ESOPs 101:
A Detailed Introduction of Employee Stock Ownership Plans

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Kyle Coltman has worked extensively in the design of employee buyouts since joining the firm in 1979. During this time he has supervised several hundred ESOP buyouts for owners of privately-held firms. Mr. Coltman’s responsibilities encompass all phases of deal structuring, financing and coordination of ongoing services.

Mr. Coltman graduated with honors from the University of California, San Diego, receiving a B.A. degree in Economics. He received his M.B.A. degree in finance at the University of California, Berkeley.
For eleven years, Phil DeDominicis has been the senior East Coast partner of Menke & Associates focusing on ownership transition situations through ESOPs and sales of businesses. He is also an expert on raising private financings, both debt and equity.

Prior to joining Menke, Mr. DeDominicis spent three years as a Director in the Mergers & Acquisitions Group of Citigroup,. Prior to that, he spent ten years as a Director in the Mergers, Acquisitions & Private Finance Group of Morgan Stanley.

Mr. DeDominicis received his degree in Chemical Engineering from the University of Delaware, and his MBA in Finance UCLA. He is an active member in the ESOP Association, OEOC and NCEO.
Menke & Associates, Inc.

Oldest ESOP advisor:
41 years in the business, 50 ESOP specialists

Most ESOPs created:
Over 2,500

Largest current number of ESOP clients:
1,000 clients

Most sophisticated online ESOP administration
$4 million investment

ESOP owned:
Menke is 55% ESOP owned
Private company liquidity options

1. Sell the company (all or nothing)
2. Sell shares to another partner (still have 100% problem)
3. Redeem shares to treasury (still have 100% problem)
4. Gift shares to children (no liquidity)
5. Sell shares to managers (can’t do 100%)
6. Sell shares to ESOP (takes time)
What is an ESOP?

- Similar benefits of other company funded retirement plans (e.g., 401k, PSP).
  - Tax deductible contributions for employer.
  - Tax deferred growth investments for employees.

- But, it is also an M&A transaction.
  - ESOP invests primarily in your company’s stock.
  - Investments are directed by the board of directors.
  - Employees then participate in company earnings.
ESOP structures

1. ESOP + one owner/operator in control
2. ESOP + partnership (“partners” in control)
3. ESOP + numerous outside private S/H’s
4. ESOP + public company shareholders
5. ESOP + family owned business
6. ESOP + special/minority status business
7. 100% ESOP
8. ESOP followed by 100% sale to 3rd party
Good ESOP Candidates

- Owners need an exit or desire some liquidity.
- Succession management team is or will be in place.
- Profitable - strong cash flow.
- ESOP valuation acceptable to owners.
- Company is large enough to warrant installation and maintenance expense.
- Owners seek to increase employee productivity.
Scenarios Where ESOPs May Not Work Well

- Doctor and dental practices, CPA firms - depending on state licensing requirements, non-licensed professionals may not be able to own shares.
- Real estate or insurance agencies - if agents are “independent” and not W-2 employees.
- Minority-status businesses - ESOP is counted as a non-minority shareholder; limits ESOP to 49%.
- Unprofitable businesses.
You will not be alone!

- ESOPs have been around since 1974.
- Over 22,000 U.S. corporations have adopted ESOPs in that time!
- Today, there are over 13.5 million participants (11% of U.S. workforce) with $942 billion in assets (27% of 401k assets). Average account size of $55,000. Average retirement distributions are $370,000! (ESOP Association 2009)
ESOPs are not a U.S. only concept

- United Kingdom
- France
- Germany
- Ireland
- Australia
- South Korea (3,000 plans, 1.2 mm workers)
- New Zealand
- South Africa
- Zimbabwe
- Kenya
- China
Why are ESOPs popular?

- **Win** - Business owners find a buyer of stock (succession planning) and leave a legacy.
- **Win** - Company has an alternative to a sale and a means to increase productivity.
- **Win** – Employees receive a company-funded retirement plan and an incentive to affect their own personal wealth.
- **Win** - Vendors & customers receive better service and product.
- **Win** – Federal Government collects more taxes.
Why are ESOPs popular?
Flexible, Flexible, Flexible

- Sell all, sell some
- Sell now, sell later
- A partner sells, some partners sell, all partners sell
- Stay, go, change position
- Keep control, sell control
- Promote concept heavily, keep low key
- Never sell the business, sell the business later
ESOPs by industry

- Manufacturing, Construction, Finance, Insurance, & Other
- Service & Professional Firms
- Distributors & Retail
ESOP stock ownership of private companies
No requirement to sell a certain percent

Percent of each private company owned by its ESOP

<table>
<thead>
<tr>
<th>Percent of private ESOP companies</th>
<th>0-10%</th>
<th>11-30%</th>
<th>31-50%</th>
<th>51-100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%</td>
<td>20%</td>
<td>25%</td>
<td>35%</td>
<td></td>
</tr>
</tbody>
</table>
ESOP stock ownership of private companies

Over 2,500 U.S. businesses are owned 100% by their ESOP!
Employee count within private ESOP companies

Source: NCEO 2012
ESOP benefits to business owners

1. Liquidity for shareholders
2. Diversify owner’s asset allocation
3. Real business succession strategy
4. Increase company cash flow
5. Enhance employee productivity
1. Liquidity for shareholders (while still running their business!)

- Many times significant portion of owner’s wealth tied up in company stock.
- Owners can sell all or part of their shares.
- Can spread sale of shares over years.
- Can keep some shares, even after retirement.
- Many times selling the entire company to a third party is not possible, but this option does not come off the table after the ESOP is started.
2. ESOPs diversify owner’s asset allocation (while still running their business!)

Pre-ESOP

Post-ESOP

Private Company

Equities

Cash

Fixed Income

Vacation Home

Private Company

Equities

Cash

Fixed Income
What is your exit strategy?

- Share ownership?
- Board of Directors?
- President?
- Officers?

Sale
Exit

Year 0  Year 5  Year 10
What is your exit strategy?

- Share ownership?
- Officers?
- Board of Directors?
- CEO?
- ESOP

Year 0                      Year 5                 Year 10
3. Adopting an ESOP is a Real Business Succession Strategy (Doing Nothing is Not!)

- ESOP is a low stress ownership transfer method.
- No third party buyer - certainty of outcome.
- Management changes only if owners choose to.
- Not an all-or-nothing proposition (sell 1%, sell 100%, or anywhere in between).
- Owners can maintain control of company down to their last share owned.
4. ESOPs Can Increased Company Cash Flow

- Are you already funding a retirement plan? Replace existing retirement plan with ESOP and receive “two bangs for the same buck.”
- Replace corporate stock repurchases with tax deductible ESOP purchases
- Use S Corp tax distributions to buy out yourself or your partners.
5. ESOPs Should Increase Employee Productivity

- In the past 30 years, numerous independent studies have measured the potential of employee productivity increases of ESOP owned vs. non-ESOP owned companies.

- Across the board, the studies indicated significant increases in employee productivity, company performance, stability and morale.
Basic ESOP Structures
Existing ESOP Misconceptions

- Must borrow money.
- Must sell 30% or more.
- Must sell stock immediately.
- Will be at lower price than selling to 3rd party.
- Employees become shareholders/get a vote.
- Must lose control.
- More difficult to sell the business in future.
- Expensive.

All..... NOT true!
How is an ESOP structured?

- The assets are held in trust for the benefit of plan participants.
- Trust is tax exempt.
- Assets invested primarily in Company Stock.
  - Highest class of stock
  - Voting
Four Basic ESOP Transactions

3. Contribute stock directly to ESOP.
4. Use cash in ESOP to buy treasury shares.
ESOP Structure #1
Cash Contribution, Buy Stock From S/H

Steps 1 and 2 do not need to occur simultaneously!

1. Retirement Plan & Tax Deduction
2. Company Stock
3. Cash

1. Cash (max 25% payroll)
2. Company Stock
3. Cash

Diversification or spending

Selling shareholders

Company

ESOP Trust

3. Financial security, better lifestyle
ESOP Structure #2a
Leveraged (Borrow from Bank)

Lender

1. Cash

1. Note & Collateral

Company

2. Note & Pledge of Stock

2. Cash

Selling Shareholders

3. Company Stock

3. Cash

ESOP Trust
ESOP Structure #2b
Leveraged (With Seller Financing)

Selling Shareholders

Company

Employee benefit

Pledge agreement

Company Stock

ESOP Trust

Seller note
Compared to Stock Redemption (Typical Shareholder Agreement)

Lender

1. Financing Loan Proceeds

1. Note & Collateral

Company

2. Company Stock

Selling Shareholders

2. Cash or Seller Note

Pro: Anti-dilutive
Con: Not tax deductible
ESOP Structure #3
Stock Contribution

Outside Shareholders

Increase company cash & productivity (2)
Dilution (2)

Company

Retirement plan & Tax deduction (1)

Newly issued stock (1)

ESOP

Stock Contribution

Outside Shareholders

Increase company cash & productivity (2)
Dilution (2)

Company

Retirement plan & Tax deduction (1)

Newly issued stock (1)

ESOP
ESOP Structure #4
Stock Purchase from Treasury

Outside Shareholders: Increase company cash & productivity (2)

Company: Cash from previous years’ contributions & distributions! (1)

Dilution (2)

Treasury shares (1)

ESOP
C Corporation Options Not Available to S Corporations

- §1042 capital gains tax deferral
- Deductible dividends allowed.
- Interest and forfeitures are not included in 25% company contribution limit.
- No “broadly based” test (§409p) – in general, need more than 10 employees.
§1042 Tax–Deferred Rollover Requirements

- C corporation only.
- Privately held.
- ESOP must own 30% or more of the stock.
- Seller must reinvest proceeds within 12 months.
- Must invest in Qualified Replacement Property.
- Tax deferral continues as long as seller holds QRP.
- Shareholder must have owned shares >3 years.
## Option 2
### The Chip-Away ESOP to §1042

<table>
<thead>
<tr>
<th>Year</th>
<th>% Shares Sold</th>
<th>% Sold - Cumulative</th>
<th>Capital Gains Tax Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>5%</td>
<td>5%</td>
<td>Taxable</td>
</tr>
<tr>
<td>2</td>
<td>10%</td>
<td>15%</td>
<td>Taxable</td>
</tr>
<tr>
<td>3</td>
<td>15%</td>
<td>30%</td>
<td>Deferral option</td>
</tr>
<tr>
<td>4</td>
<td>20%</td>
<td>50%</td>
<td>Deferral option</td>
</tr>
</tbody>
</table>
§1042 Qualified Replacement Property (QRP)

- Any U.S. corporation, public or private.
- Equity or debt securities.
- Can be a brother/sister, but not a subsidiary of the ESOP company.
- If any QRP is sold, the pro-rata deferred capital gains tax becomes due.
Benefits of S Corporation ESOPs

- Corporate taxation on ESOP shares is delayed until distributions are made to ESOP participants at retirement.
- Selling shareholder(s) participate in ESOP allocations if active employee with possible limitations (§409p).
- Note: S corporation taxes are allocated to the company shareholders for each day of the year (i.e., it matters what day you sell shares to the ESOP).
S Corporation - Example 30% Owned by ESOP

ESOP distribution can be used to repay ESOP loan quicker, buy more shares, repurchase obligation or build up in cash.

Shareholders

Taxes

Company

70% distribution

30% distribution

ESOP

$
S Corporation - 100% Owned By ESOP

A 100% ESOP-owned S corporation pays no more income taxes!

Distribution - optional

ESOP

Company

X
“Fair Market Value (FMV) is the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”
ESOP valuation procedures

- Why? Required by DOL and IRS.
- Independent appraiser required (unless publicly traded).
- Responsibility of ESOP trustee.
- Frequency:
  - As of transaction date.
  - At least annually.
- Consistency from year to year.
- Information & access to management required.
Tiers of Value

CONTROL VALUE
- Strategic Value
- Control Block/ESOP Serial Sale/Financial Buyer

MINORITY VALUE (liquidity factor)
- Public Market
- Private Market With an ESOP
- Private Market/Estate Planning
- Orderly Liquidation
Valuation Criteria

- EXTERNAL
  - General economic outlook.
  - Nature and history of the industry.

- INTERNAL
  - Nature and history of the company.
  - Normalized historic and current earnings:
    - Non recurring income & expenses
    - Non operating income & expenses
    - Discretionary expenses
  - Projected growth & earnings
Who Runs an ESOP-Owned Corporation?

- No formal change in governance:
  - Shareholders elect the Board of Directors.
    - Also vote on major corporate transactions.
  - Directors responsible for running the company.
    - Can delegate authority to managers.
  - Officers/Managers appointed by Board.
    - Have responsibility for day-to-day operations typically becomes the ESOP trustee retaining control of day-to-day operations.
Owner Typically Retains Voting Control

- The ESOP Trust is the DIRECT owner of company stock, NOT the employees.
- Employees are BENEFICIAL owners, and thus, do not have the same rights as direct owners of stock.
- Owner typically becomes the ESOP trustee retaining control of day-to-day operations until such time owner is willing to give control to succession management team – usually when they have sold a large majority of their stock.
Shareholders Retain Control – No Control Premium Received

For sales of <50% to ESOP, or >50% at BOD option
Bill initially owns 100%.

Bill sells 60% to ESOP with no control premium.

Bill appoints himself as the BOD and ESOP fiduciary.

Bill votes his own remaining 40%.

As the plan committee and trustee, Bill also votes the 60%.

Hence, Bill still votes 100%.
Independent Fiduciaries

- At times it may be advisable for the Plan Committee to hire an Independent Fiduciary to oversee a particular transaction involving the ESOP.
- Events to consider an Independent Fiduciary include:
  - 100% sale to an ESOP
  - A sale to a third party Stock sales with proceeds greater than $2 million
  - Transactions that include other aspects beside a sale of stock, e.g., a new MSBP, seller note with high interest rate or long maturity.
Shareholders Give Up Control – Pricing Premium Received

If the seller wishes to receive a control premium price for the shares sold to the ESOP, the seller must relinquish control of the company (not control the Board or trust).

Option for sales where ESOP now owns >50% at BOD option

Outside Shareholder(s)

Board of Directors

Management

Employees

ESOP Fiduciaries

ESOP Trust

ESOP Participants
Shareholders Give Up Control

- Mary initially owns 100%.
- Mary sells 60% to ESOP with control premium.
- Mary adds others as BOD and is not ESOP fiduciary.
- Mary votes her remaining 40%.
- Plan committee votes the 60%.
ESOP Lenders

- ESOP lending is a mature market and has been around for 30+ years
- Most major financial institutions welcome the idea lending to ESOP owned companies.
- Why?
  - ESOP companies tend to more stable
  - Cash flow is better - tax deduction for interest AND PRINCIPAL on the loan value, and S Corp ESOPs can use pro rata distributions for loan repayments.
Leveraged ESOP – Seller Financing

- Avoids restrictions of bank financing.
- Avoids bank financing commitment fees
- Selling shareholder receives interest payments.
- Seller gets installment capital gain tax treatment.
- Mezzanine interest rates & warrants possibly available.
- Default protection.
Employee Benefit - The Five Steps

1. Company contributions/dividends
2. Eligibility / Participation
3. Allocations
4. Vesting
5. Distributions
### RequiredDisclosure to Participants

<table>
<thead>
<tr>
<th></th>
<th>YES</th>
<th>NO</th>
</tr>
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<tbody>
<tr>
<td>Individual’s balance/vested amount</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Per share value of stock</td>
<td>✓</td>
<td></td>
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<tr>
<td>ESOP Summary Plan Description</td>
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<tr>
<td>Company financial statements</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Officer salaries</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Company valuation</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>
Do ESOPs Really Increase Employee Productivity?

- Yes!
- Numerous studies conducted over the last 30 years have all concluded that ESOPs increase company performance.
- The results are consistent and statistically significant.
What is Productivity?

- Increase upside.
- Protect downside (fix quicker what has been broken).
- Happier workforce (includes trust, respect, fairness, pride, camaraderie).
Increase Revenues 2% and Decrease Expenses 2%

<table>
<thead>
<tr>
<th>Item</th>
<th>Before ESOP</th>
<th>After ESOP</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$10,000,000</td>
<td>$10,200,000</td>
<td>2%</td>
</tr>
<tr>
<td>Expenses</td>
<td>$9,600,000</td>
<td>$9,400,000</td>
<td>-2%</td>
</tr>
<tr>
<td>Profits</td>
<td>$400,000</td>
<td>$800,000</td>
<td>100%</td>
</tr>
</tbody>
</table>
Employee Incentive

Employees in ESOP companies have on average 4x the retirement assets as employees in comparable non ESOP companies!
Typical ESOP Steps

Step 1: Preliminary appraisal / feasibility study

Step 2: Design and adopt your ESOP by FYE.

Step 3: Make annual contribution before you file your taxes (including extensions).

Step 4: Selling shares to your ESOP may take place at any time, but within a few years after the adoption of your ESOP.
Menke’s ESOP Process

- Owner/advisor completes questionnaire.
- Menke reviews questionnaire for initial ESOP feasibility or red flags.
- Educate owners.
- Menke proposes alternative ESOP structures.
- Company engages Menke.
- Valuation, if required.
- Solicit financing, if required.
- Documentation & close transaction.
Typical ESOP Installation Timing

Prefunded or Pay-as-you-go ESOP

Month 1: Design

Month 2: Documentation

Year 2+: Admin

Menke Investment Banking

Menke Legal

Menke Administration

Appraiser (pay-as-you-go only)
Typical ESOP Installation Timing

- **Month 1**: Design
- **Month 2**: Valuation
- **Month 1-3**: Financing
- **Month 4**: Documentation
- **Year 2+**: Admin
- **Year 2+**: Valuation

**Leveraged ESOP**

- Menke Investment Banking
- Menke Legal
- Menke Administration
- Appraiser
Combination Sale/ESOP Strategy

- Receive ESOP Valuation.
- Test the strategic buyer market:
  - Create small marketing document.
  - Approach logical strategic buyers only.
  - Communicate minimum purchase price.
  - 2 month process vs. 6-9 month full sale process.
- If strategic buyer(s) respond, conduct negotiated sale.
- If strategic buyers do not respond – execute ESOP.
- ESOP does NOT prevent sale at a later date.
Menke & Associates
One-Stop Shop & Full Accountability

Design
- Education
- Plan Structure (financially & legally)
- Financing
- ESOP Appraisal

Installation
- Drafting of Plan
- BOD Resolutions
- IRS Approval
- Employee Communication

Annually
- Recordkeeping (online)
- Re-Appraisal
- Plan Upkeep (legal)
- Financial, Legal, and M&A Consulting
Our other ESOP webinars:

ESOPs 201:
How to sell Company Stock to an ESOP & Resulting Tax Advantages
Our other ESOP webinars:
ESOPs 202:
Designing an Effective Employee Incentive to Increase Productivity
Our other ESOP webinars:

ESOPs 301: Advanced Strategies for ESOP owned companies’ managers and advisors
Questions & Answers
To Determine if an ESOP is feasible for your company or your client’s company, please call or email us.

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