Exploring the ESOP Opportunity

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An employee stock ownership plan (ESOP) enables owners of privately-held businesses and other shareholders to liquidate their company stock while enjoying tax benefits and keeping their jobs until they are ready to retire. ESOPs have been around since 1956, yet some misconceptions about these plans are causing many business owners to miss out on their potential advantages.

A clear understanding of ESOP benefits and what's involved in launching and running one will help you assess whether this unique employee benefit plan can serve as a win-win solution for you and your employees.

A Basic Description and Potential Advantages

A type of retirement plan that invests primarily in company stock, an ESOP holds its assets in a trust in accounts earmarked for employees. Plan participants do not directly own the stock but typically redeem shares for their value when they leave the company.

The ESOP purchases shares from owners at fair market value, generally by borrowing from a financial institution, and makes principal and interest payments with corporate funds contributed to the ESOP. In that way, it operates like other employer-funded or subsidized retirement plans. The entire cost of the loan may be tax deductible. Also, corporate-owned life insurance can play a key role in ESOP financing and offer significant tax benefits.

A shareholder properly using Section 1042 of the Internal Revenue Code can defer recognition of capital gains upon the sale of their shares to the ESOP.

According to the most recent government data posted at the National Center for Employee Ownership (NCEO) website, there are an estimated 6,700 ESOPs in the United States, covering 14 million participants and holding total assets of more than $1.3 trillion. About two-thirds of these plans provide markets for the shares of departing owners of profitable, closely-held companies, and NCEO estimates fewer than 10 percent of ESOPs are sponsored by publicly-held companies.[1]

More than
$1.3 Trillion
in assets held by U.S. ESOPs

[1] U.S. Department of Labor data available at www.nceo.org/articles/esops-by-the-numbers

To fully understand the advantages of ESOPs as an exit strategy for principal owners, it helps to review possible alternatives and some of their potential downsides:

ALTERNATIVE EXIT STRATEGY	POTENTIAL DOWNSIDE
Sale to remaining owners	Remaining owners might also want to retire, or they may lack the capital to buy out other shareholders.
Sale to a competitor	Knowing an owner wants out could devalue the company in the eyes of a competitor, resulting in a purchase price that's too low. Also, when a competitor purchases a business, it often leads to staff layoffs at the company being sold.
Sale to independent investors	Such investors often set aggressive growth and profitability targets many companies cannot meet.
Initial public offering	Not only are the regulatory expenses high, but regulatory criteria and growth and profitability expectations often are excessive.

The financial performance indicators used in your feasibility analysis should include revenue, historic and anticipated profitability, and balance sheet strength.

Feasibility Analysis

Even so, an ESOP isn't for every business, and it makes sense to conduct an ESOP feasibility analysis. Many of the criteria you should consider are the same performance metrics a lender or purchaser would examine when deciding whether to lend to or purchase a company. That's because creating and running an ESOP essentially is a slow-motion sale of the company whose buyer – the ESOP trust – needs assurance it's purchasing a viable company at a fair price. Similarly, a lender that provides the capital to finance the ESOP's share purchases needs to be confident the company will be able to service that debt.

The financial performance indicators used in your analysis should include revenue, historic and anticipated profitability, and balance sheet strength. Related factors include the existence of nonoperating capital assets and expenses, and corporate affiliates.

All of that information needs to be translated into an estimate of the company's value. Sometimes principal company owners, particularly when they're founders, believe the company is worth more than what the numbers will tell a disinterested buyer. Any such discrepancy in perception needs to be resolved before an ESOP transaction can be viable.

An ESOP can only be established by either a "C" corporation (taxed separately from its owners) or an "S" corporation (entity has the legal rights of a corporation but is taxed like a partnership). However, only C-corp shares are eligible for Section 1042 capital gains recognition deferral.

For the plan's motivational potential to be realized, employees must believe their input is valued.

Because ESOPs are qualified benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA), their viability must be assessed in light of other existing qualified plans and the company's retirement benefit strategy. For example, an employer making contributions to an existing 401(k) plan – whether matching or nonelective – might need to suspend those contributions to afford contributions to an ESOP.

Employee demographics also play a big role in any feasibility study. The smaller the number of employees relative to the value of the company, the more challenging it is to make an ESOP work. A high-value, capital-intensive company with a small workforce might not be a viable candidate for an ESOP. That's because the pro-rata employee share of the ESOP plan's funding needs might prove to be excessive. In other words, over time through the ESOP, it's typically easier for 100 employees to buy a $10 million company than for 10 employees to buy a $100 million company, because of the percentage of salary limitation that applies to qualified plans.

A final component of an ESOP feasibility analysis is owner philosophy. While an ESOP can be an excellent liquidity tool for owners under the right circumstances, it also is a vehicle for giving employees more skin in the game, and, informally at least, a voice in the direction of the company.

With an ESOP, owners do not need to relinquish control of the company earlier than they want. Furthermore, employees cannot use the voting power of their shares to dictate how the company is run (although they must consent to a major transaction like a sale of the company). Also, the ESOP's trustee is empowered to vote unallocated shares while still looking out for the employees' best interests. In addition, a privately held ESOP company is not obligated to disclose financial statements and executive compensation data to employees. Owners retain the authority to decide what potentially sensitive data to share.

On the other hand, if employees don't believe the principal owner(s) view them as worthy of giving occasional, substantive input and being informed about important company matters, the motivational potential of the ESOP will be unfulfilled.

Launching an ESOP

The preliminary feasibility analysis outlined above can be conducted with support from an institution with a strong track record of facilitating ESOP transactions. If that process leads to a green light to proceed, atop the list of next steps is securing an independent valuation of the business to affirm the assumptions made during the feasibility analysis.

Also high on the task list is lining up a credit facility that will enable the ESOP trust to purchase company shares.

Along similar lines, the company needs to secure the means to manage its repurchase liability. When an employee is eligible to redeem employer shares held on his or her behalf by the ESOP, such as at retirement, the ESOP needs to have sufficient cash available to pay the employee for those shares.

Another trigger for that repurchase obligation is the death of an ESOP participant. If the death involves a major shareholder, such as the owner, the repurchase obligation can be substantial. Corporate-owned life insurance (COLI) typically is used to cover that liability. Thus, securing appropriate COLI policies is a critical step in launching an ESOP. In addition, depending upon how the policies are structured, COLI contracts can also serve as a financial conduit to fund the ESOP's ongoing liquidity needs, although ERISA sets some parameters around this function.

Additional steps in launching an ESOP include:

- Selecting an ESOP trustee (an institution or an individual) and establishing an ESOP committee, whose function is plan oversight and communication between the trustee and plan participants
- Planning and executing the integration of the ESOP with existing retirement plans, possibly including the suspension of matching or nondiscretionary 401(k) plan contributions
- Drafting and adopting plan documents
- Creating and executing a comprehensive employee communication strategy

Employee Communication

Effective employee communication is critical to an ESOP's success. Once the essential building blocks have been put in place, employees must be kept in the loop as plans progress. Employees must understand the mechanics of the ESOP and the rationale behind it. Employee meetings featuring the business owner will go a long way to reassure employees the plan will benefit all parties and their interests will be safeguarded.

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Different service providers may be involved in various facets of launching and running an ESOP. For example, a financial institution with strong ESOP support resources might help with everything from the feasibility analysis and consulting to loans and operational management, leaving the trusteeship and annual corporate valuations to other service providers. The more players involved, however, the greater the task of coordinating their efforts.

Once the ESOP is up and running, the task of keeping it in good working order is much the same as with other qualified plans, although the ESOP's repurchase liability must be carefully monitored and managed. And, with required annual business valuations, employees will have the opportunity to track corporate financial performance. It's important, through ongoing communication, to emphasize their contribution to company performance, as well as to help them understand the ups and downs of any well-run business in a dynamic economic environment.

ESOPs are not for everyone but can be highly advantageous to business owners under certain conditions. To explore the opportunity presented by this financing mechanism, contact your BB&T banker.

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