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Is an ESOP Right For Your Business?

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As a business owner, you will exit your businesses in one way or another. As you start to consider your options, you should be considering an alternative that's not always known or properly understood – the employee stock ownership plan, or ESOP.

Several well-known companies are owned in a significant degree by an ESOP. Publix, the grocery store chain based in Lakeland, is over 90% owned by its employees. Wawa, the convenience store chain, is owned about 40% by an ESOP. Robert W. Baird, the financial services company, is also employee owned. A few past honorees of Florida Companies to Watch, including KMI International, EarthBalance and Wire Experts Group, are all highly successful ESOP companies. Those are just a few of about 6,900 ESOPs in the United States.

In this article, we'll talk about what makes a good ESOP candidate, the advantages of ESOP transactions (which include some significant tax benefits) and the process of how a typical ESOP is established.

What is an ESOP?

Fundamentally, an ESOP is a tax-qualified retirement plan – just like a 401(k) plan – that is intended to primarily invest in the stock of the company that sponsors it. Although they're qualified retirement plans, ESOPs are usually implemented as an exit strategy for an owner who is looking to sell all or a portion of the business. ESOPs can be used as an incentive plan without the need to buy out an existing shareholder – so the company just makes contributions of a small percentage of the company's stock to the ESOP and allocates it to eligible employees – but those are relatively rare.

Although ESOPs are qualified plans like 401(k) plans are, there are some very important differences. First, ESOPs are rarely funded with employee contributions – instated, the plan is funded by contributions from the employer – more on how that works later. Second, an ESOP is the only type of qualified plan which can borrow money, which is an important factor in how the plan is set up.

A common misconception about ESOPs is that employees become legal owners of the company's shares, giving them shareholder rights such as the ability to see certain financial information and the right to vote the stock. That isn't the case. All of the stock in the ESOP is legally owned by the ESOP trust, which acts through its trustee, not individual employees. The employees have a financial interest in the stock, but they aren't the legal owners and therefore don't have the rights that a company shareholder has. For cultural reasons, many ESOP companies will provide more information on the company's performance to their employees than most companies do. In privately held companies, ESOP participants don't have the right to vote the shares that are allocated to their accounts except in limited circumstances, such as where the company is contemplating a major transaction such as a merger or a sale of substantially all of its assets.

The shares in the ESOP are legally owned by the trustee, who is like a passive investor. The trustee will of course track the company's performance and make sure that it has strong governance and leadership, but the trustee is not interested in running the company's day-to-day operations. Most independent ESOP trustees act in that role for dozens of companies (if not more), so they do not have the time or the expertise in the industry to take an active role in operations. In fact, in nearly all ESOP transactions, the company's existing management (including any selling shareholders) stays in place.

What Makes a Good ESOP Company?

An ESOP simply isn't practical or feasible for every company, but many second stage companies will fit the profile of a good ESOP candidate. In general, an ESOP can work well for companies with the following characteristics:

- A history of consistent income and cash flow
- Enterprise value of at least $4 million
- Little or no corporate debt
- At least 20 full-time employees who can participate in the ESOP
- The next generation of leadership in place or being trained to take over in a few years

The motivations of the selling shareholder(s) are also an important factor in determining if an ESOP is a good alternative. Business owners who are motivated to sell to an ESOP are frequently the first or second generation owner of the company and are interested in preserving the company's legacy. It is also important to them that the employees who helped them build the company are rewarded and be given an additional opportunity to benefit from the success of the company. While an ESOP can pay fair market value for the stock that it acquires, it cannot pay a premium to account for things like strategic alliances like other types of buyers, such as private equity or a competitor, can provide. Therefore, an ESOP is not going to be a good solution for a business owner who is simply looking to get the most cash possible out of the transaction.

ESOPs Are a Flexible Exit Strategy

One of the primary attractions to an ESOP transaction for a business owner is that ESOPs offer tremendous flexibility in transaction structure. While plenty of ESOP transactions involve the acquisition of 100% of the company at once, that doesn't have to be the case. In fact, a significant number of ESOPs start with the acquisition of a minority interest in the company, usually 30% or 40%. This allows a selling shareholder, who may have nearly all of his or her wealth tied up in the business, the opportunity to diversify some wealth while continuing to own a majority of the company. In many cases, a minority ESOP will do a second stage transaction several years after the first one, in which more (and perhaps all) of the company is acquired by the ESOP.

There is also significant flexibility in how an ESOP acquisition is financed. A bank can provide a loan to the company to finance a portion of the purchase price so that the selling shareholder will be able to receive an immediate payment for a part of the purchase price. The remaining purchase price, especially in a 100% ESOP transaction, will be funded through seller notes taken by the selling shareholder that are typically payable over 8-12 years, in many cases with a detachable warrant that allows for a lower interest rate on the seller notes while preserving an adequate internal rate of return. In some cases, especially where the seller does not need the cash proceeds from the sale right away, the transaction will not involve a bank and 100% of the purchase price will be funded by seller notes, and possibly warrants.

ESOP Tax Advantages

Congress has a favorable view towards employee ownership, so ESOPs have been highly incentivized under the Internal Revenue Code (the "Code"). They are one of the few things that have strong support on both sides of the aisle.

First, under Code Section 1042, if the company is a C corporation when the ESOP buys stock from the selling shareholder, the shareholder can defer capital gains on the sale if, after the transaction, the ESOP owns at least 30% of the company. In order to defer the gain, the selling shareholder must, within one year of the transaction, reinvest the proceeds in "qualified replacement property," which includes stocks and bonds issued by domestic companies. Section 1042 treatment currently isn't available to ESOP sales involving S corporations, but it will be available on a very limited basis staring in 2028.

Second, an S corporation ESOP carries significant tax advantages. An S corporation is a "pass through" entity that doesn't (with a few exceptions) pay taxes on its income. Instead, it passes that income up to its shareholders, who report the income and pay taxes on it. An ESOP trust is a tax-exempt entity under Code Section 501(a), so any income that is passed up to it is not subject to tax. This means that an S corporation that is 100% owned by an ESOP is not subject to any federal income tax! This gives the corporation a significant cash flow advantage that it can use to invest in its business or use to make strategic acquisitions. The Code has anti-abuse rules that prevents a corporation with just a few employees from having an S corporation ESOP since that defeats the purpose of encouraging broad-based employee ownership.

Fiduciary Duties

As a qualified retirement plan, an ESOP is subject to the jurisdiction of the IRS and the Department of Labor. Therefore, it is important that an ESOP company pay attention to the fiduciary duties that are required under ERISA. This is especially the case when an ESOP is established, since it is critical to avoid a situation where the ESOP pays more than fair market value for the stock of the company. This is why we always recommend that an independent trustee be retained to act on behalf of the ESOP (and indirectly, the company's employees) in negotiating and entering into an ESOP transaction. The potential for an ESOP overpaying when it buys stock from the selling shareholder is a significant issue for the Department of Labor, so it is vitally important to use independent professionals who are experienced in ESOP transactions.

How the Transaction Works

Although ESOP transactions can be structured in any number of ways, there are a few fundamentals that are a part of every typical ESOP transaction:

- If some portion of the purchase price will be paid to the sellers in cash at closing, the company lends money to the ESOP – in most cases the company takes cash that it obtained from an outside lender and immediately loans it to the ESOP – this loan from the company to the ESOP is referred to as the "inside note"
- The ESOP buys stock from the selling shareholder(s), using any cash it was received from the company, with the remaining price (if any) payable via a promissory note to the selling shareholder(s)
- If part of the purchase price paid to the selling shareholder(s) was a promissory note, the company assumes the promissory note from the ESOP, making the company responsible for paying it, and the amount assumed by the company is added to the inside note

This is a simplification of a series of complex transactions but in the end, the company is owed the amount of the inside note from the ESOP, and then the company owes whatever combination of the loan that it received from the outside lender plus the note to the selling shareholder(s). Of course, any loan to an outside lender will have priority over the note that is owed to the shareholder(s).

When the ESOP is first established, the stock is initially held in a “suspense” account that is not allocated to individual employees. Instead, that stock acts as security for the inside note that the company is owed by the ESOP. Each year, the company will make a cash contribution to the ESOP in an amount equal to the payment that the ESOP needs make on the inside note for that year. The ESOP then makes the payment on the inside note back to the company – in other words, the cash contribution that the company made to the ESOP is returned to it – and a portion of the stock in the suspense account is released to the accounts of eligible employees. In most cases, the stock that is released from suspense is allocated to eligible employees relative to the compensation that they receive from the company for that year (but limited by the Code), although some companies will base part of the allocation formula on a combination of age and years of service in order to reward longer-term employees. It is possible for the company to make contributions to the ESOP above and beyond what is required to the inside note, and those contributions are typically used to prepay the balance on the inside note, allowing for more shares to be released from the suspense account to the accounts of eligible employees.

Once shares are allocated to an employee’s account in the ESOP, they are normally subject to vesting, just like 401(k) employer contributions may be. Vesting can occur with continued service over no more than 6 years, and an employee’s service before the effective date of the ESOP doesn’t have to count.

Employees then see the benefits from their ESOP accounts after they terminate employment. While 401(k) benefits can almost always be taken out in a single payment, an employer needs to manage its ESOP repayment obligation because the stock of the company isn’t liquid. ESOP companies rarely distribute the actual stock of the company, so either the company or the ESOP needs cash to buy the shares that are subject to the distribution. To help ESOP companies manage this, the tax code allows, in some circumstances, an employer to delay starting payouts for up to six years after termination to begin receiving distributions, and require distributions to be made over up to 5 years. However, sometimes it’s better for the company to pay out the balances of terminated employees more quickly, and an ESOP company will need to develop a strategy to manage this obligation to buy out the shares of former employees.

The ESOP Transaction Process

An ESOP transaction is much like other business sale transactions, involving multiple advisors with differing areas of expertise. The business owner should first engage a sell-side valuation advisor to guide them through the process. This generally starts with a valuation of the business to get a sense of the sale price that could reasonably be obtained in an ESOP transaction. If the owner is satisfied with this price, the next step is a feasibility study that is necessary to answer some important questions that include how the company can support the future cash flow burden of the buyout debt and if the company’s payroll and employee population be adequate to support the ESOP. This will also include modeling scenarios with several variables such as how much of the company would be sold to the ESOP and how much, if any, bank financing can be obtained to provide some immediate liquidity to the owner(s).

The remaining steps to move through an ESOP transaction are going to create an arms-length negotiation, which in many respects is similar to a normal M&A transaction. The main difference in an ESOP transaction is that the buyer (the ESOP trustee) is regulated by ERISA and cannot pay more than fair market value for the stock of the company – so there cannot be premiums for strategic or financial reasons. As such, there will need to be a buy-side team including an ESOP trustee, valuation firm (financial advisor) and an attorney. On the sell-side, the seller will also need to engage an ESOP attorney for the company, who will be responsible for helping with the negotiations and then writing up the transaction documents and the ESOP plan and trust agreement. Once the plan documents and other documents are created, the advisors will move through the closing process with all of the parties involved in documentation review, including the bank and its legal counsel. At closing, any net proceeds from the outside loan will be disbursed to the selling shareholders.

The full ESOP process can typically take six (6) months from beginning to end. There are many decisions that have to be made throughout the process. Experienced ESOP advisors are critical to this process being successful. It would be advisable to talk to multiple sources to determine the appropriate deal team and structure of your ESOP. While the fees associated with doing an ESOP transaction are not insignificant – they can easily reach $250,000 – they are usually about the same as, and sometimes less than, the cost of a traditional M&A transaction. In contemplating an ESOP transaction, it is also advisable to think beyond the transaction at the post-ESOP company and planning for a long-term sustainable ESOP that can provide long-term benefits to the selling shareholder(s), the employees, the customers, and the community.

ESOP Culture

Once the ESOP is in place – regardless of whether it owns all or part of the company – it is important for the company's culture to be properly aligned to get the full benefit of the ESOP. This is a process that involves continuous education and engagement of employees, but it's worth the investment of time and resources. If it's done properly, employees will start to think and behave like a business owner, rather than having an "I just work here" mentality. There is a significant body of research showing the ESOP companies generally outperform similar non-ESOP companies, retain more employees, and significantly improve the financial well-being of their people. While there are significant financial and tax advantages to being an ESOP company, the culture is what takes the company to the next level.

Conclusion

In the right situation, an ESOP can be an excellent strategy for a business owner who is looking to find the next generation of ownership for his or her company. While ESOPs are complex, hundreds of new ones are successfully implemented every year with the help of professionals who can help to demystify the process and achieve the goals of both business owners and employees.

John Burgess is an attorney and CPA with Jackson Lewis in Tampa who helps business owners, executives, and other senior managers with all of their employee benefits. He has worked with plans of all sizes, ranging from those sponsored by small, local companies with a few dozen participants to large, multi-national corporations with over 10,000 participants and billions in plan assets. John is one of Florida's leading experts on employee stock ownership plans (ESOPs) and helps companies establish and maintain these plans. In addition, he helps employers, from startups to public companies, establish equity-based compensation programs for their executives and employees. He helped to establish the Florida Center for Employee Ownership in 2020 and is on its Board of Directors. John is also currently the Vice President of Programming for the Florida Chapter of the ESOP Association, and is the former President of the Florida West Coast Employee Benefits Council. He also thanks Phil Hayes, a Partner at Berman Hopkins in Melbourne, for his input on the transaction process part of this article.