How to Plan to Sell Your Business
- Employee Stock Ownership (ESOP) and Ownership Transitions

Educational Series - Program 813
Tuesday, October 21, 2014
4:15 – 5:45

Topics

- What is an ESOP?
- Current state of ESOPs
- The basics of ESOP transactions
- Mini case studies
- Is an ESOP right?
What is an ESOP?

Key Points

→ A trust, not the workers, owns shares
→ Trust can own any portion of the company and can make multiple transactions
→ ESOP transactions are often financed
→ Transaction fees $90,000 (or much more)
→ Tax incentives for seller, company, and employees
→ Substantial regulation, but minimal requirements for employee governance
The ESOP Trust

Each ESOP is run by a trust.
The trust is a separate legal entity from the company.
The trust must operate “for the exclusive benefit of plan participants.”
Trustee and other fiduciaries: “prudent expert” standard.

Typical Trust Arrangements

• Who is trustee?
  Employee or employees  50%
  Outside institution  36%

• Independent or Directed?
  Independent  45%
  Directed  55%

• NCEO 2012 Corporate Governance Survey
ESOPs and 401(k) Plans

ESOPs are benefit plans.

Many of the same rules as 401(k) plans. Key exceptions:

→ ESOPs invest primarily in company stock
→ ESOPs can take loans

Employees do not use their own assets to acquire stock in an ESOP (with rare exceptions).

The good, the bad, the “meh”

**Advantages**
- Tax benefits
- Flexibility
- Reliability
- Performance

**Disadvantages**
- Regulation
- Capped at fair market value
- Repurchase obligation

**Tough call**
- Transaction costs
- Ongoing role in company
My enthusiasm for employee stock ownership plans (ESOPs) is prompted by two strongly held convictions.

First… the wealth of our nation should be more widely held…

Second… our capitalistic system should have a great many more capitalists.

Tax Issues

C Corporations
- The seller can defer capital gains tax.

S Corporations
- Possible shield for corporate income tax.
### The Current State of ESOPs

<table>
<thead>
<tr>
<th>RIGHTS</th>
<th>RESPONSIBILITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>To share in financial success of the company.</td>
<td>To contribute to the financial success of the company.</td>
</tr>
<tr>
<td>To question business practices that you do not believe are in the company's best interests.</td>
<td>To help find solutions and not just point out problems.</td>
</tr>
<tr>
<td>To have access to the information that illustrates how your actions and decisions affect company profitability.</td>
<td>To evaluate your actions and decisions from an ownership perspective.</td>
</tr>
</tbody>
</table>
A More Engaged Employee-Base

Companies with strong ownership cultures...

- **90%** of employees “care about meeting the customer’s needs.”
- **89%** “actively contribute to group problem-solving efforts.”
- **96%** are “willing to do extra work to get the job done” when the company needs it.

This data is from employee surveys conducted by the National Center for Employee Ownership and Ownership Associates of over 6,000 employees at over 40 companies.

More Satisfied Employees

Employee satisfaction at companies with a culture of ownership is almost 20% higher than the national average.

The national average is based on a 2010 survey of 5,000 U.S. households conducted for The Conference Board.

The ownership culture data is from employee surveys conducted by the National Center for Employee Ownership and Ownership Associates of over 5,800 employees at over 30 companies.
The Ownership Edge

Employee-owned companies with a strong ownership culture perform between 8% to 11% better than they would be expected to otherwise.

Employee Ownership Statistics

- 25% more likely to stay in business
- 2-5% higher productivity
- 25% higher job growth
- 4 times less likely to be laid off
What type of companies have ESOPs?

Common Industries

- Manufacturing
- Engineering
- Construction
- Banking

Size

- 22% 101-100
- 21% 51-100
- 10% 301-4,000
- 9% 1,000+
- 30% Up to 50

ESOP Defaults

Data from banks
- 1,232 loans (~40% of ESOP loans)
- From 2009 to 2013, 1.2% defaulted imposing loss on lender
- 0.2% annual rate

Data from valuation firms
- 845 loans
- 1.1% default imposing loss
- 3.1% restructure but continued paying
Latest Data

6,941 ESOPs
1,985 ESOP-like plans
Together:
  15 million participants
  $995 billion in plan assets

Current Events

Supreme Court ruling
  → Fifth Third v. Dudenhoeffer
  → June 25, 2014
  → Removes “presumption of prudence”
  → Creates standards for prudence

Department of Labor
  → Investigations
  → Proposed regulations
The Basics of ESOP Transactions

Transaction Basics

Establish ESOP trust

Trust acquires shares...

→... as direct contributions
→... by using contributed cash
→... by using money it borrowed
Sources of financing

- None
- Specialty lenders
- Banks
- Seller financing
- Gift
- 401(k) assets
- Collective bargaining / concessions

How Much Will the ESOP Pay?

- Price must not be higher than fair market value on a financial basis.
- The ESOP cannot pay synergistic value.
- Price is determined by an independent appraisal firm.
- Minority ownership sales are valued at less per share than control sales.
Valuation Methods

Asset

Income

→ 3 to 5 year projection

Comparison

→ Public companies
→ Private company M&A

Rules for Owners in Section 1042

✓ Stock must have been held for at least three years to be eligible.

✓ Only privately held C corporations qualify.

✓ 30% rule means ESOP must own 30% of all the stock after the transaction; synthetic equity (such as options) is considered as outstanding stock in making this calculation.

✓ Direct family members, sellers, and 25% owners cannot get an allocation of shares in the ESOP subject to the deferral of taxation. They can, however, if the seller opts not to take the deferral.
Mini Case Studies

Case Study: Windings, Inc.

- Founded in 1965
- Bought by Roger Ryberg in 1983
- 17% ESOP-owned in 1998
- 100% ESOP-owned in 2008
- Jerry Kauffman becomes CEO in 2008
- Board: Ryberg, Kauffman, 3 outsiders
- Kauffman: “Profit is shared by all of us, instead of just helping a guy with a Lexus put another one in the garage.”
Case Study: Berrett-Koehler Publishers

- San Francisco-based publisher
- 26 employees
- 1996: adopted ESOP, it owns 10%
- Other stakeholders (authors, suppliers, etc.) also own shares
- 2011: certified B Corp

Case Study: S&C Electric

- Chicago-based, electrical equipment manufacturer
- 2,500 employees
- $500m revenue
- KSOP owns 17% in 1989
- Next generation wants to sell immediately
- Section 1042 transaction
Is an ESOP Right for You?

When Are ESOPs a Good Fit?

**Good Fit**
- Company is profitable
- Valued work force
- Partial sale desired
- Phased sale desired
- Preserve legacy

**Bad Fit**
- Unprofitable or unpredictable
- Fewer than 20 employees
- Crisis-mode
- Strategic price necessary
Some Factors in Weighing an ESOP

- Is “fair market value” enough?
- How much stock to sell?
- Are all owners on board?
- S or C corporation
- Feasibility (debt load, payroll, stability of income, etc.)
- Management continuity
- Commitment / philosophy
- Alternatives

NCEO Resources

- 50 Webinars
- Publications
- Annual conference and seminars
- Email bulletin
- Membership
Questions?

Contact Information

Loren Rodgers
National Center for Employee Ownership
1726 Franklin Street, 8th Floor
Oakland, CA 94612
510-208-1307
lrodgers@nceo.org

www.nceo.org
The Caring Nurses story:

* Founded November 1994
* Medicare Certified April 1995
* ESOP evaluated December 1999
* ESOP 1st fiscal year:
  
  January to September 2000
ESOP

Why was this a good choice for the Principals of Caring Nurses?

(a) Problems with not being able to receive proper fair market price when it is time to retire and more importantly not having our financials and business operations and practice be criticized by perspective acquisitions parties

(b) We thought this would be an excellent vehicle to elevate the standard of care delivery by having ESOP employees feel better about the company that who they represented and how they symbolize themselves when providing skilled intervention to patients

(c) Employees Retention factor was especially important at that time and even more important today for Therapists and other clinicians – cost concerns related to recruiting and time and energy to do interviewing, hiring, orienting, training and supervising new personnel
**ESOP**

- Employees with 3 years or more of service grandfathered-in for 1 year of vesting interest

- 50.2% of the Principals shares were sold to the ESOP

- Caring Nurses borrowed the money to pay the Principals and used the borrowed money as collateral to fund the loan.

In 2008 the remaining shares were sold to the ESOP and Caring Nurses received a 10 year note using Medicare interest rates

ESOP has a rule that previous Principals cannot own any distribution shares for 10 years after ESOP is initiated – this creates a good opportunity to earn or accumulate shares (again) after the original sale has been procured.
In December 2017, retirement is scheduled – ESOP played a significant role throughout the past 14 years and will have contributed to our retirement success, financially.

All Praises and Thanks directed to Tom Boyd and Tom Nicholas with Simione Healthcare Consultants.
Contact Information

Roger Corbin
Chief Operating Officer
Caring Nurses, Inc.
702-791-3729
roger@caringnurses.com

www.caringnurses.com

Tom Boyd’s ESOP History with Medicare

<table>
<thead>
<tr>
<th>Year</th>
<th>ESOP HHA</th>
<th>HHA (Confidential)</th>
<th>HHA (CNLV)</th>
<th># Las Vegas HHA</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-1993</td>
<td>ESOP HHA CA PBGA &amp; CAHABA</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995-1997</td>
<td>ESOP NV NGS</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>ESOP HHA NV NGS</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td></td>
<td>$2 Million</td>
<td>$2 Million</td>
<td>55</td>
</tr>
<tr>
<td>2012</td>
<td></td>
<td>$1.5 Million</td>
<td>$6 Million</td>
<td>130</td>
</tr>
</tbody>
</table>
### 2102.1 Reasonable Costs (Excerpt)

Costs may vary from one institution to another because of scope of services, level of care, geographical location, and utilization. It is the intent of the program that providers are reimbursed the actual costs of providing high quality care, regardless of how widely they may vary from provider to provider, except where a particular institution's costs are found to be substantially out of line with other institutions in the same area which are similar in size, scope of services, utilization, and other relevant factors. Utilization, for this purpose, refers not to the provider's occupancy rate but rather to the manner in which the institution is used as determined by the characteristics of the patients treated (i.e., its patient mix - age of patients, type of illness, etc.).

Implicit in the intention that actual costs be paid to the extent they are reasonable is the expectation that the provider seeks to minimize its costs and that its actual costs do not exceed what a prudent and cost-conscious buyer pays for a given item or service. (See §2103.) If costs are determined to exceed the level that such buyers incur, in the absence of clear evidence that the higher costs were unavoidable, the excess costs are not reimbursable under the program.

---

### 2102.2 Costs Related to Patient Care

These include all necessary and proper costs which are appropriate and helpful in developing and maintaining the operation of patient care facilities and activities. Necessary and proper costs related to patient care are usually costs which are common and accepted occurrences in the field of the provider's activity. They include personnel costs, administrative costs, costs of employee pension plans, normal standby costs, and others. Allowability of costs is subject to the regulations prescribing the treatment of specific items under the Medicare program.
2103. Prudent Buyer

A. General.--The prudent and cost-conscious buyer not only refuses to pay more than the going price for an item or service, he/she also seeks to economize by minimizing cost. This is especially so when the buyer is an institution or organization which makes bulk purchases and can, therefore, often gain discounts because of the size of its purchases. In addition, bulk purchase of items or services often gives the buyer leverage in bargaining with suppliers for other items or services. Another way to minimize cost is to obtain free replacements or reduced charges under warranties for medical devices. Any alert and cost-conscious buyer seeks such advantages, and it is expected that Medicare providers of services will also seek them.

2103. Prudent Buyer

B. Application of Prudent Buyer Principle.--Intermediaries may employ various means for detecting and investigating situations in which costs seem excessive. Included may be such techniques as comparing the prices paid by providers to the prices paid for similar items or services by comparable purchasers, spot-checking, and querying providers about indirect, as well as direct, discounts. In addition, where a group of institutions has a joint purchasing arrangement which seems to result in participating members getting lower prices because of the advantages gained from bulk purchasing, any potentially eligible providers in the area which do not participate in the group may be called upon to justify any higher prices paid. Also, when most of the costs of a service are reimbursed by Medicare (for example, for a home health agency which treats only Medicare beneficiaries), examine the costs with particular care. In those cases where an intermediary notes that a provider pays more than the going price for a supply or service or does not try to realize savings available under warranties for medical devices or other items, in the absence of clear justification for the premium, the intermediary excludes excess costs in determining allowable costs under Medicare.
2142.1 Definition

A defined benefit pension plan is a type of deferred compensation plan, which is established and maintained by the employer primarily to provide definitely determinable benefits to its employees usually over a period of years, or for life, after retirement. Pension plan benefits are generally measured by, and based on, such factors as age of employees, years of service, and compensation received by the employees.

2142.6 Allowability of Payments

B. Reasonable Compensation.--The payments made by the provider together with all other compensation paid to the employee must be reasonable in amount.
2141. Defined Contribution Deferred Compensation Plans

2141.1 Definition.--Defined contribution deferred compensation plans include profit sharing, stock bonus, and other such defined contribution deferred compensation plans that meet Internal Revenue Service (IRS) or Employee Retirement Income Security Act (ERISA) requirements as qualified plans and have been so approved by the IRS. The plans provide for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to the participant's account. These deferred compensation plans, as well as the non-qualified deferred compensation plans described in §§2140ff, provide for the deferral of remuneration currently earned by an employee until a subsequent period (usually after retirement).

2141.2 Foreword.--Provider contributions for the benefit of employees under a defined contribution deferred compensation plan are allowable when, and to the extent that, such costs are actually incurred by the provider. Such costs may be found to have been incurred only if the requirements of this section are met.

Questions?

Q&A
Contact Information

Thomas E. Boyd, MBA, CFE  
Vice President of Reimbursable Services  
Simione Healthcare Consultants  
707-585-9317  
tboyd@simione.com

Simione Healthcare Consultants  
50 Professional Center Drive, Suite 200  
Rohnert Park, CA  94928  
707-585-9317  
tboyd@simione.com  
www.simione.com

Roger Corbin  
Chief Financial Officer  
Caring Nurses, Inc.  
2968 E Russell Road  
Las Vegas, NV  89120  
702-325-4965  
roger@caringnurses.com  
www.caringnurses.com

Loren Rodgers  
National Center for Employee Ownership  
1726 Franklin Street, 8th Floor  
Oakland, CA  94612  
510-208-1307  
lrogers@nceo.org  
www.nceo.org