ESOP FAQs

Levenfeld Pearlstein

Question: Can you briefly provide a layman's definition of an ESOP?

Answer: ESOP is an acronym for Employee Stock Ownership Plan. An ESOP is a tax qualified retirement plan and operates similar to a 401(k) plan. However, ESOPs are subject to special rules which allow the ESOP to: (i) be invested primarily in company stock and (ii) borrow money to acquire company stock.

Question: What variations of ESOPs exist? What is the most common and/or frequent type of ESOP?

Answer: ESOPs basically come in two forms. One form is what is known is a "leveraged ESOP" which means that the ESOP has borrowed money to acquire the stock held by the plan. A second type of ESOP is a "non-leveraged" ESOP which is created solely by the company which sponsors the ESOP contributing shares of its own stock to the plan much like a cash contribution to a regular profit sharing plan. Most often, when an ESOP is created in connection with a transition in the ownership of the company, the plan will be set up as a "leveraged ESOP".

Question: Can you detail the differences between ESOP plans and a direct employee ownership?

Answer: As opposed to situations where a select few employees of a company purchase stock from the current shareholders, an ESOP provides broad based employee ownership throughout the company and generally does not require the employees to come out-of-pocket to purchase that shares of stock. ESOP benefits are also an additional source of retirement savings and most ESOP companies use ESOP's to *supplement* existing compensation/retirement plans. In addition, using an ESOP to transition ownership of the company can provide unique tax planning opportunities. Selling Shareholders may be able to defer capital gain tax on the sale of their stock to an ESOP if certain requirements are met. In addition, an ESOP can provide tax savings and cash flow benefits to the Company which sponsors the ESOP. These include being able to obtain a tax deduction for the repayment of debt used by the ESOP to purchase shares of stock held by the ESOP and the potential to eliminate corporate income taxes by operating as a Subchapter S corporation after the ESOP acquires the stock of the Company.

Question: Have ESOPs become more popular in the last 12-18 months? If so, why??

Answer: In the past 12-18 months where interest rates have been rising, the traditional M&A market has not particularly active even as many companies have adjusted to the current economic climate and have continued to perform very well. At the same time more baby boomer owners of these companies have been continuing to near retirement age and still want to sell their companies. Although it is counter-intuitive to think there is a good way to sell a company when market conditions were not favorable, the ESOP is a great strategy in such an environment since by forming an ESOP, the current of the company owners can create a buyer for their stock and still stay invested in the company by continuing to work and receive benefits of ownership through ESOP participation and/or negotiating a continuing equity stake in the business as part of the financing for the transaction.

Question: What are the typical reasons business owners sell their company using an ESOP?

Answer: Using an ESOP is an effective business succession strategy for companies for various reasons:

(i) Using an ESOP allows the current business owners to control timing of a sale and permits a gradual sale;

(ii) Using an ESOP also allows the current business owners to retain an equity interest in the company through ESOP participation and maintaining operating control of the company until they are ready to retire;

(iii) An ESOP provides employees with both retirement benefits and added incentives from having an ownership interest in their company at no cost to the employees;

(iv) The ESOP benefits can be used as a recruiting tool to attract new talent to the company;

(v) The continuity of the business is preserved to ensure client's will continue to do business with the company on a long-term basis; and

(vi) There are significant tax advantages for operating as an ESOP-owned company.

Question: How can an ESOP be utilized to transfer ownership of a company?

Answer: The Company works with an ERISA attorney to adopt an ESOP and then either borrows money through a bank or from the selling shareholders in an amount necessary to buy all or a portion of the stock owned by the founders of the company. Alternatively, the company can contribute newly issued shares of stock which are then allocated among the employees of the company based on their annual compensation and the ESOP ownership of the company will gradually increase over time.

Question: What characteristics make a company a viable candidate for an ESOP? What factors should business owners consider before switching to an employee stock ownership?

Answer: Business owners who wish to adopt an ESOP to transition ownership of their company to their employees should have a strong history of sustainable cash flows which will be necessary to fund the repayment of any debt incurred in connection with the sale of stock to the ESOP and to fund the ongoing obligations to pay out the benefits earned by the employees over time by participating in the ESOP program. In most (but not all) situations, the Company should also have at least 50 employees and a payroll base which is sufficient to support the ongoing obligations to make contributions to the ESOP. Also, the company should have a viable business plan and good management to operate the company which will be owned in part or 100% by the company's employees.

Question: What types of challenges does a company face when transitioning to an ESOP?

Answer: When a company becomes employee-owned, extra care needs to be taken to ensure that the employees understand the new benefit being provided to them and to explain how their individual contributions contribute to the overall success of the company. Since an ESOP is a retirement plan regulated by the US Department of Labor, the company needs to use knowledgeable, experienced advisors to ensure that the technical rules governing the administration of the ESOP are followed. In addition, in order to sustain the company's success, the company's board of directors need to continue to train and develop the next generation of company leaders to ensure that company's operations will continue to support the growth of the employee's retirement benefits represented by shares of the company's stock. Lastly, the company needs to develop a plan to cover the liability associated with paying out the ESOP benefits earned by the employees while they are working for the company which will need to be paid when the employees leave the company.

Question: How do employees of the company benefit from an ESOP?

Answer: Employees benefit from the ESOP by receiving retirement income in the form of shares of stock of the company which employs them. Studies show that employee-owned companies have better employee morale and are more financially successful than non-employee owned companies.

Question: What are the eligibility requirements for the employee?

Answer: The technical eligibility rules governing ESOPs are the same for other types of retirement plans. With that said, particular ESOP eligibility requirements vary on a case by case basis. Some companies require employees to work with the company for at least 1 year while some companies allow employees to join as a participant in the ESOP on day #1. Some companies impose an age restriction (i.e. do not allow employees under age 21 to participate). Other companies only permit employees of one or more related companies to participate in the ESOP while excluding employees of other related companies (subject to compliance with certain coverage rules mandated by the IRS).

Question: Can you explain vesting, diversification, and distribution options?

Answer: The technical rules governing ESOP vesting requirements are the same for other types of retirement plans. Retirement plans require full vesting of retirement plan benefits either upon a 3 year "cliff vesting" or graded 6 year vesting schedule. Thus, it is intended that an employee must generally stay employed by the company for several years to obtain full benefits from participating in the ESOP.

ESOP distributions must generally start 1 year after a participants death, disability or retirement or 5 years after a participant terminates for any other reason and can be paid either in a lump sum or in installments not exceeding five years (each of these rules are subject to various exceptions).

In addition, participants who are over age 55 and who participate in the ESOP for more than 10 years can elect to "diversify" up to 50% of the shares of stock in their ESOP accounts over a 6 year period by directing the company to pay the employee the cash value of such shares which are diversified or transfer the cash value of such diversified shares to another retirement plan that offers investments other than shares of company stock.

Question: What are the tax advantages of an ESOP for the company? What about for employees?

Answer: An ESOP can provide tax savings and cash flow benefits to the Company which sponsors the ESOP. These include being able to obtain a tax deduction for the repayment of debt used by the ESOP to purchase shares of stock held by the ESOP and the potential to eliminate corporate income taxes by operating as a Subchapter S corporation after the ESOP acquires the stock of the Company. In addition, employees enjoy the benefit of having the value of their ESOP stock balances grow on a tax-deferred basis until they receive a distribution of benefits from the ESOP which are taxable upon receipt of such distributions.

Question: How are ESOPs funded? What is the most common method of funding? Can you detail the aspects of the variations of funding?

Answer: See Question #2 related to leveraged and non-leveraged ESOPs.

In a "leveraged" ESOP transaction, the funding for the deal comes from a combination of traditional bank debt and seller financing. In a leveraged buyout transaction (including ESOP transactions), a company can typically obtain a term loan in an amount between 2-3 times its EBITDA to finance an ESOP transaction and

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the remaining amount of the financing is paid over time to the selling shareholder through promissory notes that carry an interest rate of between 2-3% higher than the interest rate a bank would charge. In addition to the seller notes, in an ESOP transaction it is common for the selling shareholder to ask for a portion of the return they would receive from financing a portion of the transaction price by receiving a warrant (i.e. a right to buy stock of the company at a specified price) at the time of the sale to the ESOP.

There are other potential sources for financing an ESOP transaction. These include mezzanine loans from institutional investors as well as having employees to roll over a portion of their 401(k) plan balances to purchase some of the shares being sold by the current shareholders in the ESOP transaction.

Question: How does an ESOP buyout compare to M&A and/or the purchasing of a company by a Private Equity firm?

Answer: The main difference in selling to an ESOP is that, unlike a sale to a third party buyer, the company does not have to advertise to the world that it is for sale. In addition, unlike in a sale to a third party, the current management and operational structure of the company can be maintained by selling to an ESOP.

Question: How is a company appraised for the value of ESOP shares?

Answer: The trustee of the ESOP (see below) engages the services of a 3rd party appraisal firm to value the shares of the stock of the company held by the ESOP at least once per year. The appraiser will work with company management to obtain historical and projected financial data for the company's operations and will then use standard valuation methodologies (i.e. discounted cash flow method, guideline public company method and comparable M&A transaction method) to advise the trustee of what the appraiser's opinion is as to the value of the stock held by the ESOP. Then the ESOP trustee, relying on the advice of the appraiser, will inform the ESOP plan administrator as to the value of the shares of stock held by the ESOP will be in effect until the next valuation of the stock occurs.

Question: Who governs an ESOP?

Answer: An ESOP is managed by a person or financial institution called a trustee. A trustee is a fiduciary that must act solely in the best interests of the ESOP participants. Although the ESOP is technically the shareholder of the company, the trustee exercises various rights of a shareholder of the company on behalf of the ESOP, including voting the shares of stock held by the ESOP and monitoring the performance of the company's board of directors.

However, it is important to note that the ESOP trustee is NOT involved in the day to day operations of the business. The company will continue to be governed by a board of directors (albeit is common for the ESOP trustee to ask that some of the members of the board are "independent directors") and the company's officers who are elected and managed by the board.

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Question: Can you detail the process – from start to finish – of transitioning to an employee stock ownership plan?

Answer: The first step is to appoint an ESOP Committee comprised of various members of company management and a select group of owners of the company to begin to determine whether an ESOP transaction is feasible for the company. In most cases the ESOP committee hires a specialty ESOP consulting or investment banking firm with ESOP experience to conduct this feasibility analysis. If the ESOP committee determines that the ESOP will be the best alternative for transitioning ownership of the company, an ERISA attorney with ESOP experience should be hired to design the ESOP plan document and a trustee for the ESOP should be selected. When the ESOP is in place, then the selling shareholders need to hire their own advisors to represent them in the sale of the stock and the trustee needs to hire its own financial and legal advisors to determine at what price the stock will be purchased and to negotiate the other terms of the sale. In addition, financing for the transaction needs to be obtained if the transaction will be a "leveraged" ESOP transaction.

FOR MORE INFORMATION

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