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Shared Success

Why Employee Stock Ownership Plans Create Happy Owners, Workers, and Bottom Line Impact

An employee stock ownership plan (ESOP) can provide significant benefits to shareholders, management and employees of a privately-owned business. An ESOP:

- Can be an excellent financial alternative for business owners rather than selling their business to a third-party, such as a private equity group.
- Offer certain tax benefits while providing business owners liquidity, diversification and enhanced retirement benefits.
- Can facilitate the financing of corporate transactions and provide employees with an ownership interest in their employer and a valuable retirement benefit.

There are currently more than 10,000 ESOPs in the United States. These plans give employees a direct stake in their company's financial success and, when properly implemented, can have tremendous benefits for business owners, employees and the company. ESOPs can be used to foster employee engagement, as a means of liquidity, as a succession planning strategy and more.

The government provides significant tax incentives for businesses to create ESOPs, and most studies show that these plans outpace 401(k)'s as a source of retirement income for participants and outperform the S&P 500 in year-over-year investment returns. Given those factors, it's no surprise that the total number of ESOPs and the employees they cover has grown over the last decade. Yet, despite this recent upward trend, the number of ESOPs in the U.S. is still far below what it should be according to most experts.

There are a number of reasons for the slow growth of ESOPs but most industry pundits point to a reputation hangover from misuse of the plans by bad companies and a lack of understanding of the complex workings of ESOPs as the most likely barriers to adoption. To shed some light on these underutilized business tools, we have outlined the potential benefits of ESOPs, provided insights on when businesses should consider these vehicles and detailed the process for creating a successful plan.

The Benefits of ESOPs

- **Wealth Creation:** The tax benefits can offer significant wealth creation for shareholders, management and employees.
- **Employee Engagement:** Providing employees with a direct stake in the company's success, ESOPs increase employee engagement and performance.
- **Liquidity:** As an alternative to a traditional acquisition or private equity funding, ESOPs create liquidity for shareholders by selling the business or parts of it to employees at competitive valuation – and in some cases at significant tax savings to the sellers. These transactions can be financed by outsiders or by sellers, creating multiple means of liquidity.
- **Income/Asset Protection:** Qualified as a retirement plan, ESOPs are protected assets under ERISA, meaning that as cash is distributed from the business to the ESOP, such cash distributions are safeguarded in the event of bankruptcy.
- **Ownership Diversification:** Unlike private equity transactions, ESOPs create an opportunity to diversify the ownership of closely-held businesses without giving up operational control.
- **Stability:** As a means of succession planning, ESOPs provide corporate stability through major leadership transitions.

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In this article, we will take a closer look at the optimum makeup of an ESOP-ready company and best practices for introducing an ESOP as a business-enhancing instrument.

When to Consider an ESOP

An ESOP can be created at any time in the lifecycle of a business. Whether it is a newly-formed private equity venture, a manufacturing business, an engineering firm or a mature family-run enterprise, ESOP integration is not conditioned by a business' age. Instead, the relevant characteristics of a business that may be ready to consider an ESOP in its retirement portfolio include:

- Desire for ownership diversification and wealth creation
- A growing, profitable business – a financially-healthy business is best suited to implement an ESOP
- An ownership group that is not reluctant to allow additional stakeholders, their employees, to share in the company's equity

As with every company, its corporate makeup and financial situation is distinct. Individual business valuations are critical in determining whether or not the inclusion of an ESOP is the right step for a given business. An ESOP cannot save a highly indebted business or one with a poor business model, but it can be a powerful tool for a company that exhibits the qualities above.

How to Create an ESOP

Best practices for ESOP implementation include:

- **Perform a Preliminary Feasibility Study:** The first step in creating an ESOP is to hire an advisor to perform a feasibility study. This step will help determine whether the company's financial profile and demographics match an ESOP's needs (business earnings, debt capacity, consistent and long-term workforce, supportive leadership). More importantly, the goal of this step is to discuss a business value that shareholders would entertain. If the answer is no, the process ends here.
- **Hire a Legal Advisor:** The legal advisor will advise the company on the ESOP legal rules and steps required to execute an ESOP.
- **Select a Trustee:** The trustee of an ESOP is generally an independent fiduciary who would represent the ESOP participants. This generally avoids a conflict of interest with management or current business owners. In the capacity of trustee, this individual is generally responsible for hiring the ESOP's valuation firm and the ESOP's own legal advisor.
- **Set-Up Plan Parameters:** In this step the trustee and the seller negotiate the final valuation and the plan design. The key is to not have an excessive valuation that puts too much debt/strain on the business and its ability to succeed moving forward.
- **Plan Implementation:** This covers the execution of the ESOP, employee communications, IRS plan approval, corporate governance, executive compensation and ongoing administration of the plan.

PKF O'Connor Davies' Employee Benefits Practice can assist companies and business owners with ESOP transactions, including the financial, plan design, feasibility analysis, succession planning, tax, accounting, employee benefit transformation services and executive compensation analysis.

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