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ESOP FORMATION IN HEALTH CARE INDUSTRY EMPLOYER CORPORATIONS

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The domestic health care industry encompasses a wide array of product and service providers. In fact, the health care industry is described by several SIC codes and NAICS sectors. Some of the health care industry segments are viable candidates for ESOP formations; some of the industry segments are not. This article describes many of the common factors that financial advisers consider when assessing whether a particular health care industry employer corporation is a viable candidate for an ESOP formation.

INTRODUCTION

The health care industry is represented by a myriad of product and service providers. These providers cross a wide spectrum of medical needs. Currently, over 10,000 employee stock ownership plans (ESOPs) are in place at various companies throughout the country. These ESOP sponsor corporations range in annual revenue size from several million dollars to well over 15 billion dollars.

Generally, financial advisers consider several key factors to determine the reasonableness of implementing an ESOP at a particular employer corporation. Some of the most common factors include:

1. the operating life (i.e., tenure) of the employer corporation,
2. the size of the employer corporation (e.g., revenue and employees),
3. the cash flow generating capacity of the employer corporation,
4. the perceived ability of the employer corporation to operate successfully with "shared" employee ownership/decision making, and
5. the potential for enhanced employee productivity and commitment.

The North American Industries Classification System (NAICS) identifies over 25 broad categories of health care service providers in Sector 62: *Health Care and Social Assistance Services*. Additionally, numerous other classifications of product and device manufacturers, insurance, and health-industry-related service providers are referenced in other NAICS sectors. These other NAICS sectors

more thoroughly identify the numerous and diverse participants operating in the health care industry.

This article will address the five factors noted above as they relate to the possible formation, implementation, and operation of an ESOP at an employer corporation that provides products and/or services in the health care industry.

HEALTH CARE EMPLOYER CORPORATION OPERATING LIFE CYCLE

Typically, a start-up company (i.e., a business enterprise with fewer than five years of operating history) does not represent an ideal candidate for the formation and implementation of an ESOP. This is true regardless of the industry in which the subject company operates.

This is because start-up companies are subject to higher operating risks than are more established companies. This incremental risk is due to the fact that most start-up companies do not enjoy long-standing customer/client relationships. Such recurring customer/client relationships typically serve to increase (1) the likelihood of continued future patronage and (2) the revenue and related cash flow generating ability of a company.

Further, most start-up operations represent companies that, by definition, do not have longstanding relationships with employees and staff. In such a circumstance, it would often be difficult to form a reasonable expectation regarding the potential for significant productivity gains. Such

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productivity gains often result from employees becoming more vested in the company's future performance as a result of stock ownership.

In the case of start-up companies, most financial advisers conclude that an ESOP, with the attendant implementation costs and continuing administrative costs, does not represent the most practical and effective form of employee benefit plan for the subject company.

However, companies operating in the health care industry are subject to what arguably represents the highest level of regulatory control for any industry. This industry regulation relates to (1) developing and providing products and services as well as (2) being compensated (i.e., reimbursed) for the delivery of products and services. The Medicare Anti-Kickback Law, Stark Law, and Intermediate Sanctions Law generally exist to prevent both:

1. the over utilization and underutilization of services reimbursed by federal programs (e.g., Medicare and Medicaid), and
2. the overpayment (when buying) or underpayment (when selling) for the delivery of services or transfer of assets when tax-exempt entities are involved.

Additionally, many states operate with certificate of professional need (COPN) requirements. These COPN requirements are designed to prevent the costly duplication of medical services in certain markets.

These regulations impose measurable administrative costs on health care companies and service providers. However, these regulations also serve as barriers to entry for would-be competitors. Further, in certain areas of the country, the existence of a COPN actually serves to protect the market position and the market share for the controlling health care company.

From the perspective of implementing a health care company ESOP, the highly regulated nature of the health care industry actually serves to mitigate some of the risk that typically would be attributed to a start-up operation. Based on (1) the specialized nature of health care products and services and (2) the related regulatory constraints, a start-up operation in the health care industry typically represents an entity that is represented by founders/key management with considerable experience and continuing relationships. Such experience and relationship value typically translates into a high level of understanding with regard to regulatory guidance. That understanding facili-

tates the successful development of the start-up company. Accordingly, that understanding reduces some of the risk typically associated with a start-up operation.

Of course, exceptions to the above-stated rule always exist. In fact, the most notable exceptions relate to health care companies that are technology based. Clearly, any start-up company whose success is highly dependent on the creation of new drugs and medical-related technology and devices typically would be described as a high risk operation. Such a company typically would not represent an ideal candidate for an ESOP implementation.

However, traditional medical product and service providers that demonstrate the following characteristics, even those providers in the start-up business life cycle phase, represent viable ESOP candidates:

1. Employer corporations that are founded or managed by qualified professionals with experience and relationships in the health care industry and the relevant industry segment,
2. Employer corporations with demonstrated demand for the products and/or services they provide,
3. Employer corporations with an established business model that promotes sustainability and potential growth with regard to cash flow generating ability, and
4. Employer corporations with a trained and stable workforce that generally is motivated by ownership opportunities.

The impact of the health care industry employer corporation size, cash flow generating capacity, and the potential motivational benefit of an ESOP are discussed below.

HEALTH CARE EMPLOYER CORPORATION SIZE

Health care companies range in size from several employees to several thousand employees. Additionally, annual revenue for health care companies range from several thousands of dollars to several billions of dollars.

From the perspective of implementing an ESOP, a health care employer corporation should be large enough to confer enough ownership and value to employees so that the ESOP represents a meaningful and motivating benefit to the plan participants. Clearly, the level and value of ownership that is "meaningful and motivating" to employees will vary for each individual employer corporation.

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Implicit within the size consideration is the premise that the subject health care employer corporation is large enough to:

1. fund the required annual plan contributions;
2. service the employer stock acquisition debt obligations, in the event that the ESOP borrows funds (i.e., a “leveraged” ESOP stock purchase structure) to complete the purchase of the employer corporation stock;
3. pay dividends (that are tax deductible) that will enable the ESOP to repay the employer stock acquisition debt on schedule; and
4. fund or finance repurchase obligations created when vested employees die, are disabled, or retire from the employer corporation.

Generally, with regard to entities operating as regular “C” corporations, ESOP stock purchase transactions confer the greatest level of economic benefit when the ESOP owns at least 30 percent of the employer stock immediately after the sale. When this circumstance exists, the selling shareholders of the employer corporation stock can defer, or possibly avoid, federal income taxes on any long-term gain arising from the sale.

In order to realize this tax deferral (or tax avoidance) benefit, the proceeds from the employer stock sale must be reinvested by the selling shareholder in “qualified replacement property.” This reinvestment of the sale proceeds

must occur within a 15-month period beginning three months prior to the date of the sale.

At the 30 percent ownership level, the ESOP may control a meaningful ownership position in the employer corporation. However, such a stock purchase transaction typically requires a sizable investment on the part of the ESOP. As a result, ESOP ownership interests that achieve the 30 percent equity ownership threshold are often structured as leveraged ESOP stock purchase transactions. Such leveraged employer stock acquisitions require the ESOP to borrow funds in order to complete the stock purchase.

Given a contemplated leveraged ESOP transaction at a 30 percent ownership level, size becomes a more significant consideration with regard to the sponsor corporation. Sponsors of leveraged ESOPs are allowed to make annual tax deductible contributions of up to:

1. 25 percent of covered payroll to pay the principal balance of the employer stock acquisition loan, plus
2. the amount of interest on the stock acquisition loan.

With regard to (1) the services segment of the health care industry and (2) selected health care sectors, Table 1 presents statistics published by the U.S. Census Bureau in the *2002 Economic Census*.

Of particular note are the operating statistics reflecting the structure of health care service providers. For these health care service providers, annual payroll typically rep-

Table 1
Health Care Industry and Social Assistance Companies¹
Revenue and Operating Expenses by Type and by Kind

NAICS Code	Business or Industry Segment	Receipts/Revenue (\$ million)	Total Operating Expense (\$ million)	Annual Payroll Expense (\$ million)	Payroll Expense as a Percent of Total Expense	Employee Fringe Benefits Expense (\$ million)	Fringe Benefits Expense as a Percent of Total Expense
62	Health care and social assistance	1,257,249	1,131,530	500,216	44.2	98,849	8.7
621	Ambulatory health care services	525,144	458,951	213,967	46.6	36,176	7.9
622	Hospitals	499,272	455,724	184,853	40.6	42,929	9.4
623	Nursing and residential care facilities	128,778	123,780	60,843	49.2	12,101	9.8
624	Social assistance	104,055	93,075	40,552	43.6	7,643	8.2

Footnote:

1. NAICS Sector 62.

resents between 40 percent and 50 percent of total annual operating expenses. This circumstance provides significant opportunity for a health care company to maximize the potential benefits associated with a 30 percent or greater equity ownership sale to an ESOP.

HEALTH CARE EMPLOYER CORPORATION CASH GENERATING CAPACITY

As previously discussed, approximately 40 percent to 50 percent of total operating expenses reported by health care service providers is represented by payroll expense. Focusing on all medical service providers for the moment, such a significant portion of total operating expense represented by payroll expense presents a strong opportunity with regard to the financing of an ESOP formation.

Focusing specifically on home health care services—NAICS 6216—reported annual payroll expense in the 2002 *Economic Census* represented 54.3 percent of total operating expense. A review of Ibbotson Associates *Cost of Capital 2005 Yearbook* indicates that the median operating income margin (i.e., net revenue less operating expense, divided by net revenue) for the home health care sector was approximately 10 percent.

For the home health care industry segment, the indicated median price-to-operating income equity valuation pricing multiple was approximately 8 times for 2004.

Given (1) that payroll expense for the home health care industry sector represented approximately 54 percent of total operating expense, and (2) that the operating income margin for this industry sector was reported at 10 percent,

a home health care agency with net revenue of \$8 million would expect:

1. to report total payroll expense of approximately \$3.9 million and
2. to generate an operating income margin of approximately \$800,000.

Based on the indicated median price-to-operating income equity valuation pricing multiple of 8 times, the indicated equity value for the home health agency with \$8 million in net revenue could be estimated as indicated in Table 2.

To the extent that the subject home health agency (1) generated an operating income margin below the industry median margin of 10 percent or (2) operated with significantly greater risk, the relevant pricing multiple and the resulting value would be reduced. Greater home health care agency risk may be indicated by such factors as (1) being significantly smaller than the industry median company, or (2) having significantly greater geographic concentration than the typical industry participant.

Of particular significance in this example is the fact that an annual payroll expense of \$3.9 million could support annual ESOP contributions/debt service payments of just under \$1 million.

Assuming the subject home health agency (1) generated \$8 million in net revenue and (2) realized annual operating income of \$800,000, financing the acquisition of a 30 percent equity interest could be accomplished based on the transaction assumptions presented in Table 3.

Table 2
Illustrative Equity Valuation of a Home Health Agency

Subject Company	Net Revenue	Operating Income Margin	Operating Income	Market-Derived Valuation Pricing Multiple	Indicated Equity Value
Home Health Agency, Inc.	\$8,000,000	10%	\$800,000	8.0	\$6,400,000

Table 3
Illustrative Financing of 30 Percent Employee Stock Purchase in a Home Health Agency

Subject Company	Indicated Equity Value	Value of a 30 Percent Stock Purchase Interest	Required Stock Acquisition Monthly Payment*	Annual Stock Loan Acquisition Debt Service	Annual Stock Loan Acquisition Debt Service Capacity*
Home Health Agency, Inc.	\$6,400,000	\$1,920,000	\$28,978	\$347,736	\$360,000

* Assumes a seven-year acquisition loan payment term and interest at seven percent annually. Annual stock acquisition debt service capacity represents operating income, less estimated corporate income taxes, less estimated capital expenditure requirements.

As indicated above, the cash flow generating capacity of the home health agency provides sufficient capital to finance the acquisition of a 30 percent employer stock interest by the ESOP. Additionally, the \$3.9 million annual payroll expense of the home health agency would enable the employer corporation to take advantage of the 25 percent contribution limit with regard to annual covered payroll. Further, a payroll expense of \$3.9 million could facilitate the use of voluntary reductions in salary and/or benefits to acquire the employer corporation stock, if necessary.

Issues regarding valuation adjustments for lack of control and lack of marketability that may be relevant to the above example are beyond the scope of this article. However, the above-indicated example demonstrates that many health care companies, based on the significance of payroll expense relative to total operating expense and/or industry-based profitability, represent viable options for the implementation of an ESOP.

HEALTH CARE EMPLOYER CORPORATION ABILITY TO OPERATE SUCCESSFULLY WITH "SHARED" EMPLOYEE OWNERSHIP/DECISION MAKING AND RELATED POTENTIAL FOR ENHANCED PRODUCTIVITY

By definition, after an ESOP is successfully implemented, the employer corporation equity ownership becomes more diverse. The ESOP, as a legal entity, now represents the ownership interests of numerous employees whose perspectives will, at times, likely differ from that of (1) other employer corporation equity owners and (2) the employer corporation management.

A corporate mission statement that may apply to an employer corporation operating in the health care industry could read as follows:

To provide safe and effective medical products and services in an ethical and fair manner while providing fair equity returns and valuable opportunities for growth and development to all employees.

The implementation of an ESOP at a health care company would significantly expand the meaning intended by such a mission statement. First and foremost, the long-term success of a health care company depends on its ability to provide safe and effective products and services. The implementation of an ESOP imposes an even greater responsibility on the employer corporation staff at all levels with regard to the delivery of safe and effective products and services. Such a greater responsibility may mitigate the notion that certain decisions are only "made upstairs," or at the higher levels of company management.

Second, the concept of the "ethical and fair delivery of products and services" has the opportunity to permeate throughout a health care organization. This attitude could occur as employees at all levels become increasingly sensitive to the economic repercussions often attributable to violations of this premise.

As unethical behavior and violations of fair dealing often translate into costly regulatory and, sometimes, judicial infractions, employees at all levels recognize the value to the employer corporation of "policing" each other.

Third, the concept of "fair and equal returns" incorporated in the mission statement translates in an ESOP-based company into issues related (1) to compensation and (2) to employee benefits. This is because such issues are largely attributable to the value of the employer corporation stock.

Prior to the implementation of an ESOP, nonowner employees at a health care company likely would be more concerned with market-based compensation and generous employee benefits packages (e.g., dental, medical, and retirement). However, subsequent to the implementation of an ESOP, employees may find themselves considering less costly alternatives to existing portions of employee benefits packages.

Rather than focusing on the most comprehensive, and often the most expensive, dental and medical plan, employees may consider options that reduce some employee benefits and the related costs. The ultimate goal of such an employee decision would be to increase (1) the employer corporation bottom line performance and (2) the value of the employees' economic interest in the employer corporation.

Last, the concept of "valuable opportunities for growth and development to all employees" in the mission statement may provide a viable avenue to management level positions for some employees. These are employees who may not have been considered for management positions prior to the implementation of an ESOP at the subject health care company.

Employees operating below management levels often view management positions as unattainable, or even undesirable. This perception is based on the staff and management "divide" that often exists at many companies. However, a successfully implemented ESOP should create an environment demonstrating a shared pursuit of corporate objectives. Such an environment would serve largely to align management and staff with regard to their thoughts and actions.

In essence, the mission statement for a health care company serves the initial purpose of focusing employees—both staff and management—on the operating focus of the employer corporation. The implementation of an ESOP at a health care employer corporation has the potential:

continued on page 49

5. Companies are appointing individuals to serve on retirement plan committees who do not have the knowledge or access to inside information about the employer company's financial situation and marketplace issues. Such information is information that is not otherwise available to all shareholders. And, employer companies permit the committee to be represented by legal counsel (other than the counsel for the employer corporation and counsel for the ESOP).

This means that the chief executive officer, president, chief financial officer, chairman of the board, and other members of the board of directors do not serve on any fiduciary retirement plan committee (unless an individual's expertise is essential to the committee's function).

6. Companies are:
 - a. appointing individuals to the retirement plan committees and other fiduciaries through specific language in the plan document, as compared to the appointments being the sole responsibility of the board of directors or an officer of the company, and
 - b. documenting the qualification of the individuals being appointed to these committees.
7. Companies are using and appointing independent fiduciaries that are discretionary fiduciaries to take the responsibility for the employer company stock investments held in the retirement plans.

A recurring theme in company stock-related fiduciary litigation is that the fiduciaries failed to act in the sole interest of plan participants in deciding to purchase, sell, vote, tender or retain the company stock investment in the retirement plan. In other words, there was a "conflict of interest."

The primary purpose of the independent fiduciary is to ensure unbiased oversight regarding employer company stock holdings, provided that:

- a. the independent fiduciary that is selected and appointed is qualified (both in the terms of financial resources and being knowledgeable in the area) and
- b. the board of directors or the committee monitors the activities of the independent fiduciary.

SUMMARY AND CONCLUSION

In conclusion, it is important to be aware that case law continues to evolve in this area. In addition, employer companies, plan fiduciaries, and ESOP committee members should begin (or continue) to implement "best practices" to address those retirement plan matters.

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ESOP FORMATION HEALTH CARE

continued from page 35

(1) to enhance the meaning of the mission statement for the employer corporation and (2) to motivate employees at all levels to contribute in a manner reflecting a vested interest in the long-term success of the employer corporation.

Existing employer corporation ownership and/or management should recognize the potential for operating improvement. This operating improvement should result from meaningful contributions of employees at all levels, and it should provide opportunities for employees to make such contributions.

In a health care industry employer corporation, potential for such improvements exists with regard to:

1. identifying processes relating to more efficient and effective operations (i.e., "best practices"),
2. identifying programs aimed at reducing theft and waste,
3. developing and strengthening compliance-related programs and rewarding valuable loss prevention recommendations, and
4. fostering a strong sense of employee ownership and commitment aimed at instilling an "ownership of the bottom line" perspective.

SUMMARY AND CONCLUSION

This article provided a general discussion of several key factors that financial advisers and owner/operators often consider to determine the reasonableness of implementing an ESOP at a health care industry employer corporation. While the factors identified in this article do not represent an exhaustive list, the discussion indicates that many health-care-based companies represent viable options for the successful implementation of an ESOP.

Such an ESOP implementation could:

1. result in material benefits to both the selling shareholder(s) and the company employees and
2. produce the ultimate corporate goal of aligning the objectives of the employees with the strategic direction of the employer corporation.

This is because the ESOP participants have a vested economic interest in the future performance of the health care industry employer corporation.

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