, these issues can largely be addressed through subordination of notes owed to sellers. Companies do have to be mindful of repurchase liability, but the right distribution policy and repurchase liability plan can address this issue.

CASE STUDY

Jones Construction Company, founded in 1985 by John Jones Sr. (John), is a family-owned construction firm specializing in commercial and residential projects. John owns 80 percent of the stock, and his children John Jr. and Jane each own 10 percent. Over the years, the company has established a strong reputation for quality craftsmanship, reliability, and client satisfaction. As John nears retirement age, he faces the challenge of succession planning and ensuring the long-term sustainability of the business. His children are not interested in running the business. Traditional succession options, such as selling to a competitor or private equity firm, pose challenges in terms of maintaining continuity and employee retention and morale. The company does have three managers and a CFO who together are well-positioned to grow the business.

John decides to explore the possibility of implementing an ESOP as a succession strategy. He engages ESOP counsel and an ESOP advisor to conduct a feasibility analysis. The analysis assesses the company's financial performance, potential valuation, and readiness for ESOP adoption. Based on the analysis, John decides to sell all of his shares of the company to the ESOP; the children will sell their shares as well. The company undergoes a search process and selects a trustee for the ESOP; the trustee retains its counsel and a valuation advisor.

The transaction proceeds through negotiations with the ESOP trustee. The company is able to arrange partial financing through a bank that is familiar with ESOPs; the remaining financing will be through seller notes. Since John anticipates considerable future company growth, his advisor negotiates for the issuance of warrants. John will also remain employed by the company for five years and will be required to sign a noncompetition agreement.

The company is bonded through ABC Surety Company, and John has personally guaranteed the surety bonds. Based on the company's financial position and favorable cash flow, the surety company agrees to the proposed transaction and a release of the guaranty. The transaction will also require certain notices and consents including the consent of the landlord for the company's offices.

On the date of the transaction, the company will convert from an S corporation to a C corporation. As a result, John Jr. will utilize qualified replacement property in a Code Section 1042 transaction to defer the taxes on the sale of the stock. The children will not make a 1042 election.

Following the transaction, the company conducts employee meetings to educate employees about the ESOP, its benefits, and the impact on the company. The company continues with the same management and board, although, as negotiated, one of the three board members is a new, independent board member who works with an architectural firm. The company is well positioned for growth with significant tax deductions for contributions to the ESOP. After five years, the company will convert back to an S corporation.

CONCLUSION

ESOPs can be the right solution for construction companies, particularly closely held businesses where the selling shareholders have a need for liquidity and a desire to continue the business legacy to benefit employees.

Notes

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