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S-CORPORATION LEVERAGED ESOPS

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S-CORPORATION LEVERAGED ESOP TRANSACTIONS

S-corporation leveraged employee stock ownership plans ("***ESOPs***") have the potential for generating enhanced cash flows due to their tax-advantaged structure as well as the increased motivation of employees resulting from the employees' beneficial ownership of company stock.

STRUCTURE AND ADVANTAGES OF S-CORPORATION LEVERAGED ESOP TRANSACTIONS

Unlike other employee benefit plans, an ESOP has the ability to borrow money in order to enable employee ownership. This has led to the development of leveraged ESOP transactions as a method of corporate finance and as a catalyst for broader tax-advantaged ownership.

Leveraged ESOP transactions used for buyouts generally involve a basic four-step process.

First, the target company borrows money from senior lending institutions in exchange for senior notes, and from mezzanine capital providers in exchange for subordinated convertible notes and warrants. Next, the company lends the proceeds of the loans to the company's existing or newly formed ESOP in exchange for notes. The ESOP then buys the company's equity from its existing shareholders, resulting in a company whose equity securities are wholly owned by the ESOP.

Over time, the company makes cash contributions or pays dividends to the ESOP out of its cash flow. The ESOP then uses such contributions and dividends to pay principal and interest on its notes to the company. The company, in turn, uses cash received by the ESOP to repay principal and interest on its notes to the lenders.

Where the company is a C-corporation, the ESOP contributions or dividend payments are tax deductible. As a result, the company can in effect deduct principal as well as interest from taxes in repaying its loans. This can significantly reduce the cost of the loan to the company, by lowering the number of pre-tax dollars needed to repay the principal by as much as 34%, depending on the company's tax bracket.

As described below under "*Certain Tax and Regulatory Aspects of ESOPs*," corporations that have stock owned by an ESOP recently became eligible to make an election to be treated as an S-corporation for federal income tax purposes and be exempted from UBIT. These developments paved the way for S-corporation leveraged ESOP transactions, which have even more attractive tax advantages than C-corporation leveraged ESOP transactions.

In a S-corporation leveraged ESOP buyout, immediately following the closing of the acquisition of the company's equity from its existing shareholders, the company elects "S-corporation" status with the Internal Revenue Service. As a result, its earnings are not subject to federal income tax (or state income tax in states that recognize the "S" election) and instead pass through for federal (and certain state) income tax purposes to its sole shareholder, the ESOP (which itself is a tax-exempt entity). Accordingly, the company will have the ability to generate operating cash flows and service its debt on a tax-free basis for federal (and certain state) income tax purposes. These tax advantages also enhance the ability of the company to obtain adequate senior debt for the transaction.

There also can be tax advantages to shareholders of private companies selling their stock to an ESOP. If the requirements of Section 1042 of the Internal Revenue Code of 1986, as amended (the "***Code***") are satisfied, including the requirement that the proceeds of the sale are invested in certain qualified replacement properties ("***QRPs***"), the selling shareholder can postpone the capital gains taxation on the sale of his or her stock until disposition of the QRPs. The use of an ESOP and QRPs effectively allows the shareholder to diversify his or her wealth from a single holding in a private company into a broader portfolio without triggering capital gains tax.

In addition to the tax benefits, research has shown that the alignment of employer and employee interests an ESOP structure will improve employees' performance, increase their dedication to their companies, optimize workplace efficiencies and reduce turnover, which in turn can translate into substantial operating improvements.

COMPARISONS WITH TYPICAL MANAGEMENT BUYOUTS

The S-corporation ESOP leveraged buyout is the most powerful application of the S-corporation ESOP structure, and has inherent competitive advantages relative to traditional management-led C-corporation leveraged buyout structures, as well as C-corporation ESOP-led leveraged buyout transactions. The following charts highlight some of these advantages, as well as some potential transaction challenges.

Basic MBO & S-Corporation ESOP Differences

The following are certain basic differences between traditional equity sponsored management buyouts of C-corporations and S-corporation leveraged ESOP buyouts.

EQUITY SPONSORED MBO	S-CORPORATION LEVERAGED ESOP
▪ Financing Structure - 45 to 55% equity - 45 to 55% senior debt ▪ 5 to 10% Management incentive program ▪ Liquidity in 3 to 5 years ▪ After-tax acquisition financing ▪ Control – Equity Sponsor (active in strategy and problem solving) ▪ Strategic buyer	▪ Financing Structure - 25 to 35% equity – qualified plans - 10 to 15% subordinated debt - 50 to 60% senior debt ▪ 10 to 20% Management incentive program ▪ Long time horizon ▪ Pretax acquisition financing ▪ Tax free entity opportunity ▪ Control – ESOP Trustee (passive role) of buyout group inclusively ▪ Financial buyer

S-Corporation Transactional Benefits

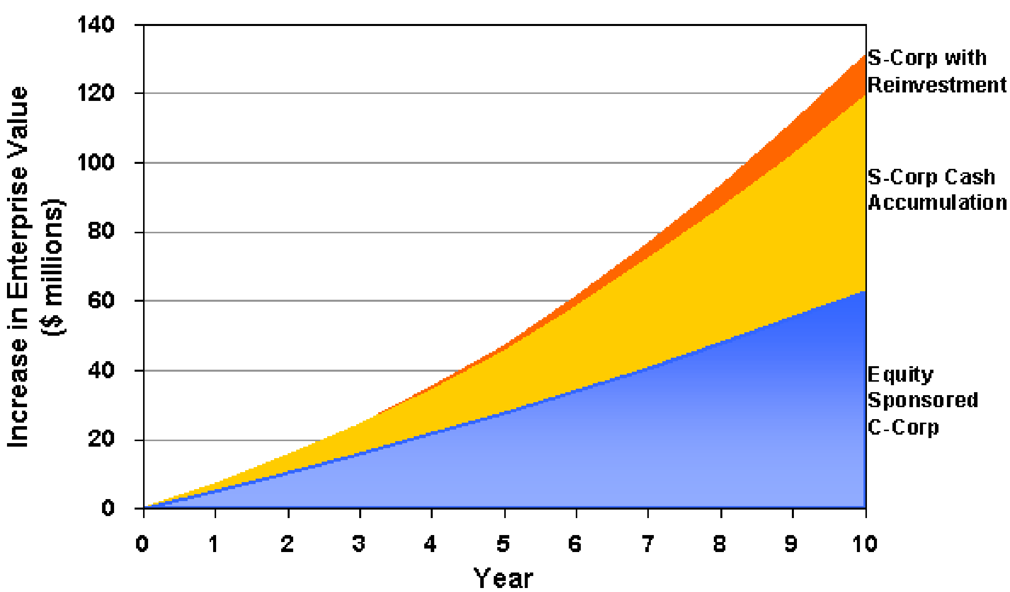
The following is an example of a hypothetical company engaging in a buyout transaction which highlights the significantly greater increase in enterpise value over time if the company were to choose a 100% S-Corporation ESOP buyout over a traditional equity-sponsored C-corporation buyout.

Transaction assumptions and financial background information for the hypothetical are as follows:

TRANSACTION INFORMATION		
EBITDA	$20	million
EBITDA multiple	5.0x	
Enterprise value	$100	million
EBITDA growth	5.0%	
Interest rate on accumulated tax savings	5.0%	
Tax Rate	40.0%	
% of tax savings reinvested	50.0%	
Return on reinvested tax savings	13.7%	

DEBT INFORMATION		
Senior Debt	$40	million
Interest	8.0%	
Interest	8.0%	
Subordinated Debt	$20	million
EBITDA multiple		
Interest	12.0%	
PIK	3.0%	
Warrants	17.6%	
Years to principal repayment	5	

The following graph, which is based on the assumptions set out above, shows the significantly greater increase in enterprise value over time in choosing a 100% S-Corporation ESOP buyout, and either reinvesting or not reinvesting the tax savings, over a traditional equity-sponsored C-corporation buyout.



Decision Factors Influencing S-Corporation Election

The following are certain factors to be considered in deciding whether to engage in a traditional equity-sponsored management-led buyout or an S-corporation ESOP-led leveraged buyout.

EQUITY SPONSORED MBO	S-CORPORATION LEVERAGED ESOP
▪ 5 to 10% management incentive program ▪ Equity sponsor has ultimate control ▪ Financial considerations – Deep pockets or allocated equity – Over funding transactions with equity or mezzanine	▪ 10 to 20% management incentive program including ESOP participation ▪ Buyout group including ESOP trustee has ultimate control ▪ Financial Considerations – pretax dollars for debt payment – tax free entity opportunity

S-Corporation Leveraged ESOP Buyouts Have Positive Attributes & Potential Issues

The following are certain positive attributes of, and potential issues relating to, S-corporation ESOP buyouts.

POSITIVE ATTRIBUTES	POTENTIAL ISSUES
▪ Tax free sale ▪ Pre-tax acquisition financing ▪ Can utilized other qualified plan assets and overfunded DB plans ▪ Wealth building opportunity – Employees – Management ▪ Employee/owner ▪ Management compensation – ESOP make up programs – Incentive compensation ▪ Not a competitive threat ▪ Flexible sale option (1% to 100%) ▪ No corporate taxes (if S-Corp) – Pay debt faster – Reinvest in business – Value grows faster	▪ Costs ▪ Regulatory oversight ▪ Corporate Governance – Information Distribution – Trustee Involvement ▪ Valuation – not an exact science ▪ Repurchase Liability – Shares bought twice – Redemption not tax deductible – Competition for capital ▪ Lower pretax price than strategic buyer (but tax benefits can eliminate difference) ▪ No built-in functional infrastructure ▪ High leverage likely

Certain Tax and Regulatory Aspects of ESOPs

An ESOP is a type of qualified employee benefit plan that enables employees to be significant owners of company stock. Certain federal tax and regulatory aspects of ESOPs are described below.

Tax Advantages of ESOPs

The fair market value of the stock contributed by a company to its ESOP, and the amount of cash contributions (including dividends in the case of C-corporations) paid to its ESOP, are deductible for federal income tax purposes. As a result, companies that make cash contributions to an ESOP can reduce pretax income, pay less in income taxes and increase after-tax cash flow.

Effective January 1, 1998, corporations that have stock owned by an ESOP became eligible to make an election to be treated as an S-corporation for federal income tax purposes. An S-corporation is not subject to federal income tax; instead, the income of the S-corporation is passed through to its shareholders, who are subject to tax on their respective shares of the S-corporation's income. When an S-corporation is 100% owned by an ESOP (a tax-exempt entity), there are no federal income taxes due. In addition, ESOPs were exempted from the unrelated business income tax ("***UBIT***"). In 2001, Congress revisited this law and enacted legislation urged by ESOP advocates that would prevent its abuse by companies orchestrating ESOPs designed to benefit a few select individuals, often in situations where an S-corporation management company was set up to manage a large C-corporation operating company. This legislation also helps protect legitimate S-corporation ESOPs from being mistakenly categorized along with questionable abusive tax schemes. In most states where the S-corporation election is recognized, the company may also be exempt from state income taxes.

Employees pay no tax on stock allocated to their ESOP accounts until they receive distributions, at which point they are taxed on the distributions. If they are younger than age 59-1/2 (or age 55 if they have terminated employment), these individuals, like employees in qualified plans generally, are subject not only to applicable taxes but also to an additional 10% excise tax unless they roll their distributions into an IRA or a successor plan in another company (unless the participant terminated employment due to death or disability). If distributions are rolled over into individual retirement accounts (IRAs) or successor plans, the employees pay no tax until the money is withdrawn.

Other Regulatory Aspects of ESOPs

While ESOPs are granted certain tax incentives, they are subject to other regulations, including, among others, the following:

Designed to Invest Primarily in Employer Securities. An ESOP must be designed to invest primarily in "employer securities." For a company whose stock is traded on an established public exchange, employer securities means tradable common stock. For a company whose stock is not traded on an established public exchange, employer securities means the common stock of the company having at least the greatest combination of voting power and dividend rights. Non-callable convertible preferred stock may also qualify as an employer security if it is convertible at any time into common stock described above at a reasonable price.

Exempt Loans. The only manner in which an ESOP can borrow money to purchase employer securities from a party in interest, or have a loan guaranteed by a party in interest, is when the loan meets the "exempt loan" requirements. Some of the requirements of an "exempt loan" are that the loan is non-recourse against the ESOP, is collateralized solely with the securities purchase, and has a reasonable interest rate. All employer securities purchased with the proceeds of an exempt loan must be allocated initially to a suspense account and not allocated to individual participants' accounts. Each year, as the exempt loan is repaid, shares are released from the suspense account and allocated to participants' accounts.

Voting Rights. With respect to employer securities of private companies held by an ESOP that have voting rights, each participant in the ESOP must be permitted to exercise certain voting rights on shares of stock that have been allocated to his or her account on major issues, such as closing or relocating, but the company can choose whether to pass through voting rights (such as for the board of directors) on other issues.

Independent Appraisal. All employer securities of private companies must be valued annually by an independent appraiser.

Share Repurchase Liability. When employees leave the company, become disabled or die, the company must buy back the shares that have vested in their account at their fair market value. Fair market value is determined by reference to the most recent independent appraisal of the company. These share buy-backs may be made in installments over a period of years, except if they are made as a result of the employee's disability or death. If the company chooses to make installment payments, the company must provide "adequate security" and pay interest to the ESOP participant on the unpaid balance of an installment distribution.