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IS AN ESOP RIGHT FOR YOU?

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A guide to understanding employee stock ownership plans

In recent years, ESOPs have become an increasingly popular business succession planning tool. And well, why shouldn't they? ESOPs can provide incredible tax advantages both to the company and the business owner who is selling that company. Further, ESOPs help preserve the legacy of the company that the seller helped to create, and they can provide a valuable employee benefit and retention tool.

Of course, like any other type of sale of a company, an ESOP transaction requires proper planning and a skilled team. This article will provide a summary of what an ESOP is, how an ESOP transaction works and potential ESOP candidates.

What is an ESOP?

An ESOP, which is an acronym for "employee stock ownership plan," is a type of profit sharing plan. Like other types of employee benefits plans, ESOPs are governed by the Employee Retirement Income Security Act (ERISA). For example, they must not discriminate in their operations in favor of highly compensated employees, officers or owners. To make sure that these rules are satisfied, ESOPs must appoint a trustee to act as the plan fiduciary. While some smaller companies appoint an officer to serve as trustee or create an ESOP trust committee, the trend is increasingly towards hiring an independent person or institution to serve as trustee.

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ESOPs have traits that distinguish them from other types of profit sharing plans. One is that ESOPs invest primarily in the common stock of the employer. Another is that ESOPs are permitted to borrow money to finance the purchase of employer stock. A common misconception is that the employees become the owners of the company. In fact, it is the ESOP trustee who is the owner of the shares and who votes the shares for the benefit of the employees. We will discuss corporate governance and control issues later in this article, but for now, the point is that an ESOP does not create a system in which the seller loses all authority or control over the company.

Some companies have traits that lend themselves to becoming an ESOP-owned company more than others.

Another important point is that an ESOP can be a useful corporate financing tool, in part because of the tax advantages offered to ESOPs. Despite these advantages, it would be wrong to assume that the tax benefits pay for themselves. Some companies have traits that lend themselves to becoming an ESOP-owned company more than others. The following discussion will explain the traits of ideal ESOP candidates.

Traits of ideal ESOP companies

As a general matter, the ideal ESOP candidate satisfies two important traits, one being financial and the other being the motivation of the selling shareholders. These traits are described below.

From a corporate or financial standpoint, an ideal ESOP candidate generally will contain the following characteristics:

- Strong cash flow
- Low level of debt on the balance sheet
- Strong management team so that the company can continue to grow after the owner has retired
- Fairly significant payroll base

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Additionally, the seller of an ideal ESOP candidate generally will have the following traits:

- Desire to preserve the legacy of the company as an independent company
- Desire to provide the benefits of ownership to employees
- Willing to continue to perform services for the company for a few years after the sale to the ESOP trust
- Confident enough about the company to be willing to finance a portion of the sale
- Desire to sell the business, but does not have a prospective third party buyer or family member buyer

How ESOPs are established

Once an owner has decided to sell to an ESOP, it is important to create the right team to guide the process through the closing of the sale to the ESOP. Adoption of an ESOP means selling all or a part of the company to the trustee of an ERISA profit sharing plan. As such, the company and its owner should engage a competent financial advisor (such as the company's CPA firm, a valuation expert, etc.) and attorney that can handle the corporate, financing and ERISA issues that will arise. These advisors can help the company engage a bank that will loan a portion of the proceeds to finance the transaction. Additionally, the company should engage a competent third party administrator (TPA) that has experience with administering ESOPs. A good TPA can assist with key ESOP design decisions.

Once the seller's team has been assembled, the next step is to interview trustee candidates to determine who will serve as trustee of the ESOP trust. For purposes of the transaction, an individual or institution that is independent of the company (i.e., does not contain any corporate employees, directors or other service providers) should serve as trustee. The trustee is the purchaser of the shares from the sellers and will hire its own attorney and also an independent appraiser to help determine the value of the shares it will purchase. The trustee and its team will perform due diligence, which will pave the way for negotiations with the seller over the price to be paid for the shares of stock and other post-transaction items. Such items include employment agreements with the key employees of the company and corporate governance issues going forward.

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Once the terms of the transaction have been negotiated, the next step is to create the ESOP plan and trust documents. After the ESOP has been established, the company's bank will lend a portion of the purchase price to finance the transaction. Typically, the bank will lend to the company, rather than directly to the trust. The main reason for doing so is that the company has different types of assets that can be used as collateral for the loan, but the trust assets will consist primarily of employer stock. Although the company could guarantee a loan made directly to the trust, there is some question as to whether such a guarantee could be a voidable preference and thus not enforceable.

After the company receives the loan proceeds, it lends those proceeds to the trust so that the trust can purchase the shares from the sellers. If the bank does not lend the full purchase price, the sellers will take back a note from the trust for the balance of the purchase price. The trust then pays the cash (and if necessary, issues a note) to the sellers, and the sellers transfer their shares to the trust to complete the stock purchase.

Once the transaction has closed and the ESOP has been established, the company will make contributions each year to the ESOP trust. In a sense, these contributions are similar to profit sharing contributions that an employer may make to a profit sharing plan. In the case of an ESOP, however, the contribution generally will be required to be equal to the amount of the loan payment that is due for the year. The trust will repay that amount back to the company (and if applicable, the former owners), to pay down the internal loan, and the company will use those proceeds to repay the external loan with the bank. As the loan is repaid, shares of company stock are released from a suspense account in the trust and allocated to the accounts of employees (typically based on the ratio of a participant's compensation to total plan compensation).

Leveraged ESOP characteristics

As the prior discussion illustrates, financing is an important part of ESOP transactions. In general, ERISA prohibits qualified plans from borrowing money, but an exception is allowed for ESOPs. A loan to finance an ESOP still needs to satisfy certain requirements in order to qualify for a prohibited transaction exemption.

Regarding the internal loan to the ESOP trust, one requirement is that the rate of interest must be reasonable, meaning that it is at least as favorable

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as an arm's length transaction. It is common to see the interest rate on an internal loan to the ESOP trust equal to the long-term applicable federal rate published by the IRS for the month in which the transaction closes (assuming that the term of the loan is longer than nine years, which typically is the case). Collateral generally is limited to company stock, and the loan must be nonrecourse. The loan proceeds must be used only to purchase shares of company stock or to pay off an existing ESOP loan. The loan cannot be payable on demand except to the extent of default.

Regarding the external loan between the company and the bank, the due diligence and loan documentation related to an ESOP transaction are in many ways similar to other financing transactions. Banks will consider levels of outside debt, free cash flow and even employee count to determine the amount it will lend in a leveraged ESOP transaction. Seller financing often will be subordinate to the bank's debt. Because of that, the interest payable to the sellers may be higher than the interest on the external bank loan. Many advisors believe that the interest rate should be lower than what is typical for subordinated debt, however, in cases where the debt holders will be in positions of management or otherwise able to exercise control over the company's operations. Even so, while there is some risk with seller financing, it can be an attractive option.

Valuation and ERISA fiduciary issues

Of course, how the value of the shares of the company are determined is important too because while the sellers may have altruistic motives for selling to an ESOP, they still want to get paid. ERISA requires that an ESOP pay no more than adequate consideration (fair market value) for the shares of stock. Thus, an ESOP will not be able to pay a premium as a strategic third party buyer might. Fair market value is a price that a willing buyer would be willing to pay a willing seller when both parties have reasonable knowledge of the facts in an arm's length transaction.

That may sound fairly simple, but the process of determining fair market value often can take several weeks. The trustee ultimately is responsible for determining fair market value, but it will engage an independent appraiser to assist with that determination. Both the trustee and the appraiser typically will interview the owners of the company to learn about the business and will request financial statements and corporate documents to review and analyze. The appraiser may visit the company after that to conduct additional research. Ultimately, the appraiser will issue

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a valuation report for the trustee to explain its due diligence process and how it arrived at the value of the company. When the sellers and trustee negotiate over the final purchase price, the trustee will be guided by the appraiser's valuation report.

In recent years, the Department of Labor (DOL) has increasingly scrutinized ESOP valuation. In 2014, the DOL entered into a settlement agreement with GreatBanc Trust Company (GreatBanc) that, while legally binding only on GreatBanc, has served as a set of best practices for trustees to demonstrate that they satisfied their fiduciary duties in an ESOP transaction. The DOL updated these practices towards the end of 2017 in settlement agreements with First Bankers Trust Services Inc. and with an individual trustee named Joyner.

The settlement agreements require a trustee to demonstrate why the trustee selected a particular appraiser, with a particular focus on the qualifications and independence of the appraiser. An appraiser should not have performed a feasibility study or preliminary valuation for the company, and the trustee needs to consider whether any other work that the appraiser performed for the company creates a potential conflict. The trustee also needs to demonstrate that it was actively engaged in the valuation process and did not blindly rely on the appraiser. For example, the trustee needs to be able to understand the projections and assumptions underlying a valuation- and explain how they are reasonable. The trustee should also consider how the ESOP terms affect the repurchase obligation and whether the plan can service the loan if the projections are not satisfied. All of these issues should be documented. That's consistent with general ERISA fiduciary advice—document every key decision and the reasons for making those decisions in order to demonstrate that the fiduciaries acted prudently and in the best interest of participants and beneficiaries.

Barriers to a successful ESOP

While the valuation and ERISA fiduciary issues usually can be addressed by engaging an experienced team of advisors, other business issues may make some companies not as well-suited for ESOPs as others. If a company is early in its growth stage, for example, shareholders may want to wait until the future to adopt an ESOP so that they can capture a greater portion of the company's growth than they would by selling early. Financially, companies that have little or unstable cash flow, little debt

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capacity, or few employees may not be able to handle the administrative costs of an ESOP. Companies with inexperienced management or that cannot succeed without the selling shareholder's management or customer relationships may also not be well-suited for an ESOP. Further, sellers who have an inflated view of their companies' valuations or who cannot relinquish control may not be well-suited for ESOPs.

Why ESOPs are so popular

While an ESOP may not be the best solution for every company, many privately held companies in particular have been successful after adopting an ESOP. Why are ESOPs becoming increasingly popular? In general, there are three main reasons:

1. Tax efficiency
2. Preservation of corporate legacy
3. Control

One tax advantage is that both the principal and interest on ESOP transaction debt generally can be repaid with pre-tax earnings. Additional tax benefits are available, depending on whether the entity is a C-corporation or an S-corporation.

Owners of a C-corporation who sell at least 30 percent of their shares to an ESOP may be able to defer the capital gain recognition from the sale under Internal Revenue Code Section 1042. To qualify for the tax deferral, the seller must have owned the shares for at least three years before the ESOP transaction, and the entity must be a C-corporation at the time of the transaction. Within 12 months after the closing of the transaction, the seller must reinvest the proceeds of the sale to the ESOP in qualified replacement property (QRP). QRP generally consists of any stocks or bonds of any public or private American corporation. Municipal bonds and mutual funds do not qualify as QRP. When QRP is purchased, the basis in the QRP becomes the purchase price. Capital gain is recognized when the QRP is sold. If the holder of the QRP dies before selling the QRP, the QRP transfers to the holder's heirs on a "stepped-up" basis equal to the value at the time of death. One caveat if a seller elects to defer capital gain under Code Section 1042, neither the seller nor any descendants may participate in the ESOP.

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Although capital gain deferral is not available to owners of an S-corporation who sell to an ESOP, S-corporations owned by an ESOP contain considerable tax advantages too. Perhaps the largest advantage is that an S-corporation that is 100 percent owned by the ESOP does not pay any federal income taxes. An S-corporation does not pay federal income tax at the entity level. Instead, the income flows through to the shareholders, and the shareholders pay the income tax. An ESOP, however, is a tax-exempt trust, and as such, it generally is exempt from taxes that other shareholders would normally pay. When participants terminate service and receive a distribution of their accounts, they pay taxes then. Because these advantages can be so extensive, the company and ESOP must satisfy anti-abuse rules under Code Section 409(p), but with careful planning, these rules should be able to be satisfied without much effort.

In addition to the tax benefits, ESOPs provide other financial benefits. According to the Employee Ownership Foundation's 24th Annual Performance Survey:

1. 77 percent of ESOP-owned companies report that their ESOP improved employee productivity
2. 83 percent of ESOP-owned companies report that their ESOP stock value increased in the past year
3. 93 percent of ESOP-owned companies report that creating an ESOP "was a good business decision that has helped the company"

ESOP pros and cons and the decision to adopt the ESOP

We have seen traits of companies in which an ESOP is a great fit and traits of companies in which an ESOP is not such a good fit. We also have seen why ESOPs are increasingly popular. Ultimately, the benefits of ESOPs boil down to the following. ESOPs offer significant tax incentives, flexible financing arrangements and an employee ownership culture that also provides a retirement benefit to employees. Further, an ESOP is a controllable transaction that often involves a shorter transaction timeline than other merger and acquisition types of transactions.

The cons of ESOPs essentially boil down to the fact that ESOP transactions need to be performed by a team of experienced professionals, perhaps even more so than other transactions. Attorneys, bankers and other professionals who are not familiar with ESOPs often perceive them to

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be extra complex and perhaps not worth the effort. ESOPs also create nonproductive debt that will be on the balance sheet. That is, the financing for ESOPs is not used to purchase new plants or equipment. It buys out the owners. As such, it is critical that a management team be in place that can continue to grow the company. Owners are not likely to get full liquidity at the sale, although the terms of seller financing can still be attractive. Finally, ESOPs involve ongoing administrative costs and require planning for the repurchase obligation.

None of these issues mean that ESOPs should be dismissed outright as a succession planning vehicle. Instead, they show the importance of having an experienced team of professionals involved in the ESOP transaction because an experienced team can navigate through these issues handily.

Ultimately, the decision to adopt an ESOP amounts to more than simply receiving the most favorable price for the business. Price certainly is one factor, but perhaps more than anything, the main factor is the owner's desire to preserve the corporate legacy that he or she created.

For more information please contact Greg Daugherty or any member of Porter Wright's Employee Benefits Practice Group.

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