

# A Guide to ESOPs

(Employee Stock Ownership Plan)



FIFTH THIRD BANK

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## Introduction

There are many strategies to help business owners of privately held companies plan for the future and reach their long-term objectives—both professionally and personally. An employee stock ownership plan (ESOP) is one strategy that can help business owners:

- Establish a succession plan
- Diversify holdings
- Obtain tax benefits
- Generate liquidity to pursue other opportunities
- Diversify net worth
- Reward and retain a strong management team

Fifth Third's national ESOP Finance team understands the complexities of ESOPs and offers broad lending experience across a variety of industries. The team serves as a reliable financing source for ESOP transactions, including full and partial sale, second stage transactions, repurchase obligation financing and seller note refinance. To see if an ESOP is right for your business, contact your Fifth Third Relationship Manager.

## How ESOPs Influence Your Company's Future

As a business owner, you're focused on day-to-day operations, but future challenges are never far from your mind: How can you ensure the continued success of your business when you're ready to retire—even if that's 5-10 years away? Are there tax saving strategies that can be implemented when thinking about succession planning? What's the secret to building and sustaining a strong management team to help guide the company? How can you deepen employee engagement? Read on to see how an employee stock ownership plan (ESOP) is a solution that can check all of these boxes.

When exploring the option of an ESOP for your business, it's important to learn about the ins and outs as well as how it can be an effective tool for creating a succession plan, generating tax benefits and providing employees with the incentive to coalesce into a strong management team.



Originally created in 1974, there are currently [approximately 6,600 ESOPs covering more than 14 million employees](#). Studies show that employee-owned companies are more successful, more sustainable and have fewer layoffs than their non-employee owned peers. According to the [National Center for Employee Ownership](#), ESOP companies grow 2% to 3% faster than would have been expected without an ESOP, with lower turnover and 2.5% higher productivity.

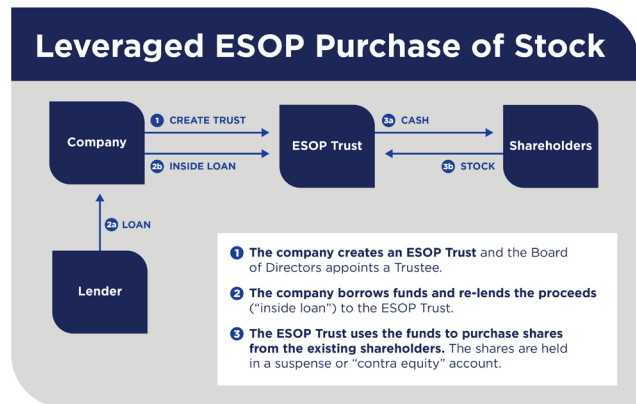
According to research by the Rutgers Institute for the Study of Employee Ownership and Profit Sharing funded by the Employee Ownership Foundation, employees at ESOP-owned companies experienced layoffs six times less often than those without employee ownership, with turnover rates as much as three times lower than in traditional companies. They also have more retirement savings, more engagement and involvement in the business, and more profit sharing.

## What is an ESOP?

An ESOP is a qualified defined employee benefit plan, similar to a profit-sharing or 401(k) plan, that invests primarily in employer company stock. The company creates a trust to purchase shares of its stock from the selling shareholders. The shares are allocated to eligible employees' accounts over time. Participating employees have the ability to monetize their shares after they reach a certain age, leave the company or retire, subject to vesting requirements.

The transfer of ownership can be financed in two different ways. In either case, the company contributions to the trust are tax-deductible, within certain limits:

1. **Non-leveraged ESOP:** the company contributes new shares of its own stock or cash to buy existing shares
2. **Leveraged ESOP:** the ESOP borrows money to buy the company's shares



## ESOPs: Myth vs. Reality

If you are at all familiar with ESOPs, it's possible you've heard some misinformation about them. For example, some business owners believe they must sell 100% of the company to the ESOP. In fact, an ESOP is one of the few avenues an owner can take to sell a minority interest in their company. And while there is no minimum, you'll want to sell at least 30% of the business to the ESOP in order to take advantage of available tax benefits.

Another misconception is that they are so complicated and expensive as to only be suitable for large businesses. While it's true an ESOP is more expensive than setting up a 401(k) plan, it's cheaper than most other ways of selling a business and no more complicated than selling to a third party. As for size, 97% of ESOP-owned company have less than 1,200 employees.

## Benefits of Transitioning to an ESOP:

1. **Preserve your legacy and stay involved.** After all the blood, sweat and tears you've invested in building your business, you no doubt hope that it will continue to thrive—in a form you'd recognize—long after you've handed over the reins. Like many successful business owners, much of your identity and self-worth are tied up in the business you've built. Selling to an outside third-party puts your legacy and the culture of your business at risk.

Maybe you're not ready to exit the business but would like to monetize part of your investment in it. Although you might want to sell to an insider, it's rare for family members or employees to have access to the financial wherewithal necessary to buy you out. An ESOP solves that problem and enables you to continue to run the company, while helping all parties save on taxes.

- 2. Take advantage of tax benefits.** As a qualified benefit plan, an ESOP provides many tax advantages. Congress created specific tax incentives to promote increased use of ESOPs in order to broaden the ownership of capital with most states following suit. Here is a high-level look at these benefits.

In C-Corporation transactions, shareholders selling at least 30% of their stock to an ESOP have the ability to defer capital gains tax indefinitely subject to meeting certain statutory requirements.

Beginning in 1998, ESOPs were allowed to own stock in S-Corporations. If an ESOP owns 100% of the common stock, the company can elect an S-Corporation tax status to eliminate all federal income tax as well as state income tax in most states. This increased cash flow allows for faster debt repayment.

- 3. Recruit and retain a strong management team, increase employee engagement and improve company performance.** Study after study has shown that employees who have a stake in their company tend to be more committed and engaged. With a greater degree of cooperation between management and employees, productivity and performance are known to rise. A 2010 study conducted by Phil Swagel of the McDonough School of Business at Georgetown University tracked the performance of ESOP-owned companies and showed that even during the first year of the 2008 recession, they were adding employees and enjoying double-digit growth.

In another study of ESOP performance conducted by Dr. Joseph R. Blasi and Dr. Douglas L. Kruse, professors at the School of Management and Labor Relations at Rutgers University, 1,100 ESOP companies were compared to 1,100 non-ESOP companies. The companies were followed for over a decade and the results showed that ESOP-owned companies had a business survival rate of 77.9% compared to 62.3% for non-ESOP companies.

## In Conclusion

Making the transition to an ESOP doesn't happen overnight. Like any worthwhile business endeavor, it takes preparation, planning, and patience; however, the rewards for both you and your employees can be significant.

## 6 Reasons to Consider an ESOP for Your Business

A business owner can benefit financially from selling his or her business to employees using an employee stock ownership plan (ESOP) structure. Using an ESOP for ownership transition can achieve significant non-financial benefits as well.

Discover six reasons this structure may be the right solution for you and your business.

### 1. If You Prefer to Sell Part of Your Business

One advantage of an ESOP is the flexibility an ESOP structure provides. Unlike a sale to a private equity firm or a strategic buyer, a sale to an ESOP doesn't have to be an "all or nothing" proposition. An ESOP can be used for a partial exit — an option that may be very useful in a variety of situations including:

- Providing minority shareholders a vehicle through which they can sell their shares
- Divorcing couples who are joint business owners
- The need to create liquidity to compensate owners who are ready to leave the business, while not undermining the foundations of the company or forcing a sale by those who wish to remain involved
- Allowing owners to partially monetize their ownership for diversification purposes



### 2. Protect Your Legacy

Some people close the door on a business and that's the end of it for them. Get the best price possible, and ride off into the sunset, looking forward to enjoying all the things they didn't have time for while building their business.

For those who see that transition differently, an ESOP can be a more attractive solution. An ESOP enables your employees to become part of your legacy. It allows you to keep your name on the door and continue to participate in—and guide—the running of your company. For example, if you are a major employer in your community, provide economic vitality, jobs and opportunity to the area, there is

no “outsider” who could decide to move the operation to another city. Or if you were an innovator in improving the employment conditions in your office or plant, an ESOP may afford you the opportunity to maintain and possibly expand those innovations.

If you’re looking to create more space in your life for non-work activities, but still want to make the most of your energy and expertise with regard to your business, an ESOP can be structured to allow you to do just that.

### **3. Recruit and Retain the Best Workers**

Recruiting and retaining people is one of the biggest hidden costs for any company, especially in very competitive markets. Being able to offer potential employees a piece of the business can be a powerful recruiting tool, compensating for an inconvenient commute or location, or differences in medical benefits. Plus, ESOPs are simpler to set up than other options, such as worker cooperatives, but can provide similar benefits in terms of providing financial empowerment for employees.

According to [researchers at Rutgers University](#), ESOPs can help marginalized workers build assets in addition to their take-home pay. This, in turn, makes it easier for them to draw from other sources of funding when they need to pay for life’s expenses. The plans have demonstrable benefits for low-wealth and low-income families when a household member is able to participate: the study found that ESOPs in these cases can account for more than 25% of a household’s long-term savings.

ESOPs also have positive effects on retirement savings plans as well — particularly for women and people of color. Statistically speaking, these groups make smaller contributions to retirement plans such as 401(k)s due to lower wages than their white, male counterparts. ESOPs, unlike 401(k)s, are not tied to earnings, which can make it easier for a broader swath of employees to accumulate shares.

An ESOP can even be structured to include contract workers, giving the business a real leg up in competing for talent. Having a real stake in the business is a benefit that isn’t available in all companies, and certainly is seldom available to non-fulltime employees. Likewise, transitioning to an ESOP can help you retain valuable employees, providing a financial benefit to the owner beyond the increased liquidity and tax advantages. In fact, studies show that employees who have “skin in the game” feel greater loyalty to their company and exhibit a higher level of productivity.

## 4. If You Want to Maintain a Sense of Control

Another way an ESOP can prove to be a more flexible alternative to a third party sale is that it allows the owner to continue managing and guiding the company.

The liquidity provided by the sale to employees allows you to diversify your holdings while continuing to participate in the leadership of the business. You can remain actively involved in your company's future—within the bounds of good corporate governance and Employee Retirement Income Security Act (ERISA) fiduciary rules.

## 5. Protect Business Information from Competitors

One of the top concerns of business owners when selling their business is confidentiality. The fear that confidential information gets leaked, or even that there is a sale process for the business, is a legitimate concern. Having financial information, customer lists, proprietary processes, or strategy plans leaked can cause substantial harm to a business. And while confidentiality agreements try to put a fence around this issue, once the horse has left the barn, the damage is done.

By selling to an ESOP, the risk that sensitive information gets out is substantially reduced. No concerns about sharing financial information; no worries about having your best customers pilfered; no issues with your vendors getting nervous about who they'll be dealing with if the company sells. Selling to an ESOP reduces the anxiety with all of these issues.

## 6. Weathering Potential Economic Downturns

ESOP-owned companies have shown surprising resilience even when the economy as a whole is facing problems. A 2010 study conducted by Phil Swagel and Robert Carroll of the McDonough School of Business at Georgetown University tracked the performance of ESOP-owned companies and showed that even during the first year of the 2008 recession, they were adding employees and seeing double-digit growth.

According to research by the Rutgers Institute for the Study of Employee Ownership and Profit Sharing funded by the Employee Ownership Foundation, employees at ESOP-owned companies experienced layoffs six times less often than those without employee ownership, with turnover rates as much as three times lower than in traditional companies. They also have more retirement savings, more training and involvement in the business, and more profit sharing.



## In Conclusion

For business owners who are interested in moving on, but have felt stymied by any of the above considerations, an ESOP provides a flexible alternative to a sale to a financial or strategic buyer. As with any endeavor of this kind, such a transition requires a great deal of preparation and a team of professionals with expertise in the creation of ESOPs. It's really a trifecta – financial liquidity, tax advantages, and securing of your vision for your company.

# The Ins and Outs of Transitioning to an ESOP

For a business owner, an ESOP can be a means of transitioning ownership while generating potential tax advantages and providing employees with the incentive to perform at a higher level. This article delves deeper into the primary structure of an ESOP, the various tax advantages it provides, the industry professionals who are typically involved throughout the process, and where to find financing.

## The Basic Structure of Employee Stock Ownership Plans

An ESOP is a qualified employee benefit plan that primarily invests in employer company stock. The company creates a trust to purchase shares of stock from the selling shareholder(s) and allocates shares to eligible employees' accounts over time, subject to vesting requirements. The transfer of ownership may be financed in two different ways:

1. **Non-leveraged ESOP:** the company contributes new shares of its own stock or cash to buy existing shares
2. **Leveraged ESOP:** the ESOP borrows money to buy the company's shares

In a leveraged ESOP structure, an inside loan is established between the company and the ESOP Trust. This inside loan is typically amortized over 15-30 years. Similar to other qualified retirement plans, the company makes cash contributions to the ESOP Trust (up to 25% of the qualified payroll). These contributions are then used by the Trust to pay down the inside loan. As the inside loan gets paid down, shares are allocated into participants' ESOP accounts. These cash contributions are expensed "above the line," thereby reducing the company's taxable income.

Assuming the inside loan is still in place, the ESOP Trust uses the cash from these contributions to make payments to the company on the inside loan, effectively making the contributions a non-cash expense. This provides additional cash flow to the company that may be used to repay debt or reinvest into the company.

## Tax Advantages of ESOPs

One of the primary benefits of ESOPs for businesses and business owners is the potential tax advantages. In addition to the reduction of taxable income described above, for a C-Corporation, the selling shareholder has the ability to utilize a 1042 rollover. As outlined in the Internal Revenue Code Section 1042, the selling shareholder has the ability to defer capital gains tax on the sale of stock if 30% or more of the company is sold to the ESOP, and the transaction proceeds are invested in Qualified Replacement Property (stocks or bonds of U.S. operating companies) within 12 months of the transaction.

For an S-Corporation, the shares owned by the ESOP are exempt from federal and most state income taxes. For a 100% ESOP-owned S-Corporation, this means the company need not make any tax distributions. This results in more cash flow for the company. The tax advantage is not tied to employee benefits, has unlimited duration and offers long-term tax relief.

A company has the ability to change its corporate status from a C-Corporation to an S-Corporation, or vice versa if desired, for certain tax advantages. Note that it may be subject to a waiting period before switching.



## Professionals and Their Roles

Many companies utilize an advisory firm/investment bank to assist throughout the ESOP process. In addition to performing a feasibility study to determine whether an ESOP is right for the business, the advisor firm may assist with the development of the ESOP and with obtaining financing. The trustee is hired by the company's board of directors to represent the newly formed ESOP Trust. The trustee negotiates the sale price with the selling shareholder(s) and utilizes a financial advisor (valuation firm) to determine the fair market value of the company.

Similar to merger and acquisition transactions, attorneys play a critical role in ESOP transactions. Typically, the selling shareholder(s), company, trustee and bank (if leveraged) have legal counsel for an ESOP transaction.

It is vitally important to utilize attorneys who have Employee Retirement Income Security Act (ERISA) knowledge with significant ESOP experience to achieve a thoughtful and economical outcome.

## Sources of Capital

If the selling shareholder is looking for liquidity from the transaction, there are multiple capital sources. Capital from a commercial bank is typically senior to all other forms of capital and represents the lowest cost of capital.

Mezzanine capital may also be available to the company, but will have a higher cost, as it will be junior to the commercial bank debt. Recently, private equity firms have also begun to recognize the value of ESOPs and are beginning to partner with ESOPs to acquire companies.

While other forms of capital exist (e.g., employee capital), the most common form comes from the seller. Yields to the seller vary. In almost all cases, seller debt is subordinated to the commercial bank debt and is junior to mezzanine debt, if any.

Businesses should work with a team of seasoned commercial lending experts who understand current market dynamics and the complexities of an ESOP.

## In Conclusion

An ESOP is a financial tool that delivers many benefits for the business owner and his or her employees. Owners are able to remain active in the companies they've created while accessing more liquidity and enjoying tax advantages. Employees acquire a stake in the company's future, which leads to deeper engagement (studies show that productivity and performance increase as a result of ESOPs). Yes, it takes planning and attention to detail, but with the right team behind you, an ESOP is an attractive and flexible business transition alternative.

## 6 Steps of Transitioning to ESOP Ownership

There are a number of reasons an employee stock ownership plan (ESOP) might be right for your business. Ensuring a successful transition to ESOP ownership, as with any complex business endeavor, requires the ability to anticipate challenges and take steps to prevent them. Some of those challenges need to be considered prior to setting up an ESOP; others are likely to arise after the transaction is complete. Being aware of these challenges will give you an advantage in overcoming them and preventing future problems.



### Depth of Management

It is extremely important that the owner/seller carefully consider the question of post-transaction management when evaluating the sale of the business to its employees. Does the business owner/ seller intend to remain actively involved in managing and growing the business? If this is the case, the trustee and any third party lender likely will require that the selling shareholder enter into an employment agreement that establishes the continuing relationship between the company and the seller as a member of management for a specified number of years. Who else will be involved in managing and leading the business after the sale? Do the future leaders and managers of the business need to be hired, or are there long-time employees who can be trained and mentored to assume greater responsibilities?

- If the owner/seller has been the primary driver of business development due to his or her industry contacts, can those relationships be effectively transitioned to someone else? Has that process begun? How long will it take?
- Has the owner/seller previously shared responsibility for leading and managing the business so others understand the ins and outs of running the business? How well do they know the business? Do they understand how to grow the business?
- If the company needs to hire outsiders, how difficult will it be to find the “right” people, and how long does the transition period need to be to accommodate that process?

If, however, the owner/seller is intending to disengage from the business after the sale, the issues raised above take on even greater urgency. Prior to the sale to the ESOP, there needs to be a senior management team in place that knows how to move the business forward. It's important to be honest in judging the capabilities of that team. If they need more experience or there are holes to fill, it's better to know in advance and work toward an eventual sale. The company's ability to thrive—or even pay off third party or seller debt—may be compromised with a too hasty sale. Additionally, the seller may find that banks are unwilling to provide financing for the sale to the ESOP until an appropriate management team is in place.

## **Operating the Business in a Different Financial Environment**

Oftentimes, privately held businesses carry little or no debt other than a line of credit used to finance working capital and perhaps a real estate mortgage or a limited amount of debt that has been used to finance capital expenditures.

The transfer of ownership to the ESOP must be financed, whether by the seller alone or by the combination of bank financing and seller-provided financing. In either case, the sale to the ESOP will be financed by the company borrowing money to lend to the employee share ownership trust (ESOT) in order to purchase company shares. Once the buyout takes place, the company will be operating with a significant amount of debt. Operating with a higher debt load will require management to perform within financial covenants set by the bank. The management team and the finance team will need to have the expertise and the tools in place to run a company carrying debt.

Does the company have a chief financial officer or controller who has the experience and knowledge to guide the financial affairs of a company with significant debt obligations?

Running a business with term debt obligations—whether to a bank or other outside lender or to the seller—is very different than running a business without these obligations. After the sale to an ESOP, a significant portion of the cash flow generated by the business will be used to meet debt service requirements.

Prior to entering into the ESOP transaction, the management team (along with a financial advisor with expertise in ESOPs and the company's accounting firm) will need to develop a three- to five-year business plan and financial projections. They will need to evaluate the company's ability to meet projected debt service obligations and future ESOP share repurchase obligations, while at the same time having enough cash flow to grow the business. This analysis should include “stress-testing” the business's ability to meet its debt service obligations even if things don't turn out as planned. The analysis should also test the company's ability to meet

the financial covenants imposed on the company by the bank. Finally, the seller and management team need to determine whether the company has the internal systems in place to generate the type of monthly financial reporting that will be required by the bank.

## **Impact on Cash Flow After the Transaction**

If the company transitioning to an ESOP is in a capital-intensive business, or will need to expend a significant amount of capital to meet its growth plans, the ESOP transaction will need to be structured so the company will be able to support the new ESOP-related debt obligations and still have enough cash (or borrowing capability) to finance operations and growth. This means being realistic about how much capital the business needs to function and to keep growing. Underestimating future capital needs can seriously hamper the future success of the ESOP-owned company. While projecting future capital expenditure needs is far from an exact science, seasoned ESOP financial advisors can help management structure an ESOP transaction that integrates and balances the company's future needs with the seller's desire for liquidity at closing.

## **A New Layer of Reporting and Regulatory Obligations**

The transition to an ESOP provides the owner/seller with many financial benefits. Those benefits go hand in hand with a number of obligations dictated by the Department of Labor and the Internal Revenue Code.

These obligations affect human resources, executive compensation, employee benefits and recruiting, and will need to be integrated into the company's policies, procedures, and strategic objectives. Prior to entering into an ESOP transaction, the owner and the management team will want to consult with experienced ESOP professionals—especially an experienced ESOP attorney—to make sure they understand these obligations and are prepared to operate within these rules and regulations. After the transaction, it will be important to stay abreast of ESOP-related tax and regulatory obligations to ensure the company remains in compliance.

ESOPs present additional record keeping and reporting requirements, which means additional time, administrative costs, and the need for new internal expertise (or outside service providers). For example, because the company will need to file regular reports with the Department of Labor, management needs to think through who will be responsible for these new tasks and potentially what outside advisors the company will hire to assist in these tasks.

In addition, there are tax regulations the company needs to be aware of and with which the company needs to comply. The best plan for dealing with these is to engage an attorney or accountant who is experienced with ESOPs and can help the company set up the systems needed to track compliance.

Finally, the company's board of directors or ESOP committee will need to hire an ESOP trustee who will be the fiduciary responsible for administering the ESOP for the benefit of the participants. In almost all cases, the initial trustee hired in connection with the sale of the business to the ESOT should be an outside trustee. After the transaction, some companies switch to an internal trustee, but this generally is not preferred by bank lenders. The cost of hiring and retaining an ESOP trustee should be taken into account when the business is developing its projections and evaluating the feasibility of the transaction.

## Preparing for Repurchase Obligations

When an ESOP participant leaves the company (whether by death, disability, retirement or termination), the participant is entitled to "put" his or her vested shares to the company. The company is required to buy back those shares at a price and time set by law and regulation. This is called share repurchase. The company's obligation to buy back shares is called "repurchase obligation" or "repurchase liability".

Repurchase obligations generally do not represent a significant cash cost during the initial five to seven years after the sale to the ESOP. However, after 10 years, they can significantly impact the business' cash resources—especially if the business is successful. In the case of a capital-intensive business, these obligations compete for cash with the need to invest in the business.

Again, a knowledgeable ESOP professional (particularly one well-versed in repurchase liability issues) can help with critical front-end decisions regarding creating the ESOP's design (matters such as structuring the internal ESOP loan, eligibility, vesting and distribution provisions that can affect repurchase obligations).

## Creating a New Culture

Transitioning to an ESOP-owned company provides the owner/seller with the means and opportunity to transform the internal dynamics of the business. As previously discussed, there is much research showing ESOP-owned companies outperform non-employee-owned peers. That said, the degree to which ESOP ownership affects a business's performance depends significantly on the desires of the selling shareholder and management team, and the intentionality with which the management team addresses employee ownership.



The first decision the business owner and management team need to make is whether the ESOP structure is being used because the business owner supports the value of employee ownership, or because the ESOP is a tax-advantaged corporate finance tool (or a combination of both). If the driver is the latter, the management team may not choose to devote time and resources to developing an “ownership culture.” If the driver is the former, management will want to work with professionals skilled at the development of communication plans and employee training to maximize the cultural and performance benefits of ESOP ownership.

Regardless of the underlying motivation for selling the business to the ESOP, management will need to decide how much information about the business will be shared with the employee owners. Legally there is no obligation to disclose anything beyond the annual share value. Many companies opt to share a great deal more because they believe it will increase the employees’ sense of ownership and buy-in.

For companies that choose to share more information about the company’s financial performance, the question becomes: How do you provide the information to employees without overwhelming them? Oftentimes many employees will have had little or no opportunity to develop a high level of business or financial literacy. Fortunately, this is exactly the kind of challenge addressed by ESOP communications experts, as well as by the various ESOP organizations that sponsor national and local conferences, webinars and publications designed to help educate employees and management of ESOP-owned companies.

## In Conclusion

There’s an old saying, “an ounce of prevention is worth a pound of cure.” By anticipating and preparing for these issues, enlisting the advice of seasoned ESOP professionals and utilizing the kinds of resources identified above, the business owner and the management team can exercise that ounce of prevention. The result will likely be a successful transition to an ESOP, benefiting both the owner/ seller and the employees.

**For more information, contact your Fifth Third Relationship Manager or our [ESOP Finance team](#).**



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