A Primer on the ESOP

Why the Employee Stock Ownership Plan May Be a Sound Alternative

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When evaluating the various alternatives for an exit strategy, a business owner should consider a sale to an employee stock ownership plan (ESOP). In order to determine whether an ESOP is the best strategy, it is necessary to become familiar with its elements.

An ESOP is a qualified defined-contribution retirement plan established under §§ 401(a), 409 and 4975 of the Internal Revenue Code. Unlike other qualified plans, an ESOP is designed primarily to invest in shares of a closely held corporation, referred to in the code as 'employer securities.' The sponsor company may transfer the shares of common stock as a qualified contribution, or the ESOP may purchase shares from shareholders or the sponsor company. In a 'leveraged' ESOP, the company takes out a bank loan to fund the purchase, then lends the funds to the ESOP to finance the purchase of shares. A 100% sale of shares to an ESOP may require a series of smaller transfers because 100% bank financing is unlikely.

The selling shareholder may receive cash as partial or complete consideration for the shares. In the alternative, or in addition to cash, the selling shareholder may self-finance a portion by accepting a note as partial payment. As the note is paid off in installments, the plan trustee transfers shares to each of the employees' accounts, eventually vesting all the stock in employee accounts in accordance with the terms of the plan.

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ESOPS are appropriate only under specific circumstances. The company must be a corporation, not an LLC or partnership; it must have earnings sufficient to support the ESOP debt payments; and the seller may need to be willing to accept a lower payment than one offered by a strategic purchaser, and usually an installment sale to permit the company to pay in cash for the shares over time, rather than simply walking away as might happen with a third-party sale.

How It Works

The ESOP sale transaction has several moving parts. The following example illustrates a hypothetical leveraged ESOP transaction.

Assume Frank started a widget company 20 years ago, and now owns all 30,000 shares of Optimistic Manufacturing Inc. The company is doing well. It has 30 employees and a fair market value of $10 million. Frank is also the sole officer and director of the company. Key employees manage the day-to-day operations of the company and are qualified to run the company without the current shareholder.

Frank is 60 years old and wants to provide liquidity to benefit his family. He wants to protect his employees and to continue working for the indefinite future. He realizes that a strategic purchaser will likely pay more and pose less risk to him than a sale to an ESOP. He will accept installment payments in order to make a 100% sale of his shares.

The success of the ESOP transaction will depend on the employees' ability to carry on the company without Frank. It is not uncommon for a business owner to do all the planning for an ESOP with a resulting decision not to proceed, because of the inability of the management team to convince Frank and the company's bank that they can successfully manage the business.

For the purposes of this hypothetical, assume the company's bank agrees to partially finance the transaction and lends the company $6 million on a six-year note. Frank accepts a promissory note for the remaining $4 million of the purchase price. The bank loan is secured by the assets of the company. Frank receives a junior lien on the assets.

The company receives the bank funds and lends the proceeds to the ESOP on the same terms. The ESOP uses the entire bank-loan proceeds to buy 18,000 shares (60%) of the company's shares from Frank. In addition, the ESOP issues a $4 million, six-year promissory note directly to Frank in exchange for the other 12,000 shares (40%). This makes the ESOP the sole owner of the company. The company guarantees the obligation due Frank and secures it with the company's assets.

Each year for six years, the company makes a tax-deductible contribution from earnings to the ESOP, which the ESOP uses to repay the notes to the company and to Frank. The company then pays the bank loan. During this time, the ESOP holds the shares in a trust 'suspense account' and releases them for allocation to participant accounts as the debt is repaid. In this six-year example, approximately one-sixth of the shares (5,000 shares) will be released to the accounts of the employee participants each year.

The ESOP is overseen by trustees. Frank may serve as a trustee. Frank may retain his position as president of the company. Each employee votes the shares that have been allocated to them, and the trustee votes the remaining unallocated shares.

There will be three sets of documents

required to complete the transaction: the sale documents (purchase-and-sale agreement, consents, etc.), the bank loan documents, and the ESOP plan documents. Approval will be needed from the Internal Revenue Service. In addition, the parties will usually need to employ a qualified appraiser and a third-party administrator to ensure that the ESOP plan complies with ERISA requirements. The agenda may be a bit long, but that should not be a reason not to consider an ESOP, because a sale to a third party may require as extensive an agenda.

Tax Ramifications

In structuring the transaction, there will be tax ramifications to consider. At the time of the transaction, the parties will need to decide whether the company will be a C-corporation or an S-corporation. If it will be a C-corporation, the seller may reinvest the proceeds tax-free in qualified investments, including corporate bonds and common and preferred stock. In order for the seller to receive a tax-free investment, the ESOP must be the owner of 30% of the shares of the company. In addition, for a C-corporation, the company will be able to contribute up to 25% of qualified employees' compensation to the ESOP plan, plus the amount of interest the ESOP paid on the loan.

S-corporations pose special difficulties, because ordinarily a trust such as an ESOP cannot own shares in an S-corporation. The above-described tax benefits are not available for S-corporations. However, if the plan is the sole shareholder of an S-corporation, there will be no federal income tax on the earnings. If sales are less than $6 million, there will be no Massachusetts tax. If annual sales exceed $6 million, the company will be required to pay Massachusetts corporate excise tax.

Valuation of the company is very important. There may be discount issues for the stock transfers with respect to sales of minority interests. Transforming the shares of a C-corporation into preferred shares with a dividend rate can enhance their value. (S-corporations can only have one class of stock, so preferred shares are not an option). The company will need a professional appraisal of the stock value each year. Despite the complexity of an ESOP, it has unique advantages that must be considered by a business owner who is considering an exit strategy. Unlike any other form of exit plan, it offers a realistic, tax-advantaged means for employees to purchase a company.

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Most importantly, it is critical to have smart, experienced employees to form the new management team. ■

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