

# ESOP 101

## WHAT, WHY & HOW

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**Mark R. Kossow** focuses his practice on employee stock ownership plans (ESOPs) and is a member at Clark Hill PLC.

His practice is focused on implementing ESOP transactions and their compliance with IRS and Department of Labor requirements. Mark's strong tax background helps corporations, fiduciaries and selling shareholders maximize the tax advantages of their ESOP transactions.

He frequently speaks on topics relating to ESOPs, ERISA and tax matters at meetings of The ESOP Association and other organizations concerned with exit planning and succession planning.

Mark is listed in Best Lawyers in America (Tax Law), and is an active member of The ESOP Association and the National Center for Employee Ownership (NCEO).

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**Paul R. Simons** is Senior Counsel in Clark Hill's Banking & Finance Practice Group. With an understanding of the complexity and variety of legal issues faced by business owners today, Paul's multidisciplinary approach allows him to sensibly and effectively navigate a wide range of business transactions. He stresses sensible solutions to business legal issues to minimize risk yet accomplish business objectives.

Paul's clients operate in the traditional middle market, and he provides sensible advice in the areas of commercial finance, mergers and acquisitions, employee benefits and related taxation matters.

Paul represents banks, mezzanine lenders, private equity firms, borrowers and other lenders in commercial financing transactions, including commercial and industrial credit facilities, mezzanine credit facilities, ESOP loan transactions and asset-based financings. He adds value and efficiency to any transaction with a sensible and organized approach.

Paul represents business owners, privately held companies and fiduciaries with transactions involving employee stock ownership plans (ESOPs). He also represents such clients in other acquisition and disposition transactions, including mergers, asset and stock acquisitions and dispositions, and leveraged buyouts across a broad spectrum of industries, including manufacturing, distribution, defense and service industries.

Paul is a graduate of Iowa State University (with distinction) and the University of Iowa College of Law (with distinction).



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**Jennifer Krieger** has nearly a decade of combined experience in public accounting and restaurant hospitality financial analysis and reporting.

Her professional experience includes performing valuations of business entities for Employee Stock Ownership Plans (ESOP), financial reporting compliance, tax compliance, mergers and acquisitions including fairness opinions, dissolution purposes and other litigation matters. Jennifer concentrates on ESOP valuation analyses for trustees and sell-side consulting along with assurance opinions for both annual ESOP stock valuations and ESOP fairness opinions. She serves a variety of industries including food and beverage, industrials, renewable energy, oil and gas, cannabis, healthcare, manufacturing, distribution and retail. Jennifer has also served in BDO Consulting's Valuation & Business Analytics practice and UHY Advisors FLVS's Business Valuation group.

She has over two years of financial analysis and reporting experience in the restaurant hospitality industry with a focus on weekly reporting, marketing analysis and ad hoc analysis including projects related to the acquisition of a national restaurant chain and initial public offering.

Jennifer is a member of the National Association of Certified Valuators and Analysts (NACVA), National Employee Ownership Center (NCEO), ESOP Association, Association for Corporate Growth (ACG), and the Secured Finance Network (SFN, formerly Commercial Finance Association). She has presented "Adventures in Valuation" at the University of St. Thomas's Cameron School of Business Symposium in November 2016 and participated in the ESOP Podcast on episode 89, mini-cast 56, mini-cast 53, and mini-cast 52.

# Exit Planning Options

# DETERMINING GOALS & OBJECTIVES



## Reason for Sale

- Retirement / diversification
- Attractive M&A marketplace
- Industry forces
- Shareholder timing
- Lack of succession



## Your Requirements

- Value expectations
- Tax planning
- Continued employment
- Continued ownership
- Size of transaction



## Potential Deal Killers

- Minimum value
- Buyer fit
- Company legacy
- Employee welfare
- Intentions of acquirer

**When selling a business, there are a number of factors, both economic and non-economic, that can impact the seller's decision.**

# OWNERSHIP TRANSITION PATHS

These paths move ownership in very different ways; however, each has its pros and cons

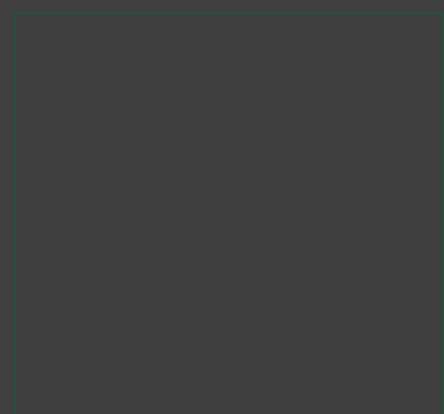


Strategic buyers  
Financial buyers (i.e. private equity)  
Whole or partial sale

## Internal Sale



Employee stock ownership plan (ESOP)  
Management buyout (MBO)  
Leveraged recapitalization  
Family Transfer



# OWNERSHIP TRANSITION PATHS

## Sale Option Pros and Cons

### Strategic Buyers

- ✔ Potential to maximize value
- ✔ Potential to maximize liquidity at close
- ✔ Potential opportunities for management
- ✔ Strong understanding of the business
- ✘ Consolidation motive may eliminate jobs
- ✘ Potential loss of legacy

### Private Equity

- ✔ Potential to maximize value legacy protection
- ✔ Infusion of talent / expertise
- ✔ Opportunity for second liquidity event
- ✔ Possible management equity participation
- ✔ Owner may continue running the company
- ✘ Lack of in-depth business knowledge
- ✘ New owner / operator partner (partial sale)
- ✘ Investment rollover may be required

### ESOP

- ✔ Tax – advantaged buyout
- ✔ Partial / total transaction
- ✔ Controllable transaction / structural flexibility
- ✔ Ability to continue to manage business
- ✔ Maintain legacy / employee-owned culture
- ✘ No strategic pricing
- ✘ Partial liquidity at close
- ✘ Administrative costs / regulatory oversight
- ✘ Non-productive debt

# WHAT IS AN ESOP?

# WHAT IS AN ESOP?

## “Employee Stock Ownership Plan”

- Retirement Plan - Qualified Defined Contribution Plan
  - Internal Revenue Code/ERISA
    - Tax-deductible contributions for employer
    - Tax-deferred growth for employees
    - Designed to invest primarily in employer stock
    - Permitted to borrow
    - Trustee
- Corporate Finance Tool
  - Tax-advantaged financing for the company
  - Deductible dividends (in some cases)
  - S Corporation ESOPs (1998) – generally income exempt

# WHAT IS AN ESOP?

## A Brief History

- The Employee Retirement Income Security Act (ERISA) of 1974 created a formal legal status for ESOPs
- There are about 7,000 ESOPs in the U.S., covering about 11 million employees (10% of private sector workforce)
- 5,000 ESOP companies are majority-owned by the ESOP and approximately 4,000 are 100% owned
- About 330 ESOPs, or 5%, are in publicly-traded companies
- At least 75% of ESOP companies are, or were, leveraged

# WHAT IS AN ESOP?

## **Creates Market to Sell Shares by:**

- Selling all or part of shares
- Combining with management buyout
- Spreading sale of shares over many years
- Allowing diversification for seller
- Retaining many control elements for seller/management
- Deferring income tax potentially forever
- Continuation of company as a going concern

# 1<sup>st</sup> Polling Question

What does ESOP stand for?

- a) Employer Stock Option Plan
- b) Employee Stock Ownership Plan
- c) Everyone Share Option Program
- d) Every Stock Ownership Program



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# BENEFITS TO COMPANIES

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## Benefits to Companies

- Contributions are deductible
  - Net effect is that the bank debt is paid with pre-tax dollars (subject to 25% of covered compensation limitation)
- Increased productivity/participation by participants
  - Studies show ESOP companies have superior sales, employment and sales/employee relationships vs. non-ESOP companies with similar size/industries<sup>1</sup>
- Potentially avoid taxes 100% – S Corporation ESOP

<sup>1</sup> Source: ESOP Association, August 2019

# BENEFITS TO PARTICIPANTS

# BENEFITS TO ESOP PARTICIPANTS

## Retirement Benefit

- Allocation of ESOP assets, usually in proportion of salary/wages to covered payroll
- Usually 100% employer-funded
- Retirement benefit grows on a tax-deferred basis

## Advantages of equity ownership

- Tangible benefits (dividends and appreciation)
- Intangible benefits (pride of ownership)

# TAX BENEFITS & SAVINGS: C CORPORATIONS

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## Tax Benefit to Selling Shareholders

- Tax deferral; Section 1042
  - C Corporation
  - Qualified employer securities
  - 30% sale/ownership by ESOP
  - 3-year holding period (tacking)
  - Stock owned is not a result of stock options or other employee benefit plan
  - Restrictions on allocations to seller, children, brother/sister, spouse or parents; or >25% shareholder
  - Purchase Qualified Replacement Property (QRP) within 15 month period
    - Stocks, bonds, debentures, or notes issued by domestic operating corporation

# TAX BENEFITS & SAVINGS: C CORPORATIONS

## Tax Savings Comparison

### ESOP Tax Savings of Sale to an ESOP

	Taxable Sale	ESOP Sale
Sale Price	\$30,000,000	\$30,000,000
Basis	5,000,000	5,000,000
Appreciation	\$25,000,000	\$25,000,000
TAX @25% <sup>1</sup>	\$6,250,000	\$0
Net Proceeds	\$23,750,000	\$30,000,000

<sup>1</sup> Approximate State and Federal Capital Gains Tax and Net Investment Income Tax

# TAX BENEFITS & SAVINGS: S CORPORATIONS

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- Corporate Income Tax Exclusion
- A 100% ESOP-owned S Corporation has significant tax saving opportunities
  - If the corporation makes an S election, there will be no federal tax on its annual income (most states mirror this provision)
  - Although income will be passed through to the shareholder (the ESOP), no shareholder level tax will be imposed because the ESOP is a tax-exempt entity
    - The income tax liability will effectively be deferred until the participants in the ESOP receive their benefits

# TAX BENEFITS & SAVINGS: S CORPORATIONS

- ESOP owns less than 100%
  - Tax exclusion in proportion to ESOP ownership
  - ESOP entitled to its share of S distributions paid if corporation makes distributions to non-ESOP shareholders to cover payment of taxes on the passed-through corporate income
  - Example
    - ESOP owns 30% of company
    - Annual taxable income was \$1 million
    - Non-ESOP shareholder income allocation = \$700,000; corporation distributes \$245,000 (35%) to cover federal tax liability
    - Corporation also required to distribute \$105,000 to the ESOP (\$350,000 total)
    - Cash in ESOP can be used for ESOP debt service, repurchase obligations, or to purchase additional shares
- If cash from S distributions builds up in ESOP, it may not be available to company for investment or expansion

## S CORPORATION ESOPS

### ESOP C Corporation vs. ESOP S Corporation

	<b>C Corporation</b>	<b>S Corporation</b>
Pre-Tax Earnings	\$1,000,000	\$1,000,000
Income Tax (21%)	\$210,000	\$0
Net Income	\$790,000	\$1,000,000
Dividend to cover S/H Tax	\$0	\$350,000
Net to Equity	\$790,000	\$650,000

# 2<sup>nd</sup> Polling Question

What are the potential benefits of an employee stock ownership plan?

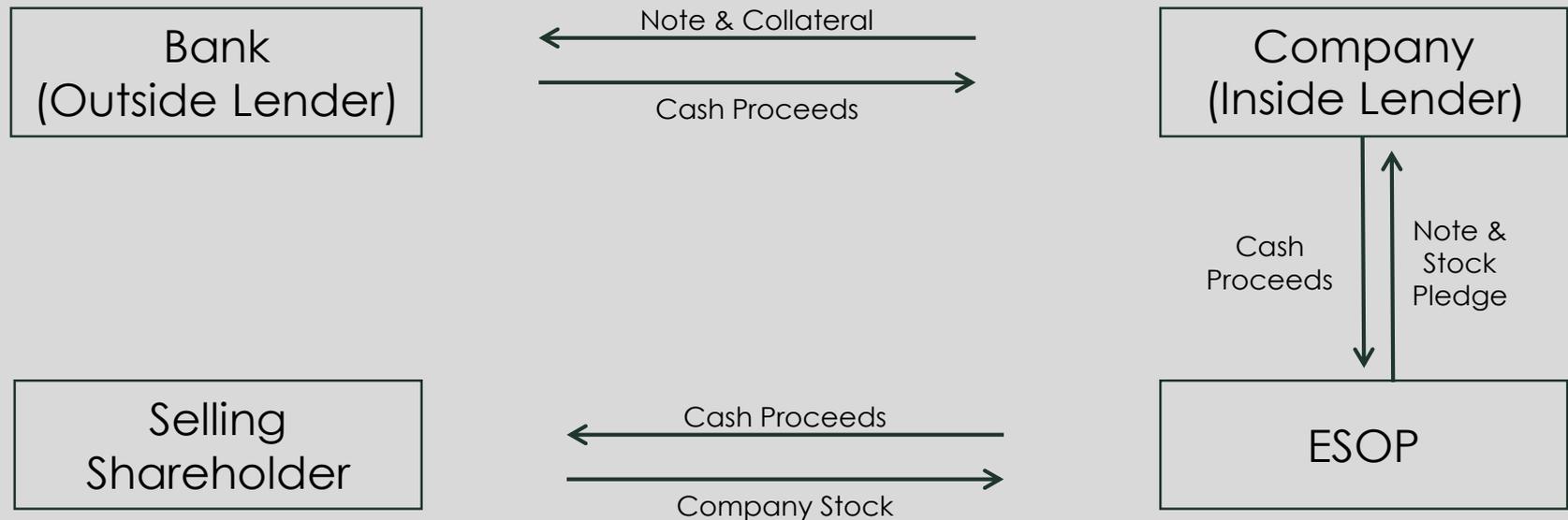
- a) Transaction tax incentives for selling shareholder(s)
- b) Increased employee productivity and retention
- c) Tax deductible ESOP contributions
- d) All of the above

## WAYS TO FUND ESOP

- Company funds ESOP with cash contributions over period of several years
- Company borrows funds from lender and then makes secondary loan to ESOP (“Leveraged ESOP”)

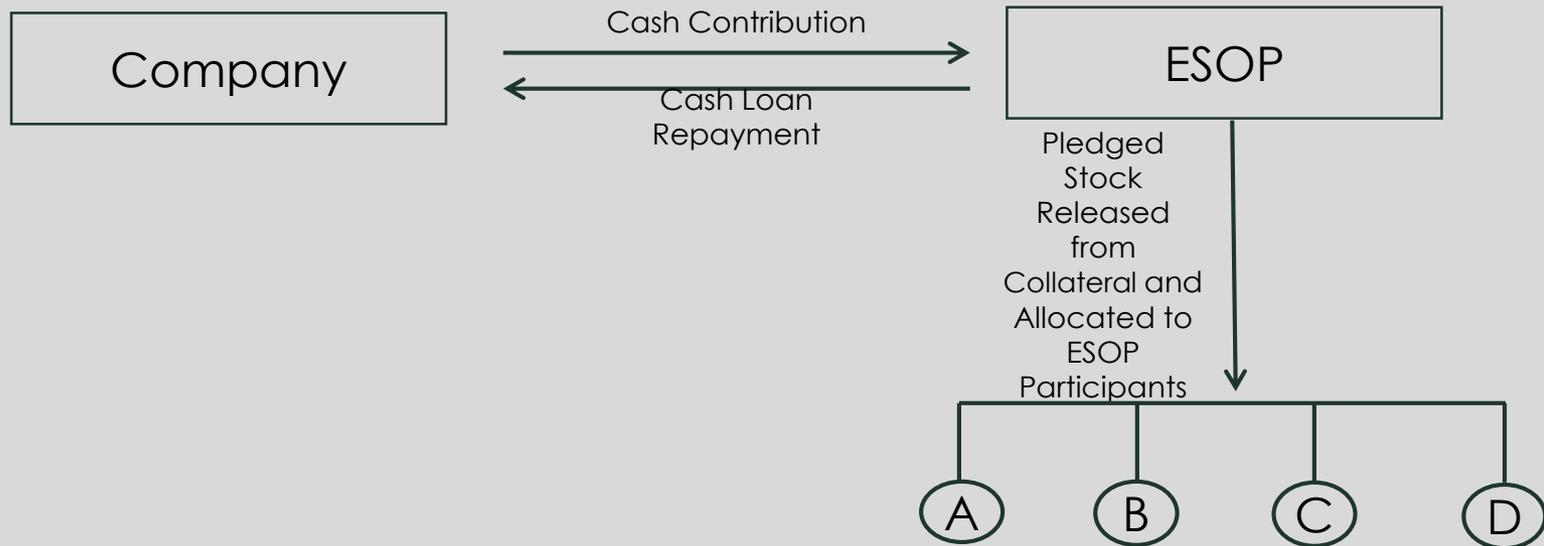
# WHAT IS A LEVERAGED ESOP TRANSACTION?

## Stage One: Loan and Stock Acquisition



# WHAT IS A LEVERAGED ESOP TRANSACTION?

## Stage Two: Repaying the Loan



# FEASIBILITY, VALUATION & FINANCING

# VALUATION & FEASIBILITY



## Who performs it?

Seller Advisor  
Trustee Financial  
Advisor



## Who is involved?

Trustee Financial  
Advisor  
Senior  
Management



## When is it done?

Value should be  
established before  
transaction process  
begins



## How long?

45 to 60 days to  
complete

**A sell-side valuation and feasibility study is performed to gauge the likelihood of a transaction taking place.**

# STOCK VALUATION

## Investors expect profit

- Looking at historical profits can be a useful indication, but change happens
- Investors are buying the future, not the past
- Risk of achieving profit expectations should be considered

## The outside world has an impact too

- Market perceptions
- Macroeconomic factors
- Industry factors
- M&A / financing markets



Liquidation Value



Guideline Public Comparables



Discounted Cash Flow



M&A Transactions

## VALUATION & FINANCING

- ESOP cannot pay more than “Adequate Consideration” for the shares = fair market value based on independent appraisal
  - This may be lower than the nominal value received in external transfer, but may be greater on an after-tax basis
- However -
  - Depending on structure, the owner can retain some elements of control
  - Owner keeps job, salary and reasonable perks (part of negotiation)
  - Owner can participate in future value of business
  - Properly installed, the ESOP can increase productivity of company and thus, the value of the retained shares (if any)

# 3<sup>rd</sup> Polling Question

An ESOP may not purchase stock from selling shareholder(s) at a purchase price in excess of fair market value.

- a) True
- b) False

# ESOP TRANSACTION FINANCING

## The least expensive form of debt

Level of financing will depend on company cash flow, borrowing base and liquidity requirements of the seller

## Seller financing can be flexible

Seller has the ability to finance entire transaction. Seller financing returns may be difficult to replicate in the public markets

Senior Bank Debt

Subordinated or Mezzanine Debt

Seller Financing

Cash or 401(k) Rollover

## This debt can be costly

If the seller's goal is to maximize liquidity at close, a form of subordinated / mezzanine debt will be required

## Unique funding mechanisms

Employees may have an option to rollover a portion of their 401(k) to fund the ESOP purchase

# STOCK VALUATION & FINANCING

## ESOP Financing Alternatives

- Bank financing
  - Asset based lenders
  - Cash flow lenders
- Seller note
- Mezzanine lenders
- ESOP cash pre-funded
- Other plan assets rollover

## Additional Considerations for ESOP Transactions

- ESOP transaction is a highly leveraged transaction
- Unlike debt financing for operations, the proceeds of the loan “leave the company”
- Enhanced cash flow available for debt service from ESOP tax benefits

# FIDUCIARY ISSUES

## FIDUCIARY ISSUES

- ESOPs fraught with fiduciary duty, conflict of interest and potential self-dealing issues
  - Valuation of stock
  - Sale of shares to ESOP
  - Trustee decisions made by owner or executive of Company
  - Litigation

## **FIDUCIARY ISSUES**

- Advantages of independent third party Trustee
  - Independent
  - Avoid conflict of interest and self-dealing issues
  - Experience, competence

# LENDER ISSUES

## LENDER ISSUES

- Personal guarantees
- Pledge of Company assets
- Restrictions in loan documents
  - Compensation
  - Bonuses and executive compensation
  - Out of the ordinary equipment or other expenditures
  - Violations can accelerate loan
  - Prior lender approval



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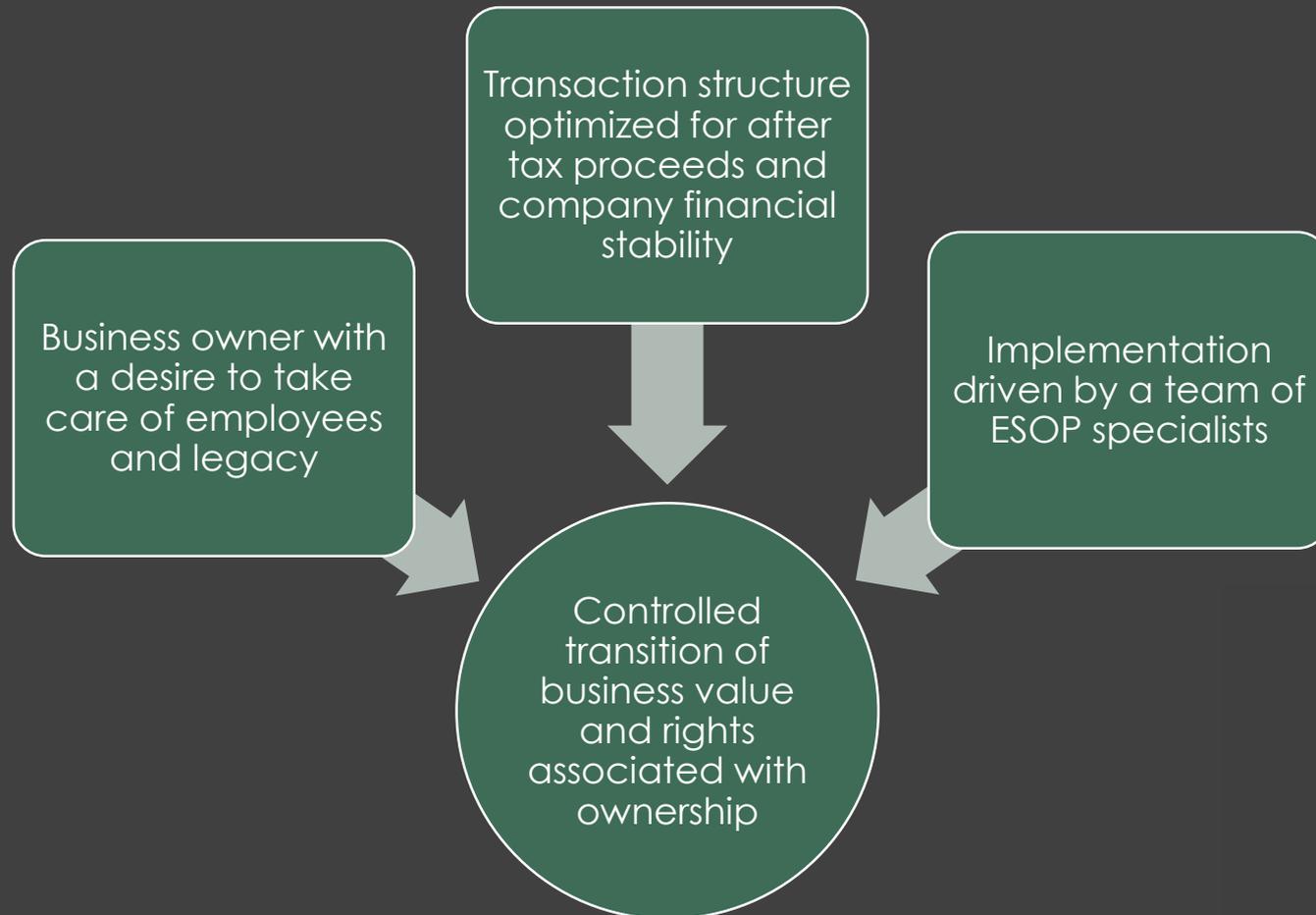
# OTHER ITEMS

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## Common ESOP Fables

- Employees will run the company - False
- Employees will access financial/confidential information - False
- Seller can not receive fair market value - False
- Seller must guarantee the ESOP loan considerations - False
- Because the business owner controls the transaction, timing is not important – False
- An ESOP requires the sale of 100% of the company - False

# WHAT MAKES AN ESOP SUCCESSFUL?





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