

## ESOP Transaction Insights

## INDIANA'S ESOP INITIATIVE

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*We recently had the privilege and honor of working with Willamette Management Associates and other professionals on the first employee stock ownership plan (ESOP) transaction to close under the new Indiana ESOP Initiative (IEI) program. Richard Mourdock, Indiana State Treasurer, created the IEI (1) to promote and encourage the formation of ESOPs in Indiana companies and (2) to incentivize and reward Hoosier workers to increase employee productivity. Mourdock is often quoted as saying, "One of the best reasons to help Indiana companies become employee-owned is that no group of employee-owners have ever, ever, ever, ever moved their company to Mexico or China!" This discussion will first describe Treasurer Mourdock's background, as well as the background of the IEI. This discussion will then focus on the IEI participation requirements. This discussion will present a brief question and answer dialogue with Treasurer Mourdock regarding ESOP formations. And, finally, this discussion will describe the application of the IEI to Radian Research, Inc. Radian Research, Inc., was the first employer corporation to implement an ESOP under this IEI program.*

*I would not have had the opportunity to serve as Indiana's State Treasurer if I had not been involved with an ESOP early in my career.—Richard Mourdock.*

In fact, at the age of 50, Treasurer Mourdock left Koester Mining confident that his retirement savings were sufficient for him:

1. to begin his own business and
2. to pursue his career goal of public service.

## INTRODUCTION

Prior to entering public service, Indiana State Treasurer Mourdock, a geologist by training, was an employee of Koester Mining, Inc., in Evansville, Indiana. In 1984, Koester Mining established an ESOP and began the process of becoming 100 percent employee-owned through an ESOP.

Over time, the company experienced changes in the economy and in its market. These changes created challenges for Koester Mining along the way. In spite of the challenges, the Koester Mining ESOP:

1. allowed for the company's expansion,
2. helped develop a sense of employee-ownership through much of its workforce, and
3. increased the company's stock value.

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On March 5, 2001, Mourdock wrote in his day-timer, "Today, I begin the second half of my working life." An ESOP allowed Treasurer Mourdock to enjoy that kind of personal and vocational freedom. And, it is an experience that Mourdock wants thousands of Hoosiers and others to share in as well.

## THE INDIANA TREASURER OF STATE

Mourdock understands firsthand that ESOPs have a clear track record of:

1. creating wealth,
2. encouraging entrepreneurial attitudes, and
3. increasing employee productivity.

He also knows that the key to retaining Indiana jobs is to increase the productivity of its workforce.

The Indiana Office of the Treasurer of State is responsible for the investment of monies placed in the state treasury. On a routine basis, the treasurer's office invests the state's monies by purchasing certificates of deposits (CDs) from Indiana's financial institutions at predetermined rates of interest.

When setting up the IEI, the Treasurer of State's Office initially made a \$50 million investment in the ESOP "linked-deposit" program. This program is intended to link the State's routine purchase of CDs from Indiana's financial institutions to Hoosier companies needing capital to complete an ESOP transaction. The CDs are purchased at a slightly reduced rate of interest and the financial institution agrees to reduce the interest rate on the loan made to the company.

The current CD rate to the state is 1.0 percent, and the current loan rate to the ESOP is 4.25 percent. The IEI also comes without creating additional burdens for taxpayers. Money to fund the program will come from money the state already invests in Indiana financial institutions.

As part of the IEI, Treasurer Mourdock also announced that Credit Suisse, the bank that manages the Indiana Investment Fund, will consider on a case-by-case basis, purchasing equity in an Indiana company for the purpose of completing an ESOP transaction. This part of the IEI program allows capital infusion that may be necessary to complete the transaction.

## THE ESOP "TOOLBOX"

The last component of the IEI program is an "ESOP toolbox" of resources and information that Treasurer Mourdock has assembled for:

1. business owners and employees wanting to learn more about ESOPs,
2. professional organizations that can assist with their creation, and
3. other ESOP sponsor companies across the state.

The ESOP toolbox is continually updated with new information and is available at <http://www.in.gov/tos/>.

Treasurer Mourdock continues to travel across Indiana telling the ESOP story. He has been referred to as the "ESOP evangelist." He has also established three committees on ESOPs—one on finance, another on legislation, and a third on education and outreach.

These committees are comprised of ESOP and business experts from all over Indiana and are designed to answer

one question: How may we encourage more companies to become ESOPs in the State of Indiana?

## AN OVERVIEW OF THE IEI PROGRAM REQUIREMENTS

In order to participate in the IEI, the following requirements, guidelines, and limitations must be met.

### Eligibility Requirements for Participation in the IEI

1. A company must:
  - a. have its headquarters located in the State of Indiana,
  - b. conduct a significant portion of its operations in Indiana, and
  - c. employ the majority of its employees in Indiana, while participating in the ESOP Linked-Deposit Program.
2. The Treasurer of State will not make any judgment on the credit quality of any applicant. But, the Treasurer will rely solely on the credit evaluation provided by the financial institution(s) providing the transactional loan.
3. An applicant may not have an established ESOP prior to participating in the ESOP Linked-Deposit Program. The program is for new ESOPs only and is not available for second-stage ESOP transactions.

### Documentation Requirements

A company must provide the following information:

1. a complete business plan
2. resumes of key managers and substantial evidence of their commitment to service after the ESOP Linked-Deposit Program is completed
3. a complete transition plan
4. names and contact information of the professionals who created the ESOP trust and performed the financial evaluation of the company

### Investment Guidelines

1. At least ten percent of a company's ownership must be transferred to the ESOP in the initial employer stock purchase transaction.

2. The maximum amount that is available to a sponsor company participating in the ESOP Linked-Deposit Program is \$5 million.
3. Funds will be deposited in the form of 12-month CDs with an “approved depository” (as defined by the Indiana Board for Depositories).
4. The CDs will be renewed on a yearly basis for up to 3 years.
  - a. The interest rate on the CDs will be determined by the Treasurer of State.
  - b. The financial institution may charge the borrower up to 3.25 percent more than the rate received by the Treasurer of State on its CDs.
  - c. CDs will be purchased by the Treasurer of State on the first and fourth Thursday of each month.
5. The interest rate for new CDs may be adjusted on a quarterly basis at the discretion of the Treasurer of State’s Office.

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### Limitations on the ESOP Loan

There are certain limitations related to the ESOP loan with respect to availability of funding. In addition, the financial institution assumes all credit risk.

In the event of default by the ESOP, the linked-deposit will be terminated at the maturity of the CDs being held by the lending institution.

### QUESTIONS FOR INDIANA STATE TREASURER RICHARD MOURDOCK

We recently asked Treasurer Mourdock a series of questions on:

1. his take on current perceptions of ESOPs,
2. how he views a change in administration may impact ESOPs, and
3. his advice to the ESOP community.

The following section presents his responses to these questions.

Q: So you are obviously very positive when it comes to ESOPs. What do you say to those opponents of ESOPs who single out companies like United Airlines as an example of ESOPs that didn’t work?

A: An ESOP is not a silver bullet or magic pixie dust, and running a business is always tough. Converting a failing company into an ESOP is never a good idea, and many ESOPs that failed were created as a last-ditch effort.

The truth remains that thousands of large and small ESOP companies, some 100 percent employee-owned and others partially employee-owned, are succeeding during these difficult economic times because of the entrepreneurial environment created by the ESOPs.

For many Americans, owning a business is a dream, and an ESOP helps make that dream a reality.

Q: Looking into your crystal ball, do you have any sense of how the new administration may affect the ESOP world?

A: Working in the financial world, I see nothing positive coming from the new administration’s plan for “fixing” the economy. In fairness, I don’t hear much positive coming from the minority party either.

I believe that we will see a slow recovery over the next several years and the state of the economy, obviously, affects every business. The move from free market capitalism to more public ownership of previously private entities is disturbing.

Some members of Congress believe that ESOPs were simply created to minimize federal tax liability, and they have lost sight of the fact

that ESOPs are about creating wealth for “working class” Americans.

Our nation’s employee-owners must do a better job of communicating to their congressmen that successful ESOPs can play a part in the American dream of having fully funded retirement savings.

Q: Do you have any advice for the ESOP community?

A: Shout it to the world! ESOPs may appear complex, but they are simply a retirement plan that allows employee-owners to have a real stake in their future. ESOPs are a good thing!

As I’ve said many times, there is now 30 years of evidence that ESOP companies tend to be more

innovative, have higher return on investment, have much higher rates of employee retention, and, best of all, in this emerging global economy, there has never, ever, ever been an employee-owned business pack up and move to Mexico or China.

In the most difficult financial period of the past 50 years, American businesses need to find new ways to motivate and keep employees; ESOPs are definitely a part of the answer.

## CASE STUDY OF THE RADIAN RESEARCH, INC., ESOP TRANSACTION

Radian Research, Inc., is located in Lafayette, Indiana. According to the company's Web site, "Radian is a recognized world leader in the research and development of energy reference standards, energy meter testing systems, current transformer testers and automated laboratory energy reference systems. Radian's energy reference standards are absolutely unequalled in accuracy, stability and reliability. Radian's customer base is worldwide and typically consists of electric utility companies, energy meter manufacturers, energy meter test system manufacturers and national metrology institutes."

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### History of Radian Research, Inc.

Glenn A. Mayfield, an electrical measurement physicist, founded Radian Research in 1982.

Mr. Mayfield devoted his life to Radian, and he was involved in every aspect of research, development, design, operations, marketing, and sales. However, while Mayfield was doing this, he also built a strong management team to help lead the company.

Mr. Mayfield passed away in January 2007. In his Will, he appointed Tim Everidge, his business associate, as his personal representative. And, he directed Tim to sell his Radian stock in a manner that was in the best interest of the employees and the other shareholders.

Radian's board of directors appointed Tim as president and CEO of the company. Tim then began to research how to fulfill Glenn's expressed wish. And, he determined that selling the company's stock to an ESOP was the best way.

Now, all Tim and other members of management had to do was to convince the company's board of directors and stockholders of this. Glenn's estate held more than 80 percent of the company's stock which was divided up among

three beneficiaries. The remainder of the company's stock was owned by three outside shareholders.

Through a series of ESOP-related meetings and conferences, the Radian Research board of directors became aligned with Tim's belief that an ESOP not only fulfilled Glenn's wishes, but it was also in the best interest of the future of the company.

### The ESOP Advisory Team

Radian Research management hired a team of ESOP experts to lead them in the design and establishment of the ESOP. Horizon Trust and Investment Management, N.A., of Michigan City, Indiana, was asked to serve as the independent ESOP trustee.

The Horizon valuation advisers were Mike Hartman and Steve Whittington of the Willamette Management Associates Atlanta office. And, the Horizon legal advisers were Stephen Smith, Alexander Mounts, and Lisa Durham of Krieg DeVault LLP in Indianapolis.

### The ESOP Transaction Structure

Radian Research management determined that the best deal structure would be for the company to redeem and retire the majority of the outstanding stock with the remaining shares to be sold to the ESOP. Immediately after these transactions,

the ESOP would own 100 percent of Radian Research, which is an S corporation.

Management understood the important income tax benefits of a 100 percent owned S corporation ESOP. And, management wanted to take advantage of these benefits as soon as possible.

The redemptions by the company were originally to be funded by ten-year notes to the sellers. However, in the negotiation process, the company decided to borrow the redemption proceeds from a bank in order to immediately pay the sellers.

As is typically the case in ESOP transactions, the purchase by the ESOP was funded by a loan from Radian, which amount Radian in turn borrowed from its bank, Key Bank.

Through a series of discussions, Radian was informed of the linked-deposit program under IEL. This transaction fit the requirements of the program and Radian was hopeful to be able to take advantage of the low interest rate.

## The IEI Program

Management, with the help of legal counsel, completed the application found on the IEI Web site and submitted it to the Indiana Treasurer's Office. Radian was the first company to apply for, and receive, a loan through the linked-deposit program.

Other than the application, there was only one other procedure to the approval process for the IEI loan. ESOP counsel, Stephen Smith, was interviewed by Richard Mourdock and his team to ensure Radian Research was stable and the ESOP transaction was financially prudent.

The IEI team relied on Key Bank to perform further due diligence in these areas. Based on the application and the interview with legal counsel, the Radian ESOP transaction was accepted into the IEI linked-deposit program.

Use of the linked-deposit program did not require any other special documentation, nor did it affect the structure of the transaction. When the original IEI application was submitted, the management intended to use seller notes to fund the redemptions by the company, so the application was only for funding the ESOP purchase.

However, as negotiations progressed and Radian Research management began to believe that the company would also have to bank-finance the redemptions, they asked the IEI team if additional linked-deposit loans could be made for the redemptions.

The Indiana Treasurer's Office determined that because all the funds were being used to establish an ESOP, it didn't matter whether the funds were for a stock redemption or a direct stock purchase by the ESOP. The additional loans for the employer stock redemptions were approved.

In light of the increased borrowings, Key Bank required additional collateral for the stock redemption loans. Each of the beneficiaries of the estate and the other shareholders were required to pledge back half of their stock redemption proceeds as collateral.

The pledge back amounts are held in Key Bank certificates of deposit. The maturity dates on these certificates of deposit match the loan payment dates on the stock redemption loans. As the redemption loans are paid off, the CDs mature and are released as collateral.

In return, the sellers received indemnification agreements from Radian which require the company to make additional principal payments under certain circumstances.

The additional principal payments will allow the collateral to be released sooner.

## The Final ESOP Stock Purchase Transaction

The Radian Research ESOP transaction was originally intended to close before Thanksgiving of 2008. However, due to prolonged negotiations with the estate beneficiaries, the ESOP transaction did not actually close until the week before Christmas.

Radian Research management is extremely pleased with the outcome of the employer stock purchase transaction. The ESOP will provide beneficial ownership and retirement savings for all of its eligible employees.

The Key Bank loans through the linked-deposit program provide cost-effective funding so Radian Research can pay off the debt as soon as practicable. Radian Research management should feel proud they have done their best to fulfill Glenn Mayfield's wishes for his company.

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## SUMMARY AND CONCLUSION

The IEI is not the only state-sponsored program to encourage the use of ESOPs to incentivize workers and retain jobs.

However, Treasurer Mourdock brings a powerful personal testimony of the benefits of ESOPs based on his prior ESOP participation.

We are eager to see if other companies, like Radian Research, will take advantage of the linked-deposit program to potentially obtain lower lending rates and thereby make it easier to fund ESOP transactions.

The current condition of the U.S. financial markets has severely impacted the ability of sponsor companies to obtain bank financing to support ESOP transactions. The Indiana IEI program is a creative solution to this problem.

We hope that this proactive initiative will find its way into other states and that forward-thinking officials like Richard Mourdock will take up the cause.

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