SHOULD YOUR CONSTRUCTION COMPANY ESTABLISH AN ESOP?

The popularity of Employee Stock Ownership Plans ("ESOP") has grown in recent years as a vehicle for owners of closely held companies to increase profitability, realize multiple tax advantages and plan an exit strategy. Furthermore, because an ESOP gives employees a share of the company, they feel a sense of pride in ownership, which can lead to an increase in productivity and a valuable incentive for employees to want the company to succeed. This investment tool is available to all closely held businesses, including construction companies. However, given the nuances involved in the construction industry and involvement of surety companies, ESOPs can be more challenging to effectuate.

Surety Programs for Construction Contracts

Most general construction companies deal with surety companies that issue bonds to assure the owner in a private project or municipality that the company will comply with the terms of the construction contract and complete the project on time. The relationship with a surety company is critical to the contractor, but the process of securing a surety bond is complex and comprehensive. If the contractor fails to fulfill its contractual obligations, the surety company is obligated to step in and complete the project, which involves risk and the need to carefully examine the contractor's financial viability.

The surety company must be satisfied that the contractor runs a well-managed, profitable enterprise and performs its obligations in accordance with contract terms. The underwriting considerations include a review of capital and cash flow to support the surety program, as well as the continuity of the principals and the management team. The surety will require the contractor to maintain a certain amount of working capital and achieve a level of net worth that supports the surety program. Generally, a surety will structure the program based on a percentage of the company's analyzed working capital and its net worth.

Each surety company has its own underwriting standards, which will vary depending on the industry, type of work, experience and whether the company is prime or a subcontractor. Sureties will often require audited financial statements prepared by a CPA firm. Underwriters track the projects on an ongoing basis to see that the projects are progressing on schedule and that there are no profit or billing issues. Complete and accurate cost recording and accounting systems are extremely important to surety companies without which the contractor may not be able to identify and correct problems before they become too severe.

The contractor will be required to execute an indemnity agreement, which obligates the named indemnitors to protect the surety from any loss or expense. The indemnity will be required of the contracting firm and any subsidiaries or affiliates. Personal guarantees from all major shareholders are usually required. There are some surety markets that will take collateral to support a surety program. Collateral can be in form of a secured interest in property or an irrevocable letter of credit. Another option would be to bring in a third party to indemnify on behalf of the company.

Advantages & Disadvantages of ESOPs for Construction Companies

A surety may consider an ESOP as part of a continuity plan with key employees that could enhance the financial wherewithal of the contractor. Oddly, only a small percentage of closely held companies have created succession plans, which presents significant challenges for the company to remain viable after the departure or retirement of the founder or major shareholder. This is an important consideration for sureties because the majority of their clients are relatively small companies that may have only a few key people. The surety will require the assurance that if something happens to the owner or a key person, existing bonded projects will be completed. An ESOP is one way to solve this problem by establishing a readily available market for the purchase of shares from controlling shareholders as part of a business continuity plan. If there is a need to purchase the shares of a major shareholder, and there is liquidity or debt capacity in the ESOP, then the financial impact to the company is minimized.

An ESOP is designed to provide employees with the incentive of obtaining an equity interest in the company and to enable the employees to share in the capital growth of the company. The retention of key employees and work crews is important for sureties as it provides comfort that their bonded projects will be properly manned and managed. Employee ownership is a good tool to lock in a work force and the goal of employee ownership is to align all of the employees' interest in the business so that everyone is motivated to achieve higher profits. This incentive can produce very positive benefits for the company's bottom line profits and surety program. In addition, a business owner can reap the added benefit of increased profits and stock valuation for the owner and his or her company. The ESOP can be particularly advantageous for companies whose rapid growth has required the reinvestment of profits, resulting in a shortage of cash available for employee benefits. A collateral benefit is that the ESOP often serves to diminish employee interest in unionization.

An ESOP can also be an effective tool for increasing cash flow and net worth. A contractor can reduce its corporate income taxes and increase its cash flow and net worth by simply issuing treasury stock or newly issued stock to an ESOP. Using this approach, a company may drastically reduce or even eliminate its corporate tax liability. The cash flow impact can be dramatic. If the contribution to the ESOP is made in lieu of cash contributions to a profit-sharing plan, the cash flow savings are even more dramatic. This has obvious advantages to contractors, as it will enhance their financial wherewithal by creating additional cash and capital to finance their projects, and consequently improve their surety program.

One disadvantage of an ESOP for a construction company relates to how it will impact the capital structure of the company that is required by the surety. If the company borrows funds and then lends the funds to the ESOP to enable the ESOP to make a leveraged purchase of company stock, the bank loan is recorded as a liability on the company's balance sheet, and a like amount debited to the equity account which is critical to the bonding program. The impact on the balance sheet of the company is to reduce the company's net worth by the amount of the bank debt.

This reduction in net worth could impact the company's ability to obtain surety bonds should the tangible net worth fall below the underwriting requirement established for the surety program. An alternative is a gradual implementation of the ESOP in which a fairly significant portion of the company's ownership is retained by the founders. Alternatively, the infusion of additional capital to meet the underwriting requirements may be required. The shareholders can inject additional paid-in-capital, or they could loan funds to the company and then subordinate the loan to the surety. Since subordinated debt is not to be paid back without the permission of the surety, they generally do not consider subordinated debt as a liability, thus increasing net worth by the amount of the debt.

Also, if the value of the stock appreciates substantially, the ESOP and/or the company may not have sufficient funds to repurchase stock upon a shareholder's retirement. Ideally, the ESOP will maintain a portion of the fund in liquid investments in order to provide liquidity for retiring or terminating employees. If the stock of the company appreciates dramatically, the liquidity needs will increase correspondingly. Conversely, if the value of the company does not increase, the employees may feel that the ESOP is less attractive than a profit-sharing plan, and the incentive attributes may be minimized.

There are some positive attributes about an ESOP that a surety will consider when underwriting an account. An ESOP may not be appropriate for all construction firms, but for some, it could be a good tool to enhance their surety program. It is most beneficial for mature contracting firms with a large non-union workforce, a consistent source of revenue, and growing but stable earnings. A company must consider the implications of instituting an ESOP and what it will do to its surety program. If there is no immediate need to cash out a major stockholder, it may be beneficial to gradually increase ESOP ownership to reduce the financial burden and any impact it will have on the surety program. Companies should discuss the implications of instituting an employee stock ownership plan with their surety broker as well as with their other business partners.

If you have questions pertaining to ESOPs, please contact PLDO Managing Principal Gary R. Pannone at 401-824-5100 or email gpannone@pldolaw.com.

Gary R. Pannone
Managing Principal

PANNONE LOPES DEVEREAUX & O'GARA LLC
counselors at law