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USING ESOPs AS AN ACQUISITION TOOL

The current press coverage of Sam Zell's proposal to acquire The Tribune Companies indicates that he plans to use a leveraged employee stock ownership plan ("ESOP") to do the deal. While we don't yet know the specific details of the proposal, the broad outlines of the general structure are fairly well-known in the ESOP world and should be of significant interest to private equity and other investors.

An ESOP is a qualified employee retirement plan designed to invest primarily in employer stock. An ESOP's earnings are tax-free. When an ESOP owns an S corporation, there are no federal income taxes at the corporate or ESOP-shareholder level. ESOPs can be used as a tool of corporate finance in a variety of ways. One way, which is becoming more and more popular in the M&A and private equity world, is to use an ESOP — S Corporation structure to acquire other companies.

In the kind of acquisition structure that is probably being used by the Zell/Tribune proposal, the ESOP will own a significant portion of an S corporation acquisition vehicle (the financial sponsor and management may also own a chunk). The investors will invest cash for equity and subordinated debt with a warrant (having up to 49% of the fully diluted equity) in the S corporation - neither the subordinated debt nor the warrant will be counted as outstanding stock for qualified S corporation shareholder purposes. The S corporation will borrow the senior debt and possibly other mezzanine debt from banks and institutions. The S corporation will re-lend the outside debt proceeds and its initial equity capital to the ESOP (inside loan) which will use them to buy the target stock and, in the case of a public target, take it private. In a public company target context, the selling shareholders will not be eligible for the tax-free sale treatment that is available for nonpublic company shareholders who sell to an ESOP, but they will be expecting taxable capital gains in any event.

The target becomes a "Q-sub" and so is thereafter ignored for tax purposes. The S corporation pays no taxes on its or the Q-sub's operating income over the ensuing growth years and neither does the ESOP on its pass-through share. In effect, principal repayment of the outside debt - which is funded with the S corporation's contributions to the ESOP - which in turn is used to repay the ESOP's inside loan — is with pre-tax dollars because the ESOP contributions are tax-deductible and there is no tax liability on operating income at either the target or the ESOP shareholder level. When the exit sale or IPO comes several years later, after the inside and outside loans (including the subordinated debt) have been repaid, the investor exercises its warrant and gets the benefit of the tax-free debt repayment and of the inside tax-free buildup in the value of the business of the target. In effect, the double tax-free impact of the S corporation/ESOP structure is to allow annual compounded tax-free growth of the target's business (without current taxation of operating income to the warrant holder).

Employees of the target company (and of other possible portfolio companies) will be mandatory participants in the ESOP and will be allocated target company shares as the ESOP inside loan is repaid (with contributions from the S corporation). On the exit, they will also profit from the tax-free growth of the target. From the investor's perspective, however, this structure is a very powerful financial tool inasmuch as such tax-free inside growth (shielded by the warrant) is not possible in any other business investment context. Private equity funds and other investors can very significantly boost their yields in transactions such as this. Moreover, the outside lending institutions will likely lend more to an ESOP-owned S corporation because of the ability to repay the debt with pre-tax dollars.