For Many Companies, Major Benefits from ESOPs

By Christina Groll, John R. Maxfield and Elizabeth A. Nedrow

***IF YOU EAVESDROP** on any two people discussing incentive compensation, you could get lost in an alphabet soup of acronyms: ISO, ESOP, ESPP, 409A, SARs, 16b-3, RSUs, and more. This article will describe some of the more interesting characteristics and uses of an incentive* compensation tool known as an ESOP, specifically in the context of a privately-held corporation.

ESOP stands for employee stock ownership plan. Basically, an ESOP is a qualified retirement plan much like other more familiar profit sharing or pension plans. This means that ESOPs must follow the same broad-based eligibility rules, vesting mandates and other requirements the IRS sets for retirement plans.

What's unique about ESOPs is that they are designed to invest primarily in the stock of their sponsoring employer. The ability to provide "pure" equity compensation to employees at all levels is a great performance incentive.

Employee ownership proponents have statistics and many studies to back their claims that employee-owned companies are more successful than other companies.

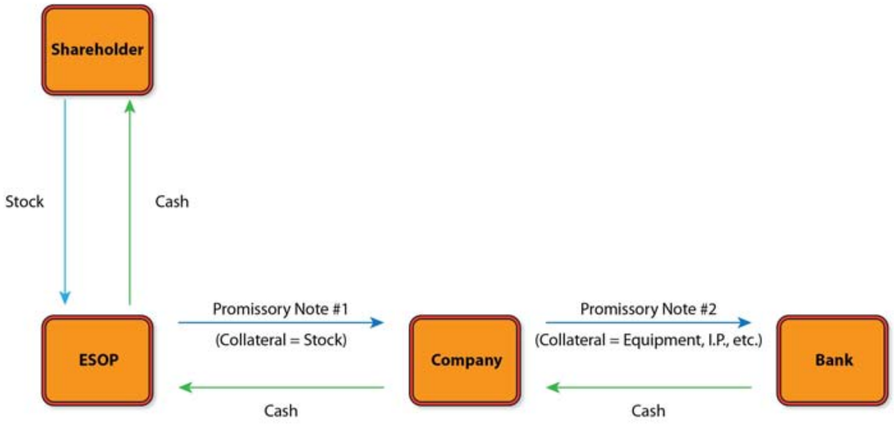
The most-cited study was done in 2000 by Douglas Kruse and Joseph Blasi of Rutgers University. Comparing closely-held ESOP companies with comparable non-ESOP companies and then tracking their performance over a period of six years, the study concluded that ESOP-owned companies had between 2.3 percent and 2.4 percent higher sales, employment growth and growth in sales per employee.

FUNDING ALTERNATIVES

Aside from being an employee motivator, ESOPs have some other interesting purposes and uses. Most of these derive from another unique characteristic of ESOPs: their ability to borrow funds to purchase employer stock. No other retirement plan has this ability. What this means is that an ESOP can be part of a long-term business succession strategy. An ESOP can buy all or some of the stock from retiring shareholders, or it can facilitate a business divorce.

One alternative is the leveraged ESOP. The is frequently done as shown on the first flowchart below.

The company borrows funds from an outside lender (typically a bank), and



the loan is secured by the equipment, intellectual property and other collateral of the company. At the same time, the company makes a so-called "mirror" loan to the ESOP, secured by the shares being purchased from the shareholders. (Often the selling shareholders carry a portion of the purchase price with subordinated debt that yields a market rate return.) The ESOP uses the loan proceeds to buy the stock of the retiring individual shareholders, and holds the stock in a suspense account for future allocation to employees.

Throughout the term of the loan, the company uses cash flow to make annual tax-deductible cash contributions to the ESOP, while at the same time the ESOP returns the cash to the company as payment on the ESOP's mirror loan.

The company then has that cash available to make payments on its loan to the outside lender. This annual payment cycle is what drives the benefit to the company's employees. As the ESOP repays its loan to the company, blocks of stock are released from the suspense account and allocated to the accounts of eligible employees. The allocation is made proportionately, based on the employees' relative compensation levels. This annual payment and allocation process is demonstrated in the flow chart to the right.

The savvy business planner will recognize that the leveraged ESOP structure provides an opportunity for tax-advantaged funds for business operations. If the company sells treasury (or otherwise unissued) shares to the ESOP in a leveraged transaction, the company's tax-deductible cash contributions to the ESOP are effectively returned to the company each year. The company is then free to use the cash for any business purpose, including repayment of the initial loan.

Another funding alternative is the unleveraged ESOP. Even an unleveraged ESOP provides tax advantages for the sponsoring company. ESOPs are usually designed so that the company can make annual discretionary contributions in either cash or stock. Stock contributions made to the ESOP are tax-deductible by the company up to their fair market value on the date they are transferred to the ESOP.

ADVANTAGES

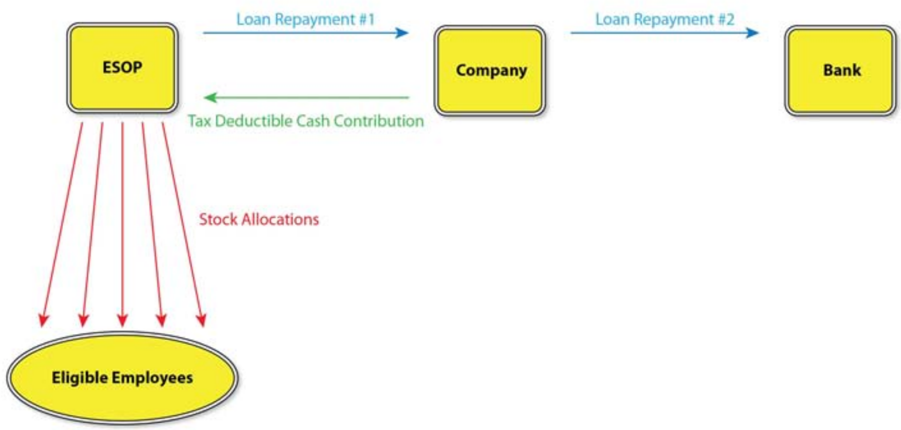
From the company's perspective, one of the most interesting ESOP models – and the one that probably provides the greatest advantage – is the S corporation ESOP.

The basic principle of an S corporation is that there is no taxation of the company's income at the corporate level, and instead all taxable income is passed through to the shareholders and taxed at the shareholders' respective individual rates.

To the extent that the ESOP owns stock in an S corporation, the income that is passed through to the ESOP is exempt from tax, since the ESOP trust is a tax exempt entity. Eventually, the trust's value is taxed when it is distributed to the ESOP participants, so the tax advantage is probably more accurately described as a deferral rather than an exemption.

An S corporation often distributes cash to its shareholders to assist them in satisfying their tax liabilities on this pass-through income, but in a wholly ESOP-owned company, this cash distribution is not necessary. The company can instead retain the cash for business purposes if it so chooses.

From the perspective of the selling shareholder, an ESOP transaction has advantages, as well. A special provision in the tax laws permits a selling shareholder (if several conditions are met) to use the cash received in an ESOP sale to invest in designated securities and defer tax on the sale proceeds until the reinvested assets are later sold. This is called a "1042 rollover," after the section of the Internal Revenue Code that allows it.



Aside from this direct tax benefit, an ESOP sale can provide a selling shareholder with the peace of mind that his or her life's work will be passed on to knowledgeable employees who are more likely to preserve the business in its current form, as opposed to going to liquidation or sale to a strategic buyer or third party with no culturally-related background.

STRICTURES AND LIMITATIONS

It bears noting that the ESOP's participation in transactions like stock purchases is tightly governed by fiduciary principles. As a retirement plan, the ESOP is subject to the federal Department of Labor's fiduciary fairness rules, which means that before the ESOP can act, trustees (who usually are independent third-party professionals) must decide that the transaction is in the best interest of the ESOP participants.

The complexity of these fiduciary rules (not to mention the qualification rules of the IRS) means that the company, the ESOP trustee and the selling shareholders all need experienced professional advisors, both when the ESOP is established and for ongoing maintenance and operation. Not surprisingly, this also means that ESOPs involve ongoing financial expense and administrative time.

One of the key ongoing tasks involved in maintaining an ESOP is the requirement that the stock be valued each year by an independent appraiser. This valuation is used to communicate with the employees about the value of their accounts and to ensure compliance with the various tax deduction and other financial limitations of the ESOP.

It is also a factor used in predicting what the ESOP's "repurchase liability" will be. Repurchase liability is the phrase commonly used to describe the amounts of cash the company is predicted to need to fund benefits to the ESOP participants when they retire, die, or terminate employment. When a participant becomes entitled to a distribution, the company must be prepared to convert the stock in the participant's account to cash.

While ESOPs have some special tools to delay distributions longer than is typically seen in 401(k) plans, the need for future liquidity to fund retirement benefits from an ESOP should not be underestimated.

WHICH COMPANIES ARE LIKELY TO BENEFIT

In many cases, however, the complexity and expense of an ESOP is more than offset by the substantial cultural and economic advantages ESOPs can bring to the table. Specifically, you might consider an ESOP for your company if it has all of the following characteristics:

- Predictable (and ideally, increasing) operating cash flows, sufficient to both service the ESOP's debt and fund the estimated repurchase liability associated with paying benefits to former employees.
- Best corporate governance practices or a willingness to adopt them, including audited financials and one or more independent directors.
- A strong management team that supports the ESOP and has incentives to remain with the company and drive its success.
- A commitment to developing a culture of employee ownership, including sharing information with the employee owners and getting them involved in the day-to-day decisions affecting their work.

For a company lacking any one of these characteristics, an ESOP might not be the way to go. But if these characteristics are present, an ESOP probably is at least worth exploring. A good place to start is with an ESOP exploration committee or a feasibility study. An experienced ESOP advisor can help with the next steps.

The National Center for Employee Ownership, a nonprofit group dedicated to ESOP education and promotion, estimates that since 1974 over 4,000 corporations are majority-owned through an ESOP, and thousands more are partially owned.

These companies have realized that an ESOP is a powerful mechanism to transfer ownership to a company's employees, at the same time it delivers remarkable tax and other benefits to the company and its existing owners.

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