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At the end of the 1990s, consolidation coursed quickly through commercial lighting manufacturers. **Litecontrol Corp.** fielded offers from prospective acquirers almost daily, says Veda Ferlazzo Clark, the company's CEO and president. Litecontrol was vulnerable. The second generation of the Danforth family owned the company. Robert Danforth wanted to cede control, but he saw no third-generation heir apparent on the horizon.

In 1999 four Litecontrol competitors succumbed to acquisition offers and sold out, Ferlazzo Clark recalls. All but one have since been closed down. "It was almost an inevitable process," she says of the mergers and subsequent contraction. "We just didn't want it to happen to us."

Litecontrol instead initiated an employee buyout known as an employee stock ownership plan, or ESOP. Employees now hold about 33% of the company and should own the entire company by 2010.

The manufacturer based south of Boston not only has survived, it is also flourishing. Worker productivity has experienced huge gains. The operation is profitable. Ferlazzo Clark says Litecontrol is now contemplating making acquisitions itself to boost its $35 million annual revenue.

With Litecontrol, the gospel according to ESOP gained more converts.

For years ESOPs have veered in reputation from a kind of quaint afterthought to an embarrassing misstep. Negative perceptions were deepened by the collapse of **UAL Corp.**, parent of United Airlines, the biggest and most high-profile ESOP ever.

Now, however, there's evidence of renewed interest in ESOPs as a means of acquiring companies. Aided by recent changes in the tax code, some of the more successful ESOPs are themselves in a better position to become acquirers. Those sorts of deals are only now gaining traction.

"It doesn't work all the time, especially if a seller's primary objective is to get the most dollars out day one," says Mary Josephs, a senior vice president at **LaSalle Bank Corp.**, who is in charge of that Chicago-based bank's active ESOP department. "But you won't find an [acquisition] tool that is as flexible."

In a typical ESOP, an owner sells a privately held company — in whole or in part — to its employees. Secured bank loans usually finance the transaction, although the owner sometimes helps underwrite the deal himself. Typically, the owner takes warrants or extends a loan, which the company guarantees. As long as the seller reinvests the proceeds within one year, there is no tax liability on capital gains.

Less often, ESOPs can be used to take companies private or to spin off divisions of public companies.

Independent valuations determine the sale price. Under the law, a company can't be sold to an ESOP for a premium over fair market value. The ESOP shares are administered by a trust.

Sexy it's not. This type of buyout traditionally is seen as so lacking in glamour, it's often considered a kind of wallflower at the M&A dance. Many investment bankers simply ignore ESOPs as an option. Others plead ignorance.

That was compounded by the failure of United Airlines. "The ESOP community realizes the image this has cast is something that has to be dealt with," says Gregory Brown, a partner with Chicago-based law firm **Gardner Carton & Douglas LLP**. "It is being dealt with, but it's not easy."

Add to this an upturn in traditional M&A activity. It would seem to spell yet another long night by the punch bowl.

Not so, maintain a wide variety of lawyers and bankers versed in ESOPs. Expect ESOP-related activity to increase. "A rising tide raises all boats," says J. Michael Keeling, president of the ESOP Association, a Washington-based industry group. "When there's more M&A, there's going to be more ESOPs."

Not that ESOPs will instantly emerge as the hot instrument of choice. Just about everyone agrees the bigger the company and the more employees, the more difficult an ESOP becomes. Highly leveraged companies have a tough time. Although ESOPs offer huge tax advantages, the plans can almost always be outbid by strategic buyers. And they remain one of those investment instruments that simply are hard for many to fathom.

"ESOPs haven't moved as far into the mainstream as I hope they would," Brown says. "There are increasing inquiries about ESOPs, but I wouldn't classify them as the flood gates opening."

Josephs, for one, says she's seeing a lot more potential deals. She ticks off 20 potential ESOPs in her own pipeline, with enterprise values ranging from $25 million to $450 million. These include everything from a public company going private to a spinoff.

Of these potential deals, seven represent auctions in which ESOPs are competing with other buyers for companies, she says. The companies range in value from $35 million to $250 million and include manufacturers, a construction company, a retailer and a service company.

Josephs maintains all ESOPs are competitive in what they can bid and how much money they can raise. "That model can leverage more senior credit than any other M&A alternative you can put before me," she says. ESOPs have become a "new and creative way to do M&A."

New? ESOPs actually have been around for decades. According to the ESOP Association, there are 10,000 ESOPs in the U.S., of which about 10% are publicly traded.

What is true is that thanks to a change in the tax code, ESOPs have revitalized.

In early 1998 Congress enacted legislation that gave ESOPs the ability to become subchapter S corporations. Under S corporation regulations, a company with fewer than 75 shareholders can elect to pay income, rather than corporate, tax. The ESOP counts as a single shareholder. Because a trust holds the ESOP shares on behalf of employees, there is no income to tax. A 100% S corporation company, therefore, pays no federal tax.

Even supporters of the legislation expected the IRS would attempt to tinker with the ESOP's tax-exempt status. Many ESOP specialists held off recommending the mechanism until the smoke cleared. "Everyone thought it was a loophole the IRS would plug. They didn't," Josephs says. "The S corporation tax shield is here to stay."

By the time ESOP advocates felt comfortable with the regulatory changes, other factors worked against any big increase in demand. The economy sputtered. Valuations fell. Credit tightened. Potential sellers backed off, not wishing to cash out in a down market. Other possible niche markets, including taking small-cap companies private, just didn't materialize. According to the ESOP Association, the number of ESOPs actually declined 13% from a peak of 11,500 in 2000 to last year.

A few high-profile ESOPs joined the ranks during this period. Perhaps the largest was the $810 million ESOP purchase of Appleton Papers Inc., now known as **Appleton Inc.**, from **Worms & Cie.** of France. The deal closed in November 2001. Retirement funds provided the $107 million equity component. The rest was financed by a combination of senior debt, junk bonds and a seller carry-back.

"To make it work, you need to have enough money in the 401(k) plan," says Paul Karch, the company's vice president of human resources and law. "And you need to have employees who believe enough in the company to take the risk."

Appleton, which makes carbonless and other specialty paper, is significant because of more than its size. This wasn't a case of a family business wanting to empower workers. Neither was it a case of workers mounting a

last-ditch effort to save the company from closure. Appleton's owners "didn't want to shut us down, they wanted to sell us," Karch says.

Worms & Cie. derived no tax benefits from the sale to an ESOP, so the bid had to be competitive, he says. There was outside interest, although the backers of the ESOP were fortunate in that no strategic buyers — who can almost always outbid financial buyers — put in an offer.

Appleton management had to convince employees the deal made financial sense, not just play to their insecurities. "We had to sell it to workers to invest because it was a good investment, not that this is the only way to keep your job."

In stark contrast, desperation was the underlying message United Airlines workers received when they were asked to sign onto an ESOP in 1994. United Airlines became the biggest-ever majority-owned ESOP. (Many companies, including several airlines, have minority ESOPs often stemming from restructuring. Others initiate a minority ESOP as a kind of employee stock plan.) It also became the biggest-ever bust. The airline's bankruptcy last year was the sort of public relations disaster that can devastate the perception of ESOPs. At one time, United Airlines' ESOP held 55% of the airline's stock. After the bankruptcy, this equity stake was nearly worthless.

Under the contentious plan for the airline, employees agreed to $4.9 billion in wage and work concessions in return for the majority stake.

For a few years, the airline stabilized its balance sheet. The stock was flying high. But this was no workers' paradise. Labor and management clashed. Add to this that the flight attendants' union never participated in the ESOP, pitting some workers with an ownership stake against others with none. By the time the economy turned in 2000 and the airline's fortunes fell, the ESOP had failed to engender any sense of belonging.

"They didn't sustain an ownership culture," says Corey Rosen, executive director of the National Center for Employee Ownership, an ESOP research and information organization based in Oakland, Calif. United "couldn't get past the managers and the unions being adversaries."

That sense of culture and purpose is a tough slog even when labor-management relations are superb, ESOP executives say. "The danger is after the first few years, the ownership culture becomes institutionalized and then ossified," says J. Timothy O'Reilly, president and CEO of **Newport Harbor Corp.**, an ESOP with restaurant, hotel and catering properties in Newport, R.I. "We're working very hard to not let that happen."

Newport Harbor initiated its ESOP in 1995. It was a fairly typical conversion. Six individuals founded the company about 70 years ago. After three generations, shareholders were scattered and interest in the company varied. After mulling several alternatives, O'Reilly proposed an ESOP, funded through the sale of the company's heating oil division. The company was valued at $20 million.

Newport has since acquired $6 million of real estate. That purchase diluted by a few percentage points the ESOP, which now holds 42% of the shares. Complete control is expected in another 10 years.

Before the ESOP, O'Reilly acquired about 12 heating-oil companies. Many were financed through debt. Now he hesitates when it comes to further expansion. "Any merger I have to look at very carefully," he says. He is reluctant to assume major liabilities. He doesn't want to dilute trust ownership. He needs to remain profitable to fund the ESOP. "Since this company has gone ESOP, we are more conservative," he says.

Even so, an ESOP as acquirer has numerous advantages. The tax savings gives the bid a huge leg up. "An ESOP can pay a fair-market value," Josephs says. "It will beat a financial buyer every time because it doesn't need a 30% gain."

ESOPs must be valued independently to retain their status. So, advocates maintain, ESOP companies are less prone to the whims of the marketplace. Companies are "being valued not so much on hype and expectations but on real money," Keeling says. Valuations are "tied to revenues, not tied to analysts, not tied to being spooked by corporate malfeasance."

While advocates such as Josephs expects several ESOP-related acquisitions will be completed over the next several weeks, evidence of these kinds of deals is only now beginning to dribble in. In April, for example, Appleton acquired two privately held companies, which make plastics film and packaging, for a total of about $50 million.

Not that potential acquisitions are necessarily jumping at the chance of hooking up with an ESOP. **Your Building Centers** is a small chain of home improvement centers in Pennsylvania. It became an ESOP in 1989 and is now highly profitable, says Phil Skarada, the company's president.

Skarada bought out his biggest competitor. Now he's on the prowl for acquisitions that can add manufactured lines to retail. The ESOP structure, he says, should help. It doesn't. "We've tried to acquire a number of family-owned businesses. It's like pulling teeth," Skarada says. "They just can't understand it."

Education also is the biggest obstacle when it comes to drumming up new companies for ESOP conversion, its advocates maintain. That also holds true of the bankers. "If we had been an LBO, it would have been easier because banks didn't understand ESOPs," Karch says.

But the falloff in M&A, Josephs says, allowed ESOP experts the time to fashion new variations and bring some investment bankers up to speed.

The pitch is simple: ESOPs provide huge tax savings for all concerned.

For the seller, the gains are substantial. Under the law, the seller — as long as it's an individual or partnership — doesn't pay capital gains tax and must reinvest the proceeds within one year in other securities. That makes it much more attractive to diversify.

But the intangibles are often just as compelling. There's a sense of loyalty. Owners understand the outright sale to a strategic buyer usually means many employees will lose their jobs.

For many owners, there's a reluctance to completely cut the ties. ESOPs allow a phased withdrawal. "Being an owner one day and an ex-owner the next is not all that attractive," Rosen says. With ESOPs, "you can get out on a schedule you want to get out on."

There's one more indication of growing interest in ESOPs. Since most are in the $20 million to $100 million range, they traditionally are the domain of midmarket specialists such as **William Blair & Co. LLC**, **Houlihan Lokey Howard & Zukin** and **Raymond James Financial Inc.**, as well as commercial banks such as LaSalle Bank, that have developed niche expertise. Other investment banks including **Bear, Stearns & Co.**, **Lehman Brothers Inc.** and **UBS** are beginning to sniff around, Josephs says. "You're starting to see them. Just starting."