

Surety Considerations for Construction Company ESOPs

About the Series

This paper is the second in a CICPAC series on ESOPs in the construction industry. It examines how ESOP transactions affect bonding capacity and surety relationships, helping owners and their advisors anticipate underwriting concerns before pursuing a transaction.

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Introduction

For construction companies, the surety relationship is foundational. Bonding capacity determines what work a contractor can pursue, and the financial and organizational changes that accompany an ESOP transaction can raise legitimate questions for surety underwriters. At the same time, a well-structured ESOP can actually strengthen the surety relationship over time.

Proper succession planning has long been of paramount importance to both construction company owners and their sureties. With the aging ownership population in this industry, solving for this risk while balancing the interests of all parties is an ever-increasing challenge. The lack of proper succession planning and the improper execution of succession plans have historically proven to be risk factors that lead to contractor difficulties and, often, to failure. If executed correctly, however, employee stock ownership plans (ESOPs) can be a viable vehicle to facilitate ownership transfer and perpetuate a company.

This guide outlines how sureties evaluate ESOP-owned construction firms, the concerns they commonly raise during and after a transaction, and the ways in which an ESOP - when properly designed - can enhance long-term bonding capacity and surety confidence.

Timing of Surety Involvement

As with any form of continuity succession planning, timing of a surety's involvement with the ESOP process is critical. It is critically important to bring the surety in early to allow the opportunity to ask key questions and identify potential impacts on surety credit.

A Note on Professional Skepticism

Because ESOPs are highly regulated and financially complex legal entities, any contractor considering an ESOP should involve an experienced consulting firm to help determine whether the company is a good candidate. However, consulting firms are not created equal in terms of value provided. ESOP consultants have a vested interest in selling the deal and in remaining involved for the potentially lucrative annual administration of the ESOP.

How Sureties Evaluate ESOP Construction Firms

Surety underwriters approach ESOP contractors through the same fundamental lens they apply to all construction firms - management, financials, and project execution—but with additional scrutiny on the structural changes introduced by the ESOP transaction itself. Six areas receive the most attention:

Sureties and ESOPs: A Maturing Relationship

Sureties have now accumulated significant experience underwriting ESOP contractors, and most report positive long-term performance from these firms. That track record has increased confidence across the bonding industry in supporting ESOP-owned construction companies—provided the transaction is structured responsibly and management continuity is preserved.

1. Management Continuity and Leadership Stability

Sureties place significant weight on whether the leadership team remains intact following the ESOP transition. Strong, experienced management is one of the primary underwriting factors for any construction contractor, and it becomes even more critical when ownership is being transferred. The importance of strong leadership to the success of an ESOP cannot be overstated. Good stewardship leads to high employee-owner engagement, motivation, productivity, and ultimately, profitability. Just as strong leadership guidance can drive success, weak and/or misaligned leadership can have dire implications for these ownership structures.

Sureties want to see:

- Key principals and project managers committed to the company post-transaction.
- A clear organizational chart with defined roles and responsibilities.
- Succession depth below the senior leadership level.
- Sellers and/or the current management team remaining involved and in control of the company, at least while the management transition occurs.
- No disconnect between old and new management regarding ESOP ownership—ideally, new executive leadership will have been actively involved with the ESOP from the beginning of the process.
- Clarity on who controls key business relationships.
- A company culture that promotes strong leadership and ambition to succeed among employees, with remaining employees who value the opportunity to become owners.

- A relatively large employee base with adequate talent and age diversity to maintain continuity for the ongoing entity.
- The highest level of transparency
- Including employee owners in the process to promote engagement and alignment.

2. Leverage and Post-Transaction Capital Structure

ESOP transactions often introduce substantial new debt—both senior bank financing and seller notes. Sureties carefully evaluate the resulting capital structure to assess financial resilience:

- The total amount of senior and seller debt added through the transaction.
- Whether operating cash flow is sufficient to support both debt service and ongoing project needs.
- The impact on working capital and net equity, which are core bonding metrics.
- A history of profitability and a reasonable expectation of continued profitability.
- Little to no long-term debt prior to the transaction.

Higher leverage can temporarily reduce bonding capacity immediately following the transaction. Sureties generally expect a clear roadmap for how the company will rebuild its balance sheet in the years ahead.

Leveraged Plan: The company borrows money, either from a bank or from the selling shareholders, to purchase shares of the company's stock.

- If financed by a bank, the company borrows enough money to cover the stock purchase, then re-loans money to the ESOP. The ESOP pays the shareholders/owners and receives the stock. The company then makes contributions from its earnings to the ESOP trust, and the ESOP returns money to the company so it can cover its debt service to the lender(s).
- If financed by the selling shareholders, the mechanism works much the same, except the note is held by the selling shareholders and is usually paid back over several years to prevent the company balance sheet from taking the full hit of a cash-out all at once.
- Sureties generally prefer that the selling shareholders hold the note so that a bank does not have control. Selling shareholders are often willing to be flexible with repayment terms (if needed) and interest rates. Banks typically offer less flexibility on repayment terms and interest rates.
- Shareholder note(s) can be subordinated to the surety and therefore be counted as soft equity.

Warrants Represent Unique Risk

Consultants often use warrants to maximize proceeds to the seller while managing debt and cash flow at the initial transaction. A warrant is a call option on company stock, giving the holder the right to purchase additional shares at a future date at a stipulated price - often the original transaction price. Because exercising a warrant dilutes existing shareholders, it can reduce per-share value for employee-owners and undercut morale even when the company is performing well. Warrants can also be gifted or transferred through estate planning, which may change who holds them over time. Contractors should ensure warrants are formally subordinated to the surety's indemnity position, just as seller notes are.

Non-Leveraged Plan: Instead of borrowing money, the ESOP is generally funded in one of two ways: the company contributes shares of its stock, or the company makes cash contributions which are used to buy stock from the company or the selling shareholders.

Sureties generally prefer the non-leveraged method because establishing a leveraged plan may negatively impact the company's net worth, working capital, and debt-to-equity ratios, thereby reducing the company's ability to pursue bonded work.

Regardless of the method used to finance the ESOP, it is important to know the financing composition and terms, including the proposed payment and debt structure and the components of consideration to the selling shareholders.

Note: A detailed illustration of the accounting entries and financial statement impacts of leveraged and non-leveraged ESOP structures will be presented in a forthcoming paper in this series.

3. Cash Flow and ESOP Contribution Sustainability

Sureties analyze whether the company can sustain multiple competing demands on cash flow simultaneously:

- ESOP loan payments (in leveraged transactions).
- Required annual contributions to the ESOP trust.
- Ongoing working capital needs across the project portfolio.
- Share repurchase obligations to ESOP participants/shareholders.
- Reinvestment for growth.

Under an ESOP purchase agreement, the company is literally buying itself with future cash flows, so adequate future cash flow is of paramount importance. Cash flow forecasting is highly recommended. Forecast assumptions should be scrutinized for reasonableness and evaluated against historical data. Projections provided by outside consultants have proven to be optimistic, so it is important to conduct independent analysis.

Because construction cash flow is inherently cyclical, sureties pay particular attention to backlog quality, margin stability, and how the company has performed through prior down cycles.

Note: The specific accounting treatment and cash flow statement presentation of these transactions will be covered in greater detail in a forthcoming paper in this series.

Repurchase Obligations

Most ESOPs own the stock of privately owned firms, and as a result, no public market exists for sale of the company stock. ESOP provisions require the trust to purchase vested shares upon retirement, death, disability, or termination (under certain circumstances) of the participants. The degree and timing of the repurchase obligations demand detailed cash flow and overall organizational-impact forecasting. Age diversification will lessen the financial strain and risk associated with repurchase obligations. Near-term repurchase obligations must be evaluated against near-term projected earnings.

4. Company Valuation

Stock valuation is a critical underwriting consideration. Sureties evaluate:

- Whether the valuation was done by a reputable independent firm. The valuation should not be unrealistically high based on estimated future performance of the company.
- Whether the valuation is considered conservative, realistic, or aggressive. Given the volatility of a construction company's results, sureties prefer a more conservative valuation when determining the sales price.
- What assumptions went into the valuation, including when in the economic cycle the valuation occurs. Consultants frequently secure different valuations based on various revenue and profit margin assumptions.
- Whether pro-forma financial statements were presented. Oftentimes, ten years of forecasted financials are provided including a balance sheet, income statement, and cash flow forecast.
- Whether the required annual valuation of company stock has shown any significant fluctuations, and the impact on employee-owner morale when stock value decreases - not only their jobs but also their retirement savings are at risk.

5. Governance and ESOP Trustee Oversight

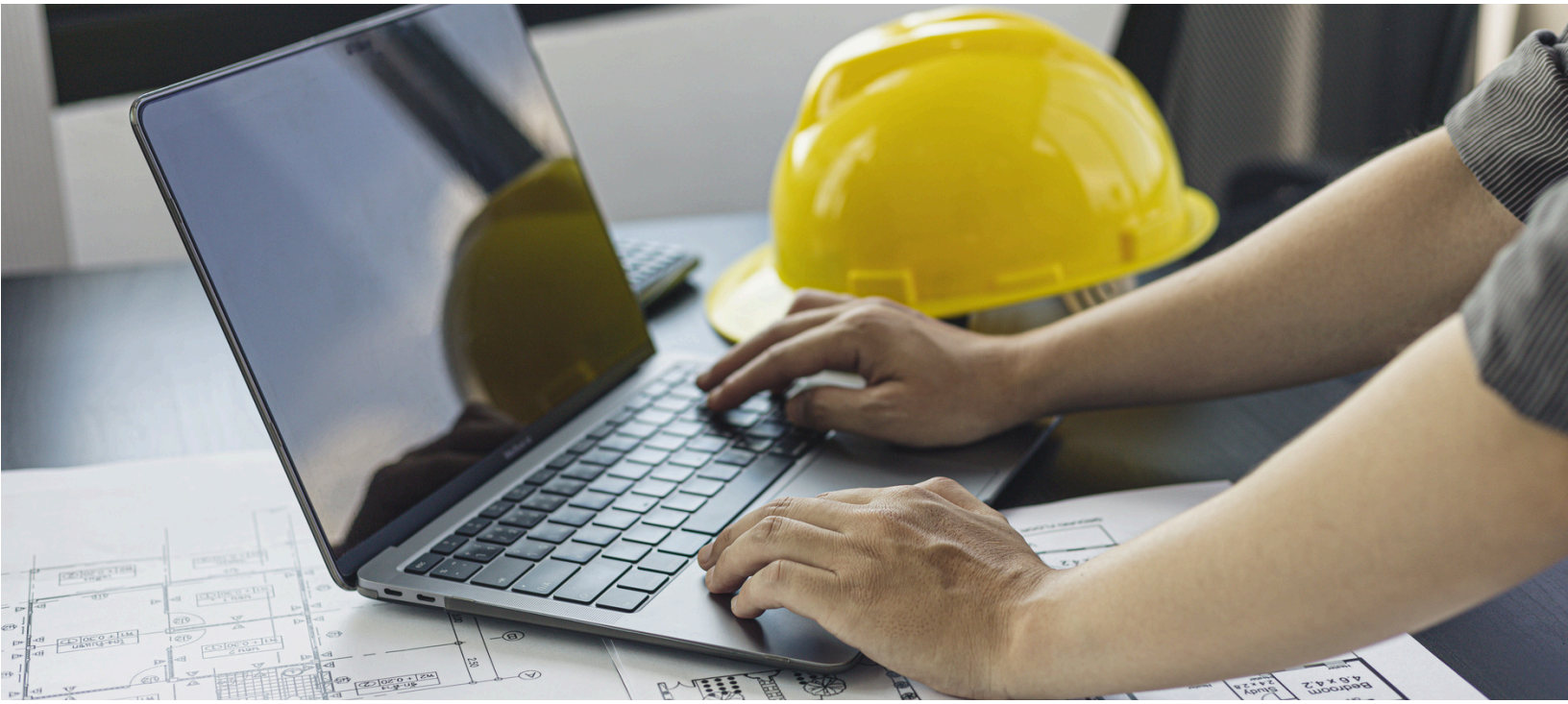
A well-designed governance structure can actually improve surety confidence in an ESOP contractor. Sureties look for:

- A trustee with genuine experience in construction industry risk and ESOP fiduciary obligations.
- An independent board of directors (or advisory board) to provide financial oversight.
- Decision-making processes that remain disciplined and focused on long-term financial health rather than short-term distributions.
- A clear plan administration structure - unless the board appoints an individual or committee as the plan administrator, the board assumes that power.

6. Phased Ownership Transfer

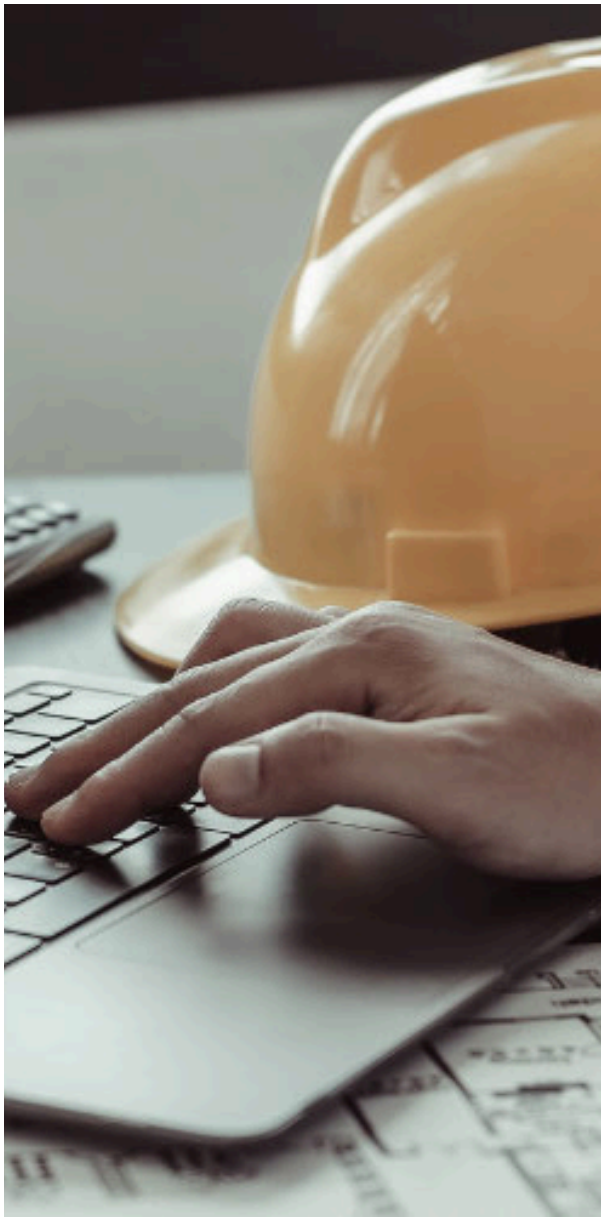
A partial ESOP transaction (sale of less than 100% of the stock) reduces risk and allows for other potential advantages. Sureties consider what percentage of equity the ESOP will comprise, and over what time period that amount of stock will be redeemed or paid for. Benefits of a partially owned ESOP and phasing of ownership transfer include:

- Enables the seller to sell additional shares later at a potentially higher value.
- May be beneficial to the surety, as it promotes continued vested interest of the seller(s).
- Enables selling shareholders to play a role in the ongoing plan administration.



Key Surety Concerns During and After an ESOP Transaction

Even when sureties are generally supportive of ESOPs, they will probe specific risk areas during the underwriting process. Contractors should be prepared to address the following questions directly:



- Will the transaction leverage reduce working capital or equity below acceptable thresholds?
- Are backlog, revenue and profit projections realistic?
- Does the company have a realistic, funded plan for managing the repurchase obligation as employees retire?
- Is the ESOP being used to cash out departing owners at a valuation the company cannot sustainably support?
- Will seller notes and warrants be properly subordinated to senior debt and surety indemnity obligations?
- Does the company maintain adequate liquidity to execute its current project backlog without disruption?
- What motivates the seller to remain engaged post-transaction? Personal indemnity obligations and outstanding note payments give departing owners a continued financial stake in the company's success.
- What are the total costs to complete the transaction and the ongoing administrative fees? (These can be expensive, particularly for smaller companies.)

Sureties also monitor whether the ESOP structure affects the company’s capacity to reinvest in equipment, technology, and talent over time - factors that directly influence long-term project execution capability.



Evaluating Potential New Accounts Currently Owned by an ESOP

Since the construction industry is cyclical in nature, construction companies generally have cyclical business activity. They also operate in highly competitive markets. Therefore, there may be challenges in generating enough earnings to pay down the debt associated with an ESOP year after year. To determine whether to extend surety credit to a potential new account that is currently owned by an ESOP, a surety underwriter needs to first gain an understanding of all the above factors that pertain to how the particular ESOP was established. Then, particular attention should be paid to the following:

- How long the ESOP has been in existence.
- Ability to secure profitable backlog.
- Whether the sellers of the company are still employed by the company.
- Whether there has been a smooth transition to the new management team.
- How successful the company has been at servicing the debt and repurchasing the shares related to the ESOP. How strong are company financials, and how have they trended since inception of the ESOP? This includes net worth, working capital, liquidity, history of profitability and expectation of continued profitability, amount of long-term debt, and strength of cash flow.
- Age diversity of the employee group (e.g., whether a large number are retiring soon), how large near-term repurchase obligations are, and whether those obligations can be covered with near-term projected earnings.
- Trends in the company's annual stock valuation (see Company Valuation, above).

Documents a Surety Should Review

Legal interpretation of the ESOP documents and CPA consultation on a correct financial analysis are a must. Given the highly complex and technical nature of this ownership structure, it is advisable to seek specialist and/or legal consultation to interpret the numerous documents and assumptions. Among the documents a surety should review are the following:

- ESOP plan document
- Pro-forma financial statements, including the appearance of the balance sheet directly following ESOP inception and multiyear projections for the balance sheet, P&L, and cash flow
- Trust agreement
- Bank loan documents and covenants (if applicable)
- ESOP/shareholder promissory notes (if applicable)
- Shareholder Redemption Agreement and authorizing Corporate Resolution
- ESOP Stock Pledge Agreement
- ESOP Stock Purchase Agreement
- Shareholder employment agreements (if applicable)
- IRS Form 5500



Positive Impacts of ESOPs on Bonding Capacity

When structured thoughtfully, an ESOP can be a meaningful positive in the surety relationship. Several ESOP characteristics work in a contractor's favor:

- Employee ownership increases workforce engagement and tends to reduce turnover, both of which support consistent project performance.
- S-corporation ESOPs generate substantial tax advantages (as much as 40% over non-ESOP-owned firms) that strengthen free cash flow, improving debt service coverage ratios that sureties monitor closely.
- ESOP companies typically adopt more formal governance structures and financial discipline than the closely held firms they were before—an underwriting positive.
- Long-term succession clarity reduces key-person risk, a factor that has historically created concern for sureties when closely held contractors approach ownership transition.
- Creates a market for company shares that might not otherwise exist, allowing orderly ownership transfer.
- Provides remaining employees with retirement benefits and an ownership incentive.
- Tax-deductible contributions can be used to fund debt payments with before-tax dollars. The substantial tax savings also serve to build company share value and company liquidity.

Taken together, these factors often result in expanded bonding capacity over a two-to-five-year horizon following the initial transaction, once leverage has been reduced and financial performance has been demonstrated under the new structure.

How Sureties View ESOP Risk Factors

- ESOPs do not guarantee benefits, and they put plan assets at greater risk than the typical diversified ERISA-regulated plan because they generally invest solely in the company's stock.
- For private companies, the stock is not readily traded, and there can be significant fiduciary issues in valuing shares.
- Costs of ongoing plan administration can be high and even burdensome for smaller companies.
- The surety may not be able to obtain personal indemnity of the ESOP shareholders or of the ESOP itself.
- Bonding capacity could be reduced after the conversion to an ESOP.
- ESOPs are not well suited for companies with a history of volatile earnings.
- Employee-owner morale can be impacted by a company's poor performance. Both their employment and their retirement savings are potentially affected.
- Selling ESOP-owned firms is challenging because of the breadth of the ownership structure and the many regulations that govern such sales.
- Significant obstacles exist if the company requires additional capital or financing.
- Downsizing will cause repurchase obligations.
- ESOP trustees have fiduciary liability, which involves challenging obligations.
- Private owners who ask to review a contractor's financial statement as a prequalification measure may look unfavorably on the balance sheet of a leveraged ESOP-owned firm.

Company Characteristics Sureties View Favorably for ESOP Success

- Financially successful track record, with reasonably predictable profitability and cash flow.
- Adequate capitalization in place to sustain future company growth.
- Little to no permanent debt.
- Reasonably large and diversified revenue base.
- Balance sheet with sufficient collateral to support additional bank financing.
- Not particularly prone to changes in the business cycle.
- Highly strategic in its business model, with a high level of sophistication.
- Solid management team to carry organization forward after the departure of selling owner(s).
- See also Management Continuity and Leadership Stability, above, for the leadership and culture attributes sureties weigh most heavily.
- An owner willing to accept less than a strategic sale value.
- An interest in good stewardship of the selling shareholders toward the organization.
- Close alignment of seller and employee-owner interests (where the company is not 100% ESOP-owned).
- Highly structured, with clear communication throughout the ranks.

If too many of these attributes are not present, an ESOP succession plan can be challenging. Many companies in the construction industry are highly susceptible to its cyclical nature and thus may face more challenges than companies in other industries that have a greater degree of stability and diversification in revenue streams.



Surety Evaluation Summary: ESOP Contractors

The table below summarizes how sureties typically view the key evaluation areas for ESOP-owned construction firms, including both the positive attributes and the areas of concern that must be proactively managed:

Evaluation Area	Positive View	Potential Concern
Management	Continuity, strong leadership retained; employee-owner engagement	Leadership turnover post-transaction; disconnect between old and new management
Leverage	Moderate, well-structured debt; seller notes subordinated as soft equity	High leverage reducing working capital or equity; bank-held debt typically offers less flexibility on repayment terms. Warrants.
Cash Flow	Tax savings improve debt service coverage (up to 40% advantage)	ESOP contributions and repurchase obligations strain project liquidity
Valuation	Conservative, independently appraised by reputable firm	Aggressive valuation the company cannot sustainably support
Governance	Trustee + independent board adds discipline	Inexperienced trustee or weak board oversight
Long-Term Stability	Succession certainty, strong ownership culture	Repurchase obligations not adequately planned; volatile earnings history
Phased Transition	Seller retains vested interest; reduced initial risk	Full 100% transition creating excessive immediate financial burden



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This guide is intended for informational purposes only and does not constitute legal, financial, tax, or surety underwriting advice. Construction companies should consult qualified advisors before proceeding with an ESOP transaction.

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