ESOP Reference Guide

Employee Stock Ownership Plan - What is it?

An employee stock ownership plan ("ESOP") is a tax-advantaged way to sell a business to the employees of a company. An ESOP allows the employees of a company to be the beneficial (not legal) owners of a company's equity. Employees receive benefits in retirement from the payout of share benefits earned during their tenure with the company. An ESOP is a qualified retirement plan sponsored by a company, but unlike a 401K, an ESOP must invest primarily in the stock of the company sponsor and an ESOP may borrow money to finance the purchase of company stock.

Advantages

- Preservation of the values and corporate culture of the company, jobs, and community
- Tax advantages to the selling shareholder and the sponsor company
- Flexibility on the timing and percentage of the company to be sold to the ESOP
- Selling shareholder involvement in the company is possible following an ESOP sale
- Greater employee retention and productivity as a result of the ownership culture
- Continuity of service to customers and maintenance of suppliers and vendors
- Reduced confidentiality concerns during the transaction as the buyer is not a competitor

Considerations

- Inability to receive greater than fair market value in an ESOP transaction; i.e. unable to obtain a strategic sale price which PE or a competitor may be able to offer
  - However, the proceeds from a strategic offer may be less than fair market value received in an ESOP transaction due to tax implications
- Ongoing costs of maintaining an ESOP: valuation, administration, possibly external trustee
- ERISA fiduciary obligations
- Future repurchase obligations (i.e. redeeming stock from employee beneficiaries in retirement)
- ESOP debt is non-productive debt

Characteristics of a Good ESOP Candidate

- Stable cash flows with EBITDA in excess of $500,000
- History of incremental growth in revenues and profitability
- Human capital intensive company with payroll as a significant portion of expenses and about 20+ employees
- Management succession in place or plans to obtain it with involvement of the selling shareholder over a transition period
- The ESOP candidate is not overleveraged such that the company may take on new debt
- Selling shareholders willing to be patient in receiving their consideration partially upfront and/or over time
- Altruistic motivation of selling shareholder to reward and stabilize employees/community beyond their own time with the company

For further questions on ESOPs, please contact **Jennifer Krieger**
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