

# The Journal of Employee Ownership Law and Finance

Volume 10, No. 4 • Fall 1998

Published by the National Center for Employee Ownership (NCEO)

## Seller-Financed ESOPs and Leveraged QRP Transactions

**James G. Steiker**

*Shared Equity Strategies, Inc.*

*Steiker & Fischer, PC*

7318 Germantown Avenue

Philadelphia, PA 19119

215-242-5200

Fax 215-248-2288

[www.Shared-Equity.com](http://www.Shared-Equity.com)

**Bruce F. Bickley**

*UBS PaineWebber*

This reprint is being provided as a courtesy by Shared Equity Strategies/  
Steiker & Fischer for informational purposes only, and should not be construed  
as investment, tax or legal advice.

# Seller-Financed ESOPs and Leveraged QRP Transactions

**Bruce F. Bickley**  
**James G. Steiker**

*Many ESOP transactions use funds borrowed from an outside lender, such as a bank. These bank loans may be secured by company assets or through a guarantee of the bank loan by the selling shareholder. One alternative is for the selling shareholder to receive a note as payment for some or all of the sale price of the company sold to the ESOP. This article discusses the structure, benefits, and disadvantages of this approach. It further describes the use of seller financing in conjunction with "leveraged qualified replacement property (QRP)" approach to Section 1042. Under this approach, the seller (1) finances the transaction by taking a note from the ESOP; (2) buys a floating-rate note as QRP within 12 months of the sale date, using borrowed funds collateralized by the QRP; and (3) receives ongoing payments from the ESOP as principal and interest on the seller's note. The seller can freely spend, invest, and/or pay down the loan with the proceeds from the ESOP note and the floating-rate note. Among other things, this approach allows the seller to obtain the benefits of Section 1042 (which requires the QRP to be purchased within 12 months after the sale) even though the sale proceeds are received over a period of years.*

**T**he key motivation for many ESOP transactions in closely held companies is the ability of the selling shareholder to defer capital gains tax on sale of shares to an ESOP under Section 1042 of the Internal Revenue Code (the "Code"). Section 1042 requires as a condition of capital gains tax deferral that upon completion of the sale, the ESOP own at least 30% of the outstanding shares of each class of company stock or stock representing 30% of the value of all company stock. At this time, the Section 1042 tax deferral is available only to selling owners in C corporations, not S corporations.

Section 415 of the Code imposes significant limitations, as a percentage of participant compensation, on how much company stock may be allocated to ESOP participants in a single year. Most ESOP transactions in closely held

---

Bruce F. Bickley is a Senior Vice President—Investments and Senior Portfolio Manager—Portfolio Management Program for UBS PaineWebber who works with selling shareholders in section 1042 transactions. He has earned his CPA with a Masters of Taxation and frequently speaks on ESOPs. James G. Steiker is the founding principal of Shared Equity Strategies, Inc., and its related law firm, Steiker & Fischer, PC. The firms provide legal and financial services to owners, employees, and trustees in connection with the creation, maintenance, and sale of employee-owned companies. Their advisory services include designing and managing ESOP transactions from beginning to end, assessing feasibility, drafting plans, raising the necessary financing, and providing plan administration post transaction.

companies are therefore leveraged, as very few companies have a significant enough payroll base that 30% of the company's stock can be allocated to participants in a single year in compliance with applicable Section 415 limitations. In a leveraged transaction, the ESOP uses borrowed money to acquire a significant block of company stock and promises to repay the loan from future company contributions.

Often, the ESOP borrows from an outside lender, such as a bank, to obtain the funds to buy company stock. However, sellers may prefer to finance the ESOP transaction themselves, either because they want to avoid bank financing (due to cost or other considerations) or because it is simply difficult or impossible to obtain bank financing. Under this approach, the selling shareholders receive a note from the ESOP as payment for some or all of the sale price. This article will discuss seller financing, its advantages and disadvantages, and the use of "leveraged QRP."

## **Rationale of Seller Financing**

One condition of Section 1042 capital gains deferral is that the selling shareholder purchase "qualified replacement property" (QRP) with a value equal to the amount received in the qualifying ESOP transaction. (The shareholder can choose to purchase QRP equal to only part of the amount received, in which case the shareholder will pay taxes on the remainder of the proceeds.) QRP can include the stock and bonds of most, but not all, domestic operating corporations. It does not include mutual funds, real estate investment trusts (REITs), or government bonds. The selling shareholder defers capital gains tax until sale or other taxable disposition of the QRP. Banks generally consider the QRP to be purchased by a selling shareholder as excellent collateral for an ESOP loan.

Selling shareholders generally view a pledge of QRP or other seller guarantees of bank ESOP financing as a creating a level of personal risk similar to providing the financing for the transaction themselves. Moreover, the company or the ESOP usually do not provide additional compensation to the selling shareholder in exchange for the pledge of QRP or the guarantee. The question is often framed as, "Why shouldn't I (the selling shareholder) collect the interest rather than the bank?"

## **Structure of Seller Financing**

Most ESOP transactions use a "mirror loan" format. The lender makes a loan to the company and the company makes a loan to the ESOP to finance purchase of company stock from a shareholder. This structure can be followed where the lender is the selling shareholder, but is not always desirable.

In a mirror-loan structure, the company makes a loan to the ESOP, and the ESOP uses the proceeds of the loan to purchase shares from a shareholder. The shareholder makes a loan to a company, and the company issues a note to the shareholder. The advantage of this structure is that the holder of the note has direct recourse to company assets, some technical legal issues concerning “fraudulent conveyance” are avoided, and there may be advantageous timing differences between the company’s payment of contributions or tax-deductible dividends to the ESOP to repay the loan and the company’s payment of the obligations under the note. For example, a company with extra cash would pay off the external loan faster, using a slower schedule to pay off the seller, either to avoid Section 415 contribution limit problems or to stretch out allocations to include more future employees. The disadvantage of this structure is that a shareholder who does not elect capital gains deferral under Section 1042 may not elect installment sale tax treatment as an alternative based on the deferred note payments. In other words, the seller will be taxed on the proceeds.

The deferred payments to the shareholder may be structured as a direct obligation of the ESOP. Usually, the company will provide an additional guarantee of the note from the ESOP. In this scenario, a shareholder who does not elect Section 1042 capital gains deferral may instead elect installment sale treatment with respect to the proceeds of the note. The balance sheet treatment of the ESOP obligation on the financial statements of the company is unaffected by whether the company provides a guarantee of the ESOP’s obligation.

## **Section 1042 Considerations**

Section 1042 requires, as a condition of capital gains deferral, that the selling shareholder purchase QRP during the 15-month period commencing 3 months before and ending 12 months after the date of a qualifying sale to an ESOP. This period is not extended by the ESOP’s payment of the purchase price for the shares in the form of a note.

This creates a dilemma for a shareholder who is otherwise willing to sell shares to an ESOP in exchange for a note. Payment of the sale proceeds to the shareholder may occur over several years. Purchase of the QRP must, however, take place within one year of the date of sale. For a shareholder who receives a note as payment in an ESOP transaction to elect capital gains deferral under Section 1042, he or she must use other available funds to purchase QRP during the applicable period. (The IRS ruled in Private Letter Ruling 9102017 that the money used to buy QRP need not be the actual sale proceeds.) Relatively few shareholders have sufficient liquid assets to accomplish this funding.

## Use of Leveraged Qualified Replacement Securities

Section 1042 concerns based on a need for short-term funds to purchase QRP may be addressed by purchase of QRP that may be used as collateral for a margin loan at a relatively high loan-to-value. The major brokerage houses will typically offer margin loans on securities without other collateral at specified ratios and at or near the "broker call" rate. Advance ratios against stocks are 50%, while advance ratios against debt instruments (e.g. bonds) range from 70% to 75% depending on whether the coupon is fixed or floating. (Banks are not subject to the same margin restrictions that brokerage houses are, so with a bank the advance ratio against a stock could be over 50%.) The broker call rate reflects short-term interest rates and varies at around 0.5–2.0 percentage points below the prime rate. If the value of the underlying margined security drops, the brokerage house may make a "margin call" requiring sufficient repayment of the loan such that the advance ratios described above are not exceeded.

The desired attributes of the QRP are therefore (1) a debt instrument (to maximize the potential amount of the margin loan), (2) high safety/credit quality (to reduce risk and price fluctuations based upon the creditworthiness of the issuer), (3) a long maturity and call protection (so that the capital gain deferred on sale of shares to the ESOP will not be recognized upon maturity or call of the debt instrument), and (4) a floating interest rate (to avoid price fluctuations and potential margin calls based upon changes in underlying interest rate conditions).

Several brokerage houses offer a form of QRP with these attributes called a "Floating Rate Note" (FRN). These securities, generally issued by large corporations, have high credit ratings, normally AAA or AA, and a floating interest rate, therefore insuring relative price stability and security. The term of the notes usually range from 30 to 60 years. It is relatively easy to purchase this security with a down payment of as little as 10% of the underlying value of the FRN, with financing from a lending institution. Brokerage houses are subject to a maximum ratio of loan to value of 75% to 80%; however, commercial banks may lend at advance rates as high as 90%.

### Example of Seller-Financed ESOP with Leveraged QRP

The following example illustrates the use of leveraged QRP in a seller-financed Section 1042 ESOP transaction:

1. Seller sells \$10 million stock to the ESOP in exchange for \$1 million cash and a note for the \$9 million balance (the proportion of cash and note may vary).

2. Within 12 months of sale date, seller deposits \$1 million cash proceeds with an outside bank or brokerage house (“Lender”).
3. Simultaneously, seller purchases \$10 million as QRP under Section 1042.
4. Lender loans seller \$9MM on (30-day) LIBOR-based rate secured by pledge of FRN.
5. Seller receives ongoing payments from ESOP as principal and interest on seller note. Seller may use payments to reduce Lender loan or may otherwise invest or spend proceeds.

The net cash flow of interest from these transactions is illustrated below:

*Sample applicable rates:*

Seller Note @ Prime	8.50%
FRN Yield @ Commercial Paper – 25 basis points	5.25%
Bank loan secured by FRN @ (30) LIBOR + 50 basis points	6.15%

*First-year interest cash flow:*

Seller Note Interest Income (\$9 million @ 8.50%)	\$765,000
FRN Income (\$10 million @ 5.25%)	525,000
Less: Interest expense to Lender (\$9 million @ 6.15%)	<u>553,500</u>
Net Interest Income	\$736,500

*(First-year effective yield = 7.365%)*

## Pros and Cons of Seller Financing

Seller financing is especially appropriate for consideration in a Section 1042 transaction where the seller will likely pledge all of the QRP to be acquired with the proceeds of the transaction as collateral to the lender. Seller financing may provide a greater financial return relative to risk as the Seller may capture a premium representing the gap between the rate charged by a lender on a loan collateralized by QRP and the rate a seller may command as a “reasonable rate” on the seller note. Seller financing, when appropriately subordinated, may help companies subject to bonding or other balance-sheet related credit tests, where the outside bonding agency or creditor might view bank financing as excessive leverage. Seller financing may also provide greater flexibility to structure a leveraged transaction around seasonal or fluctuating cash flow. Seller-financed transactions are also less expensive to accomplish and require less documentation and due diligence.

Seller financing using leveraged QRP may subject the seller to an under-

lying lack of diversification if one were to invest 100% in a single security. Sellers can use the proceeds from the note to purchase a diversified portfolio of investments, but they will do so over time. In essence, the sellers would be dollar-cost averaging into the market, buying fewer shares when stock prices are high and more shares when prices are low. During a period of rising stock prices, the rate of return on the notes, even with the positive interest float from the ESOP note to the seller, will be below the typical rate of return on equities; thus, the seller would lose out on the opportunities a Section 1042 transaction provides to get this higher rate sooner by investing immediately. For example, if a seller elects Section 1042 treatment and invests in equities with a 10% annual return, that seller will be better off than one who invests in a FRN with an effective rate of 7.365% (adding in the extra interest from the note to the seller).

A selling shareholder may also find it difficult to balance his or her lender concerns against his or her management or ownership concerns if the company experiences difficulty in making timely repayment of the seller note. Additionally, bank financing imposes discipline and due diligence on a company to ensure that the projected ESOP debt is appropriate and that there are no other concerns that militate against the proposed ESOP transaction.

However, the leveraged QRP approach allows a seller who cannot obtain, or does not want to obtain, bank financing to elect Section 1042 treatment on the entire amount of the sale proceeds.

## **Conclusion**

Seller financing may be a desirable alternative to conventional bank financing, and it may provide a level of subordinated debt to achieve a desired debt package in certain leveraged ESOP transactions. If the seller desires to elect Section 1042 treatment but needs short-term funds to purchase QRP within the required 15-month period, the leveraged QRP approach described here can be used to provide those funds within the context of seller financing.

### About the *Journal of Employee Ownership Law and Finance*

The *Journal of Employee Ownership Law and Finance*, which is published quarterly by the National Center for Employee Ownership (NCEO), explores the legal and financial issues surrounding employee ownership in a manner accessible to both the layperson and the specialist. It is the only professional journal in the U.S. solely devoted to employee ownership. Articles are written by practitioners, academics, and corporate executives who are experts in the field and deal with employee ownership every day.

### About the NCEO

The National Center for Employee Ownership (NCEO) is a private, nonprofit membership, information, and research organization that serves as a central source of information on employee ownership. Supported by its members and services, the NCEO offers a wide range of publications and other resources relating to employee ownership and holds workshops, conferences, and other events. NCEO members receive a bimonthly newsletter, the *Employee Ownership Report*; access to the NCEO's members-only Web site, which includes resources such as a searchable database of over 200 consultants; discounts on the NCEO's publications and events; and the right to contact the NCEO for consultation and information about employee ownership.

**For more information, call the NCEO at (510) 208-1300 or visit its Web site at <http://www.nceo.org/>**

### ORDER FORM

Name \_\_\_\_\_

Organization \_\_\_\_\_

Address \_\_\_\_\_

City, State, Zip \_\_\_\_\_

Telephone \_\_\_\_\_

Check enclosed (payable to "NCEO")

Please charge my credit card (circle one):    VISA    MC    AMEX

Acct # \_\_\_\_\_ Exp. \_\_\_\_\_

Signature \_\_\_\_\_

One-year Journal subscription (\$75 NCEO members, \$100 nonmembers)

Introductory NCEO membership (\$70 for one year)

TOTAL

**Mail to: NCEO, 1736 Franklin St., 8th. Flr., Oakland, CA 94612  
or fax (credit card orders only) to (510) 272-9510**