

# **ESOPs 101: A Detailed Introduction of Employee Stock Ownership Plans**



**MENKE & ASSOCIATES, INC.**

**ESOP ADVISORS AND INVESTMENT BANKERS**

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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.



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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 3<sup>rd</sup> 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.

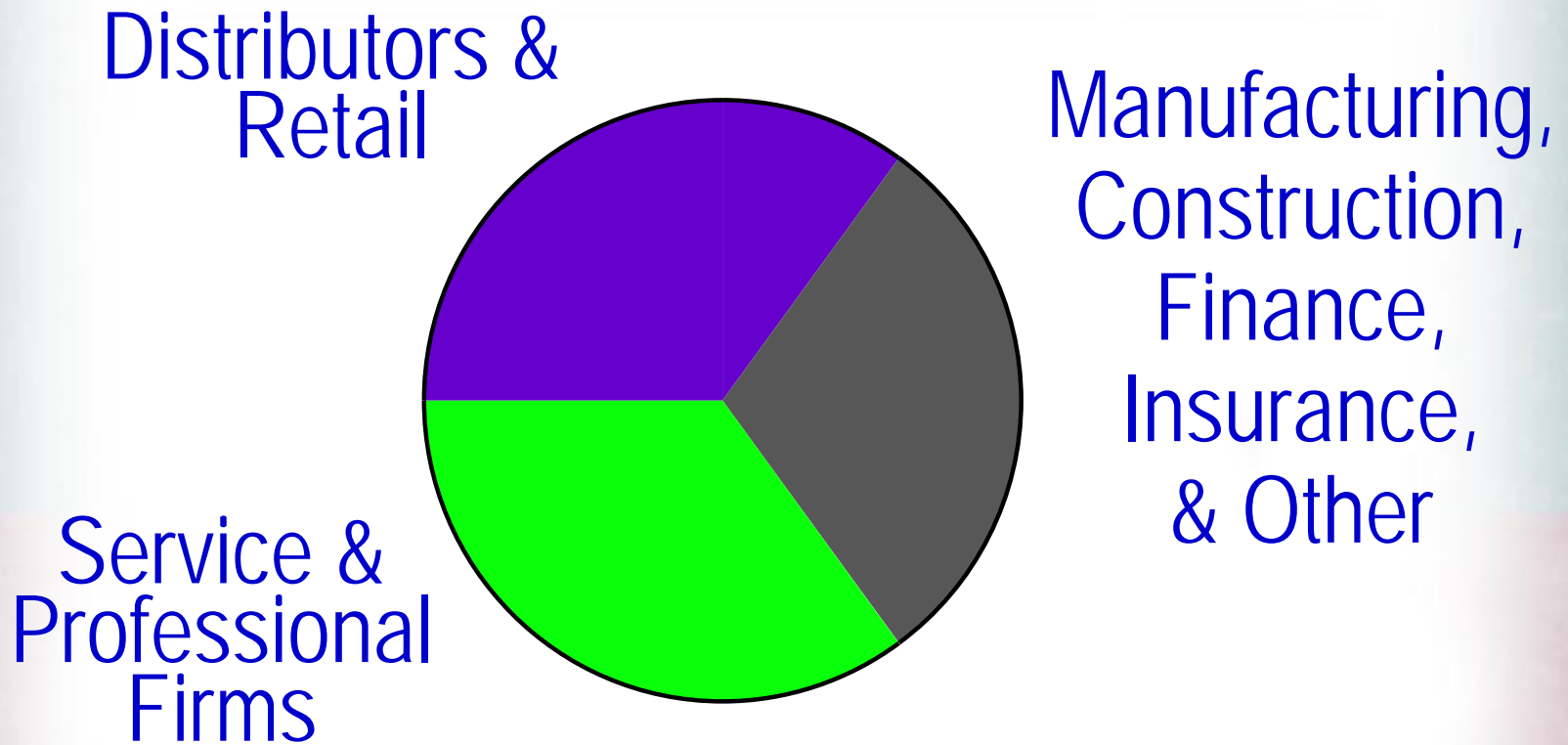


# Why are ESOPs popular?

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



# ESOP stock ownership of private companies

## No requirement to sell a certain percent

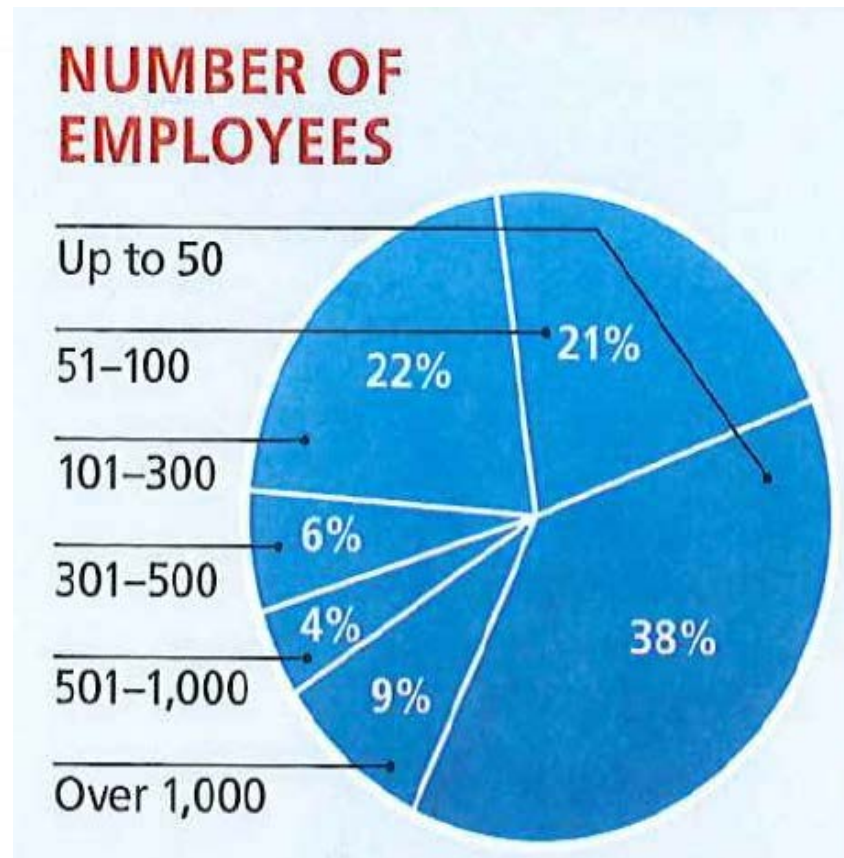
	Percent of each private company owned by its ESOP			
	0-10%	11-30%	31-50%	51-100%
Percent of private ESOP companies	20%	20%	25%	35%

# 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

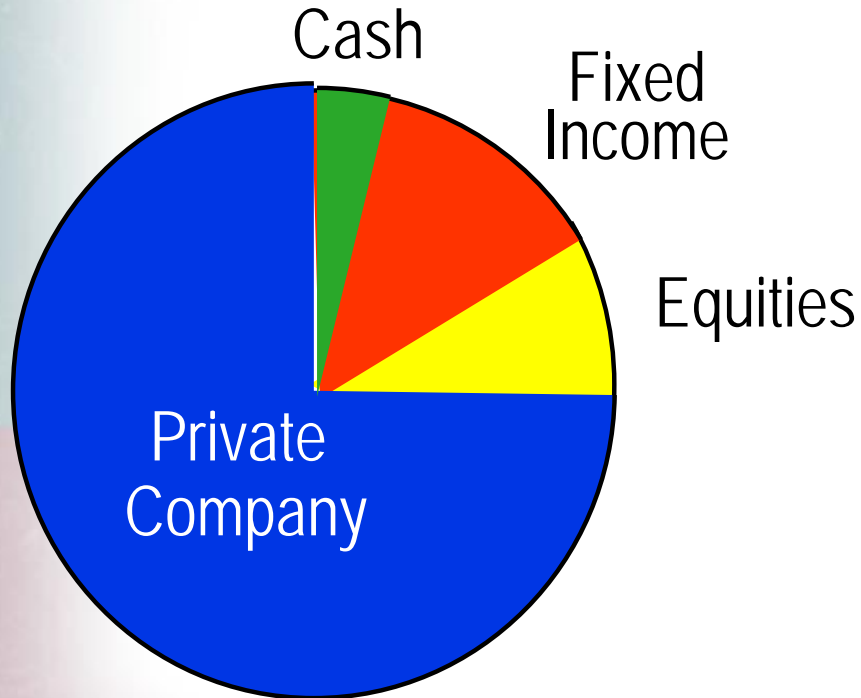
1. Liquidity for shareholders
2. Diversify owner's asset allocation
3. Real business succession strategy
4. Increase company cash flow
5. Enhance employee productivity

# 1. Liquidity for shareholders (while still running their business!)

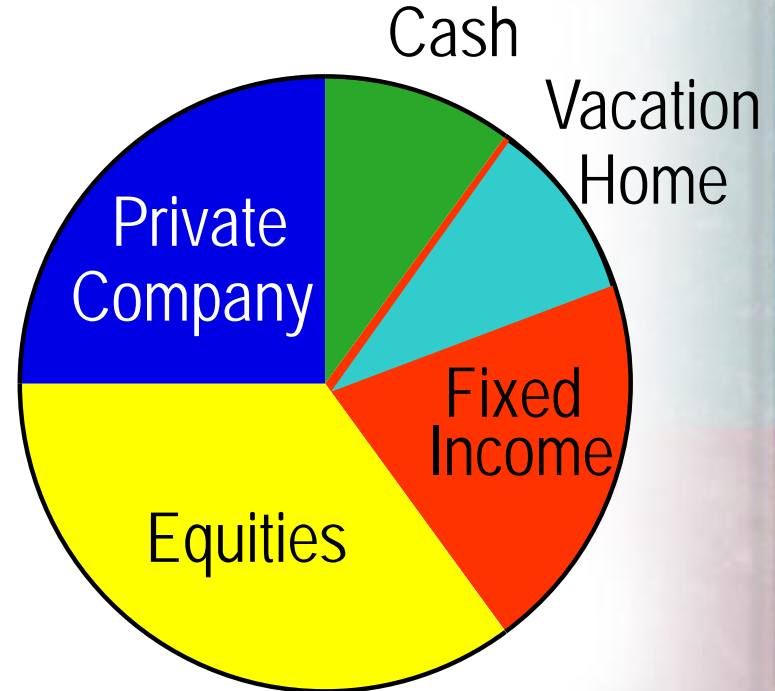
- ▶ Many times significant portion of owner's wealth tied up in company stock.
- ▶ Owners can sell all or part of their shares.
- ▶ Can spread sale of shares over years.
- ▶ Can keep some shares, even after retirement.
- ▶ Many times selling the entire company to a third party is not possible, but this 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





# What is your exit strategy?

Share ownership?

Board of Directors?

President?

Officers?

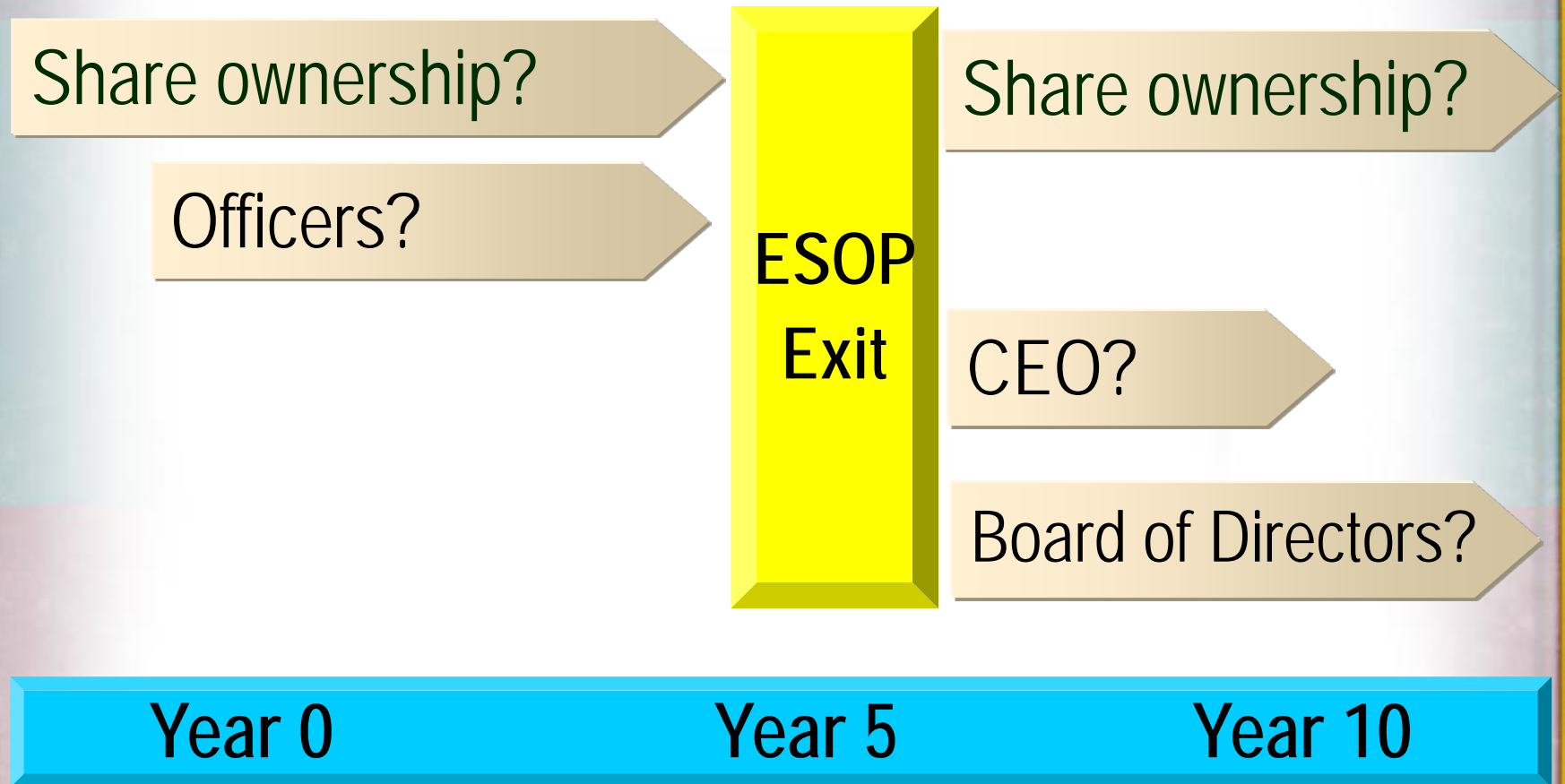
**Sale  
Exit**

**Year 0**

**Year 5**

**Year 10**

# What is your exit strategy?



### 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

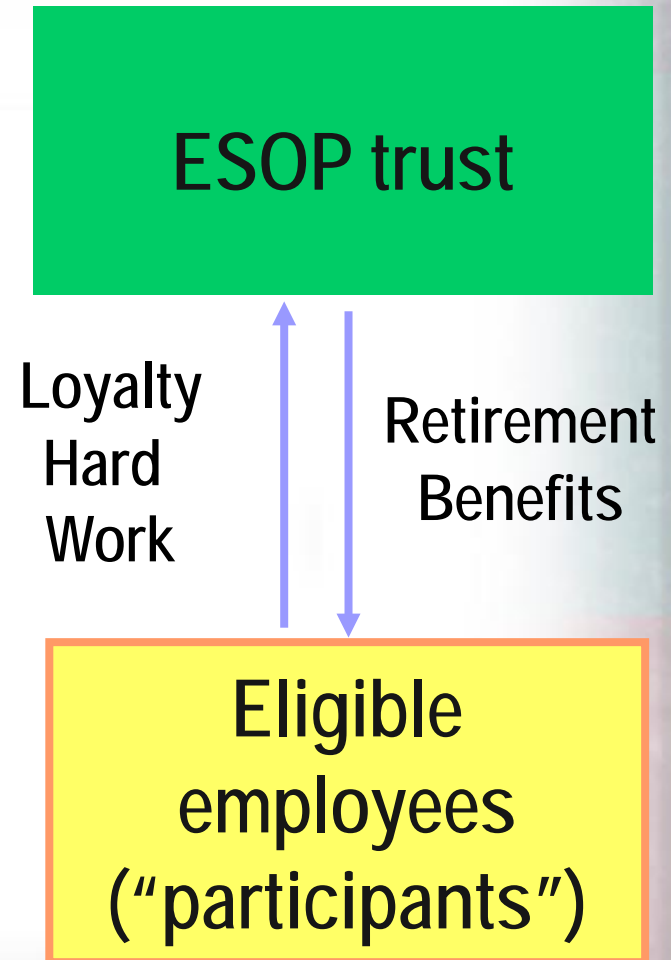
# Existing ESOP Misconceptions

- ▶ Must borrow money.
- ▶ Must sell 30% or more.
- ▶ Must sell stock immediately.
- ▶ Will be at lower price than selling to 3<sup>rd</sup> 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



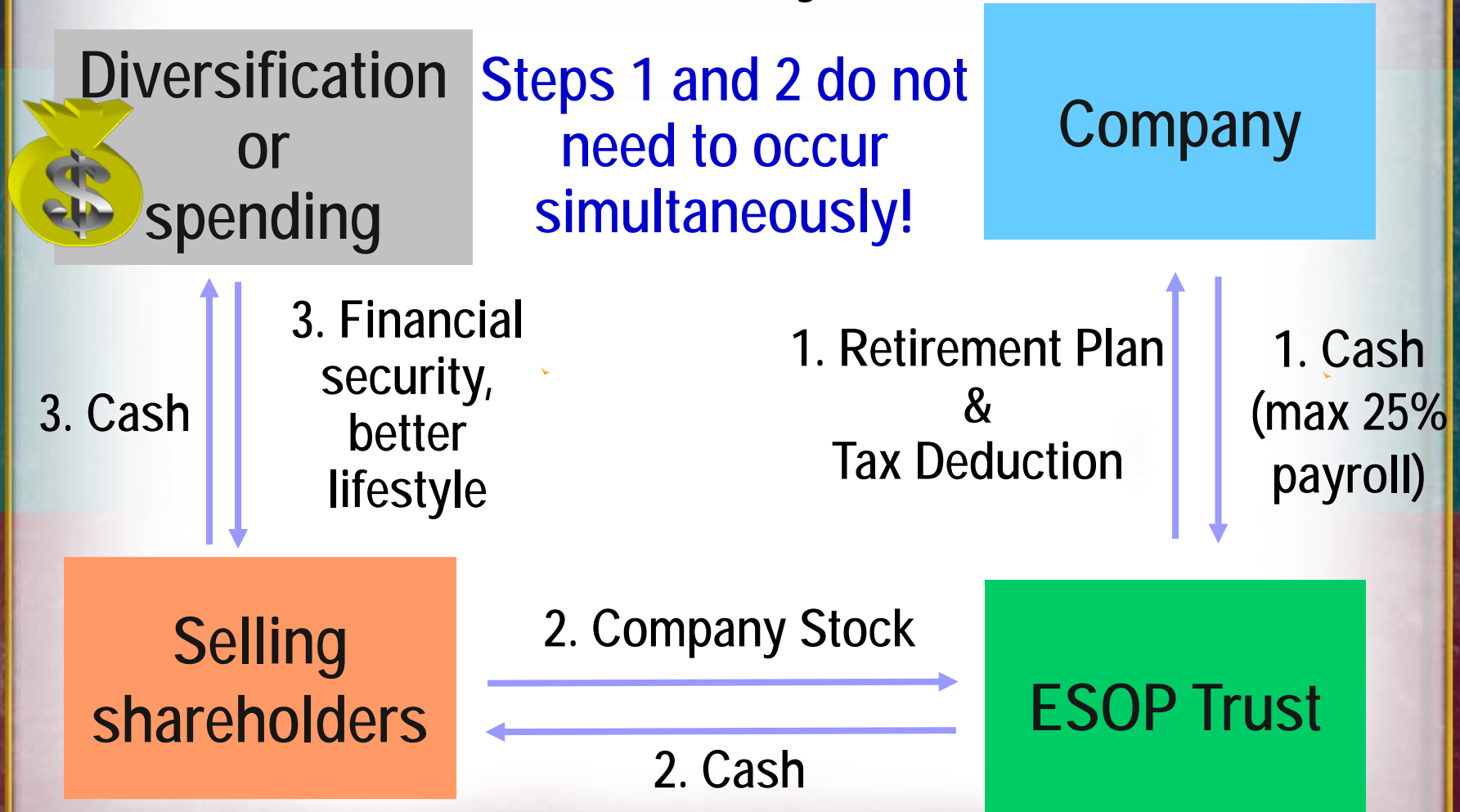
# Four Basic ESOP Transactions

1. Contribute cash – buy stock from shareholder.
2. Borrow cash – buy stock from shareholder.
3. Contribute stock directly to ESOP.
4. Use cash in ESOP to buy treasury shares.

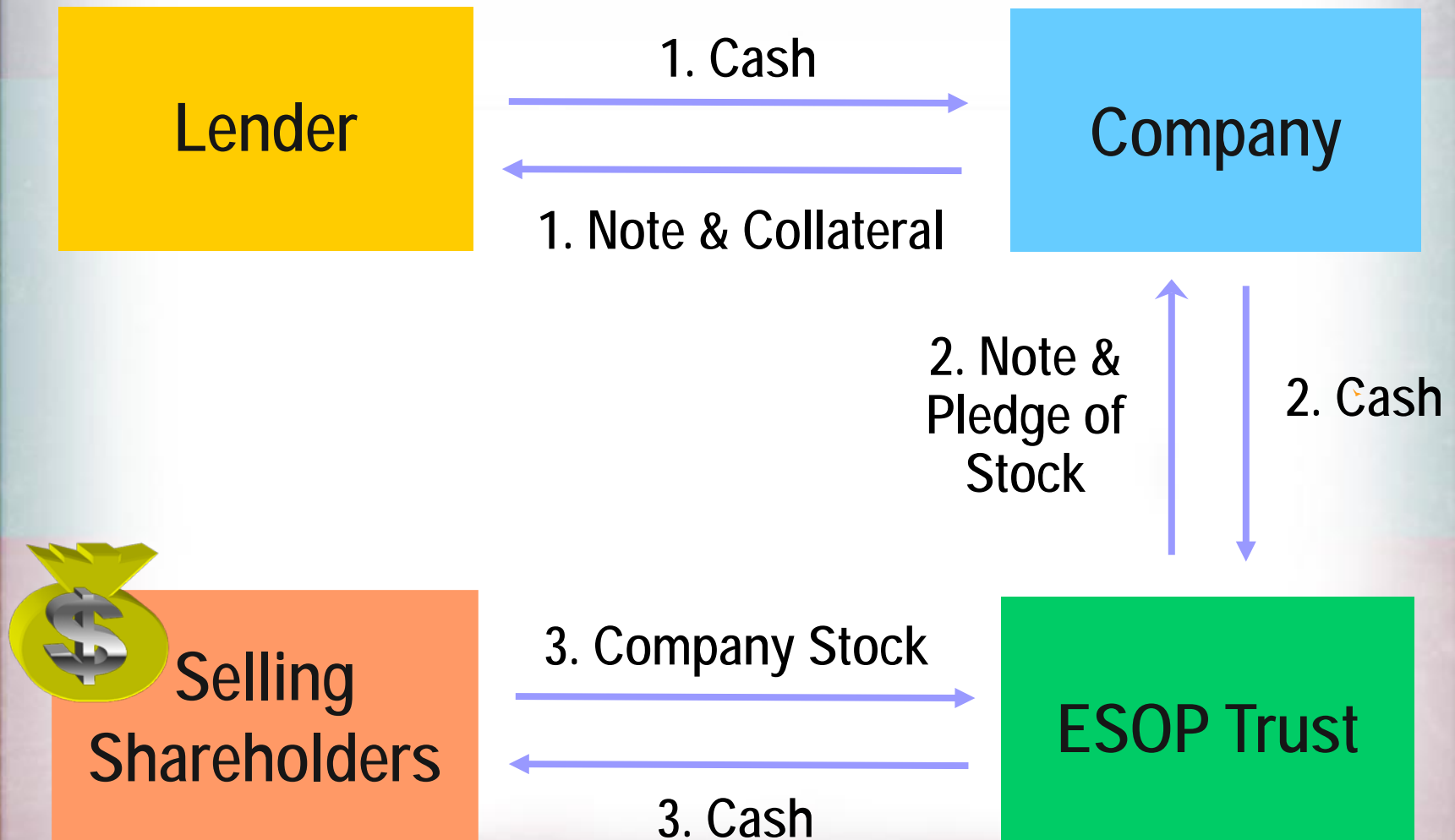


# ESOP Structure #1

## Cash Contribution, Buy Stock From S/H

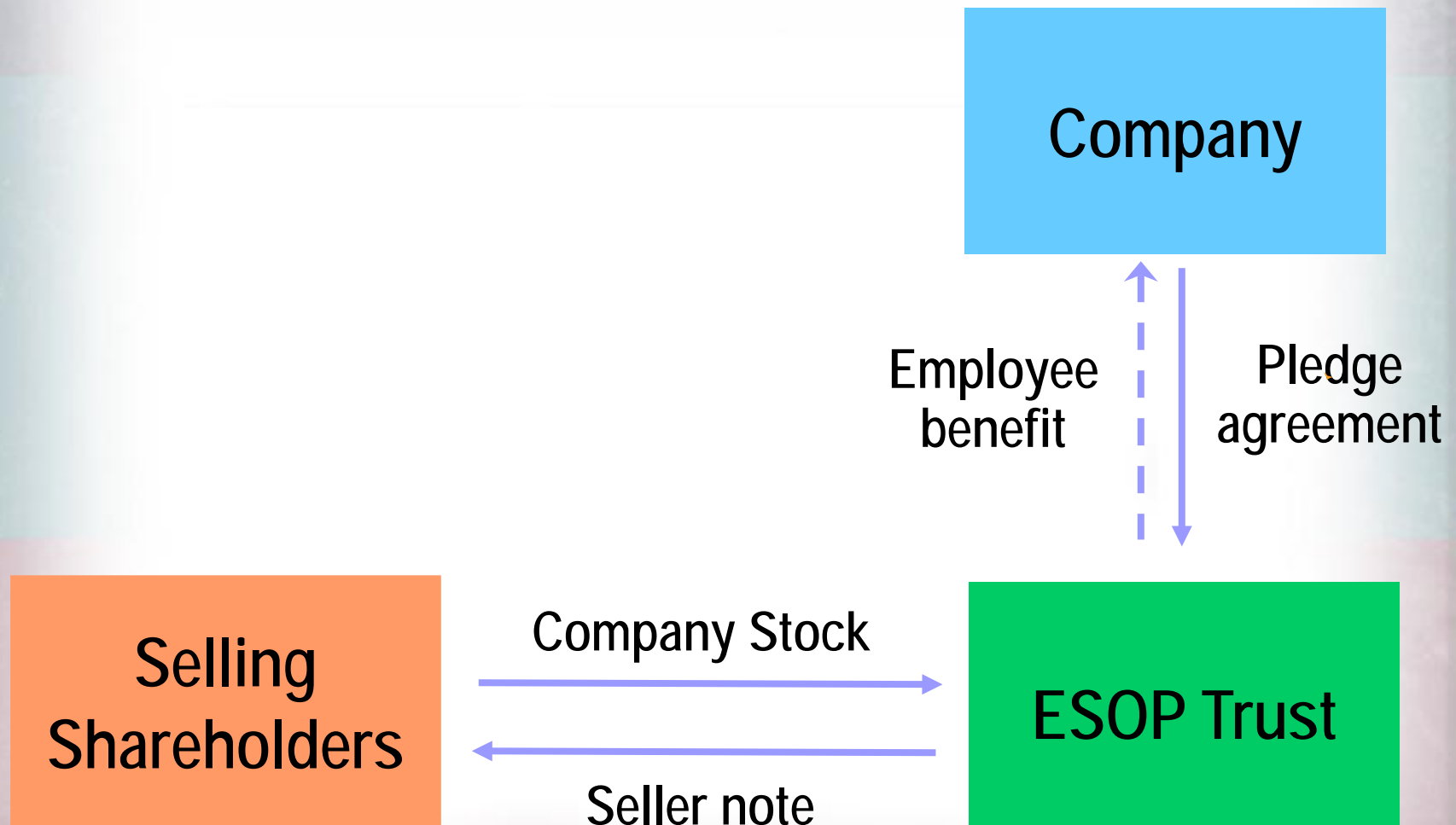


# ESOP Structure #2a Leveraged (Borrow from Bank)

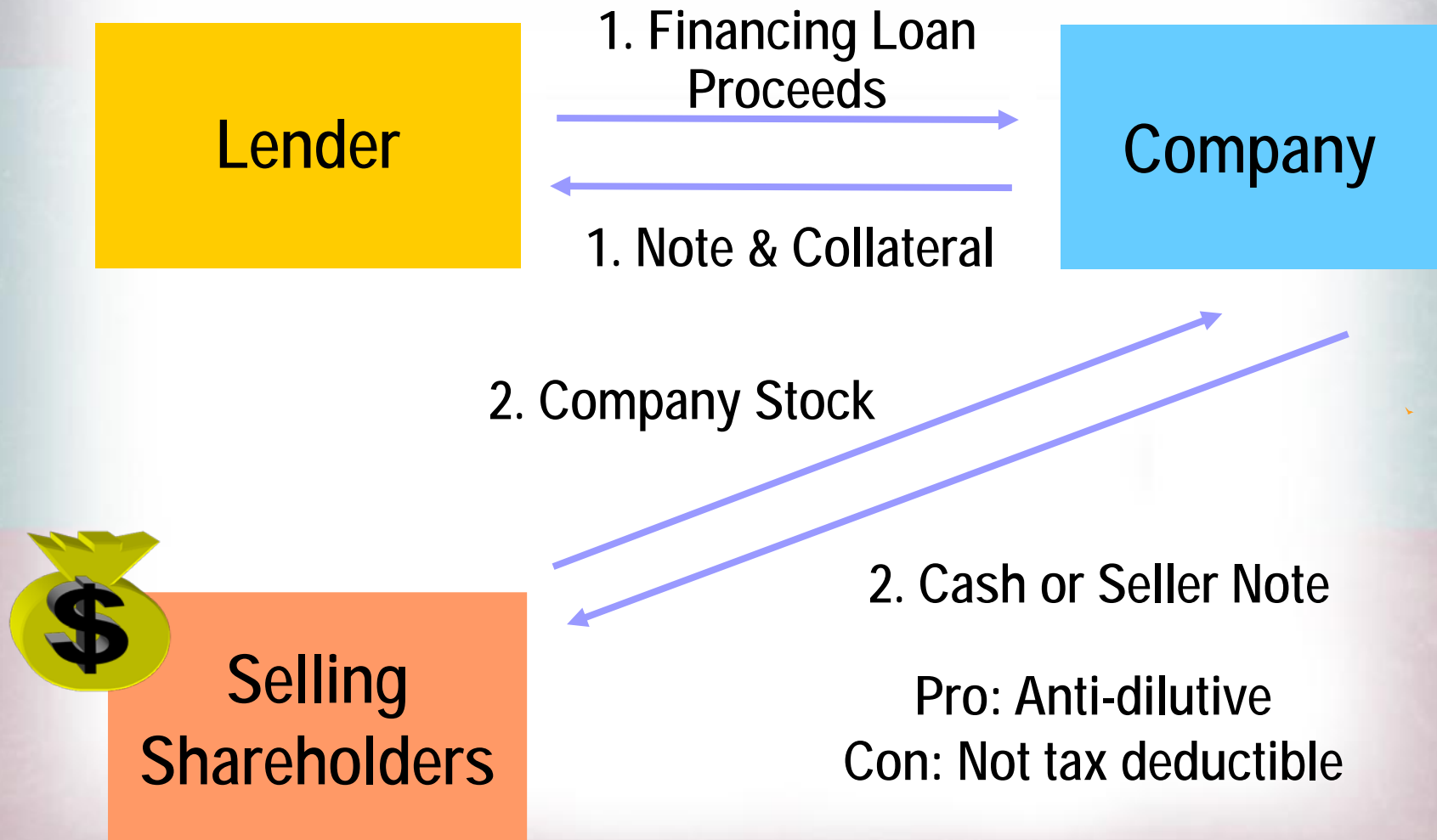


# ESOP Structure #2b

## Leveraged (With Seller Financing)

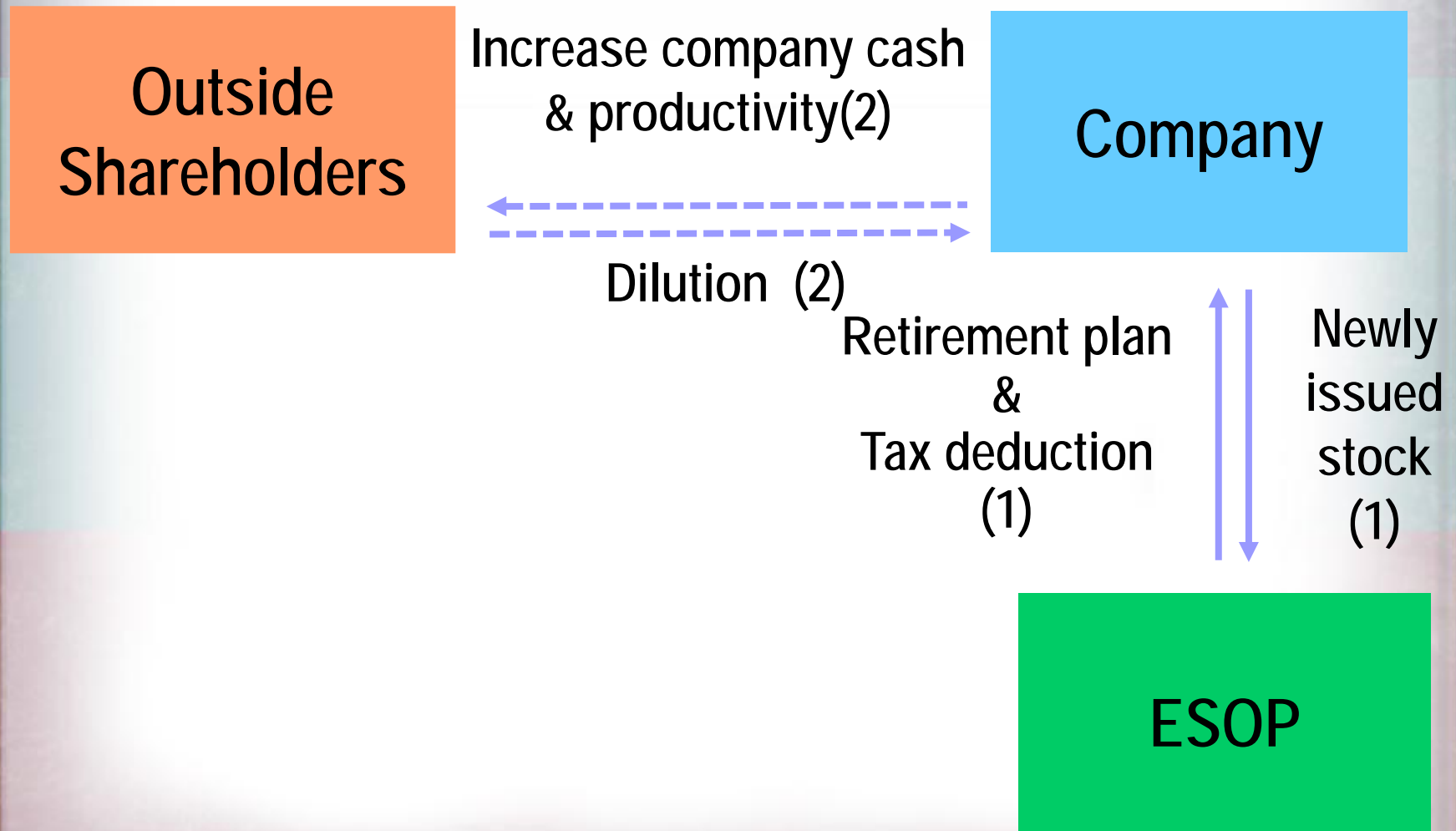


# Compared to Stock Redemption (Typical Shareholder Agreement)



# ESOP Structure #3

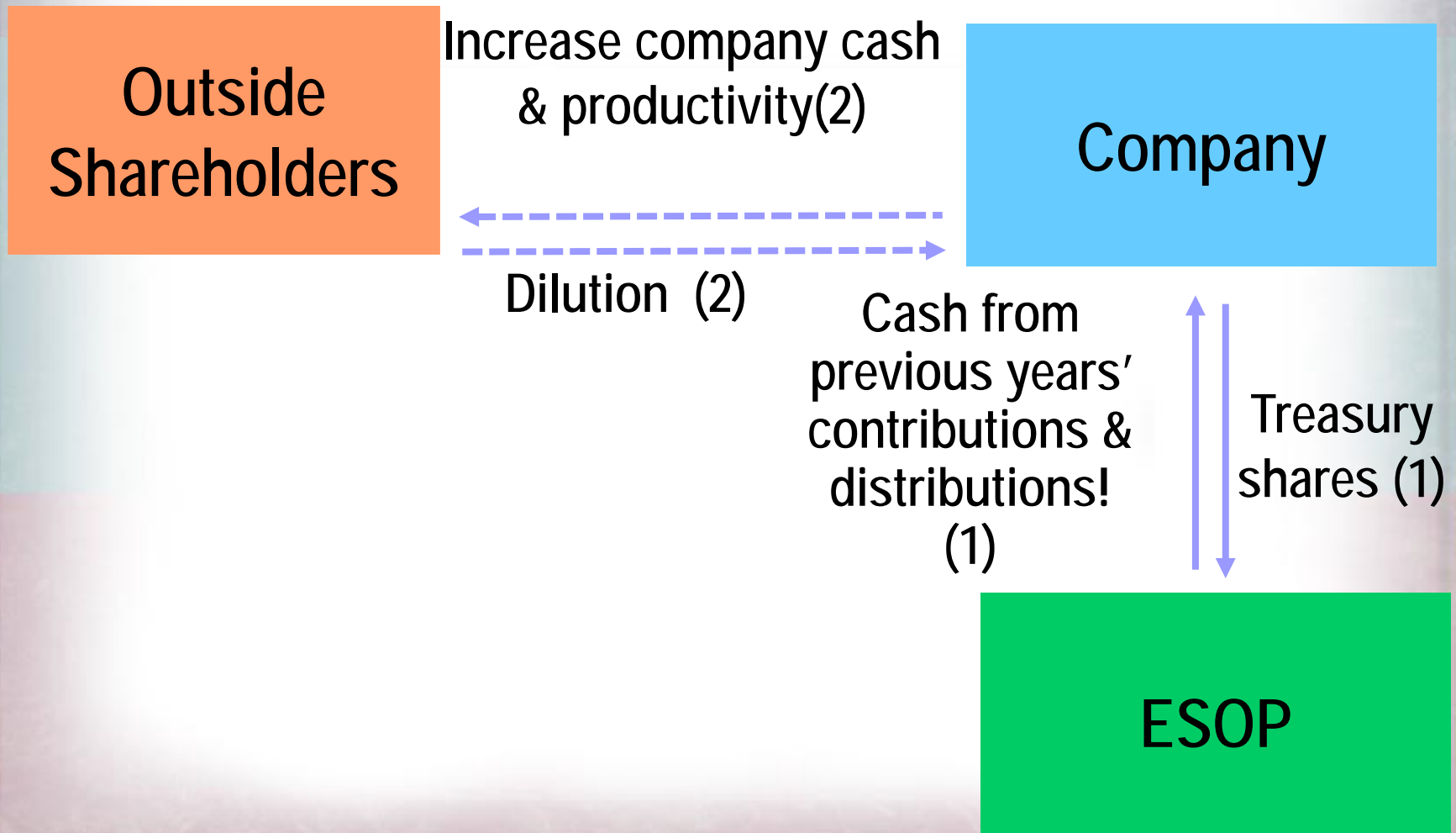
## Stock Contribution





# ESOP Structure #4

## Stock Purchase from Treasury



# 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

Year	% Shares Sold	% Sold - Cumulative	Capital Gains Tax Treatment
1	5%	5%	Taxable
2	10%	15%	Taxable
3	15%	30%	Deferral option
4	20%	50%	Deferral option

# §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



Taxes



Shareholders

70% distribution

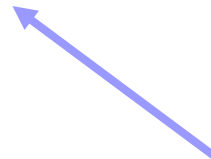
ESOP distribution can be used to repay ESOP loan quicker, buy more shares, repurchase obligation or build up in cash

ESOP



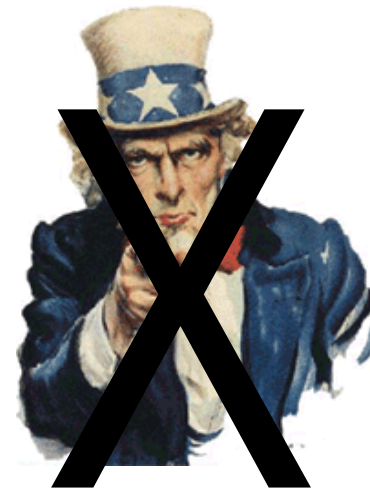
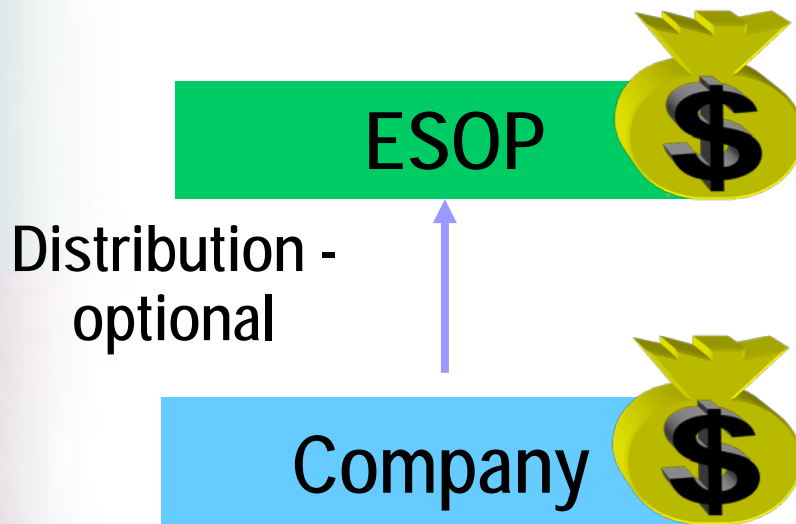
30% distribution

Company



# S Corporation - 100% Owned By ESOP

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



# ESOP Can Not Pay More Than FMV

## Revenue Ruling 59-60

"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.



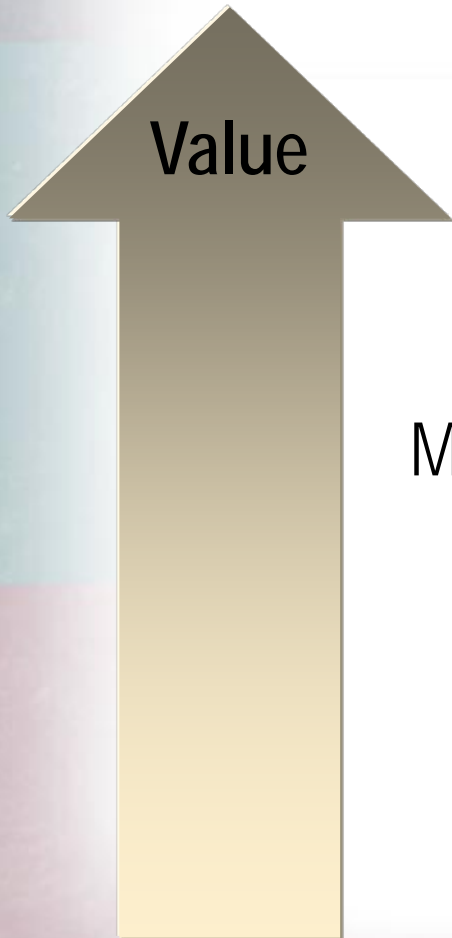
# Tiers of Value

## 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

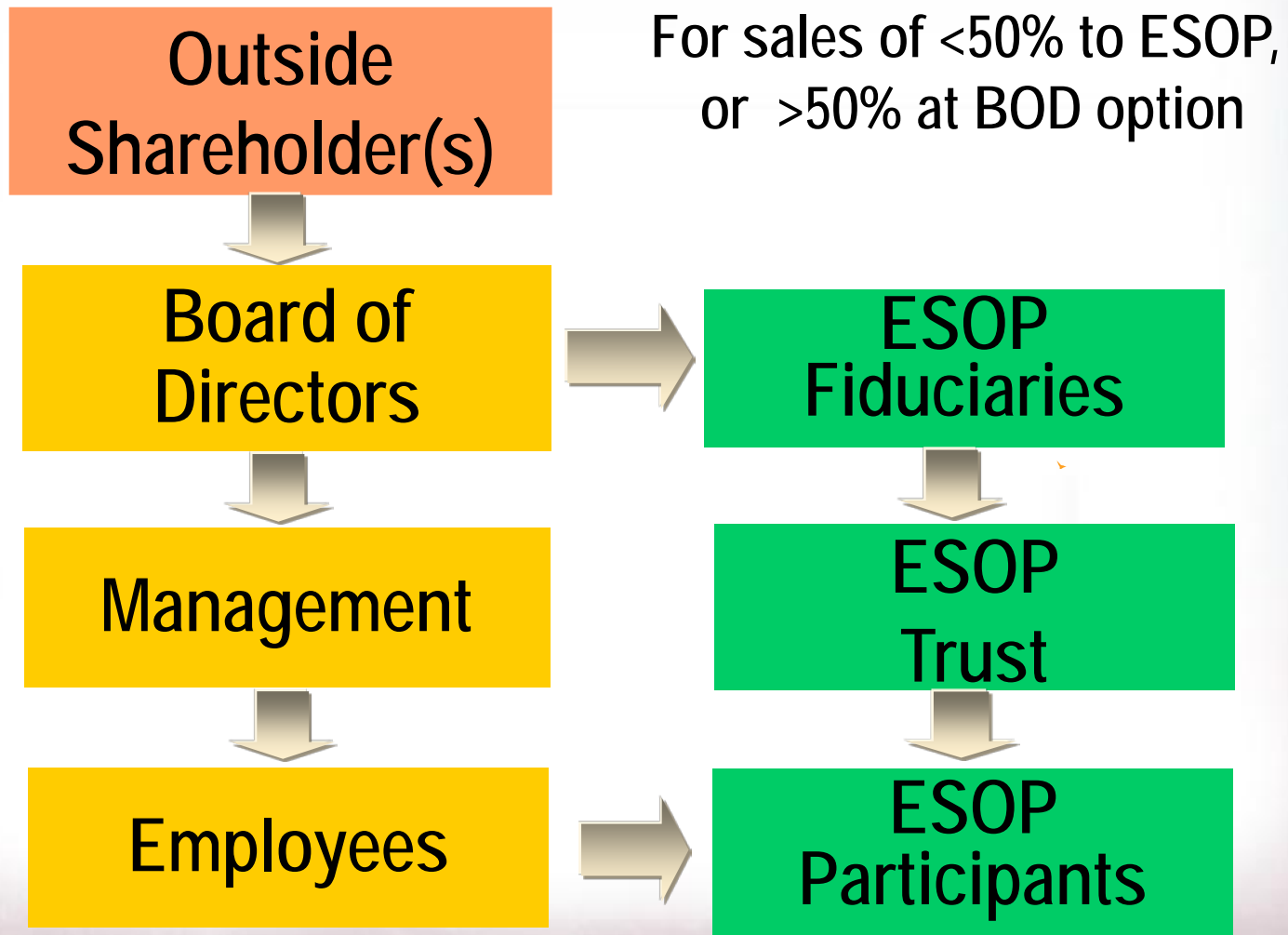
# Who Runs an ESOP-Owned Corporation?

- ▶ 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

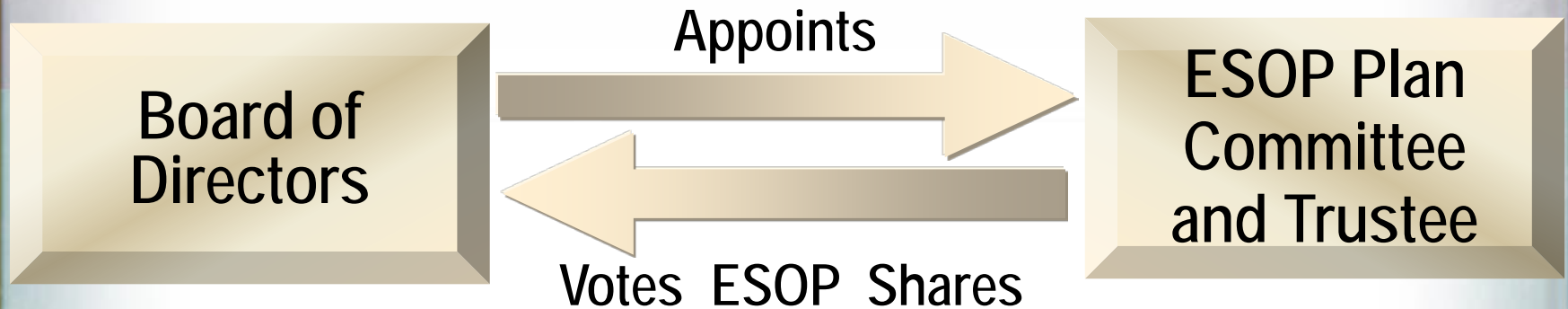
- ▶ The ESOP Trust is the DIRECT owner of company stock, NOT the employees.
- ▶ Employees are BENEFICIAL owners, and thus, do not have the same rights as direct owners of stock.
- ▶ Owner typically becomes the ESOP trustee retaining control of day-to-day operations until such time owner is willing to give control to succession management team – usually when they have sold a large majority of their stock.

# Shareholders Retain Control – No Control Premium Received





# Shareholders Retain Control

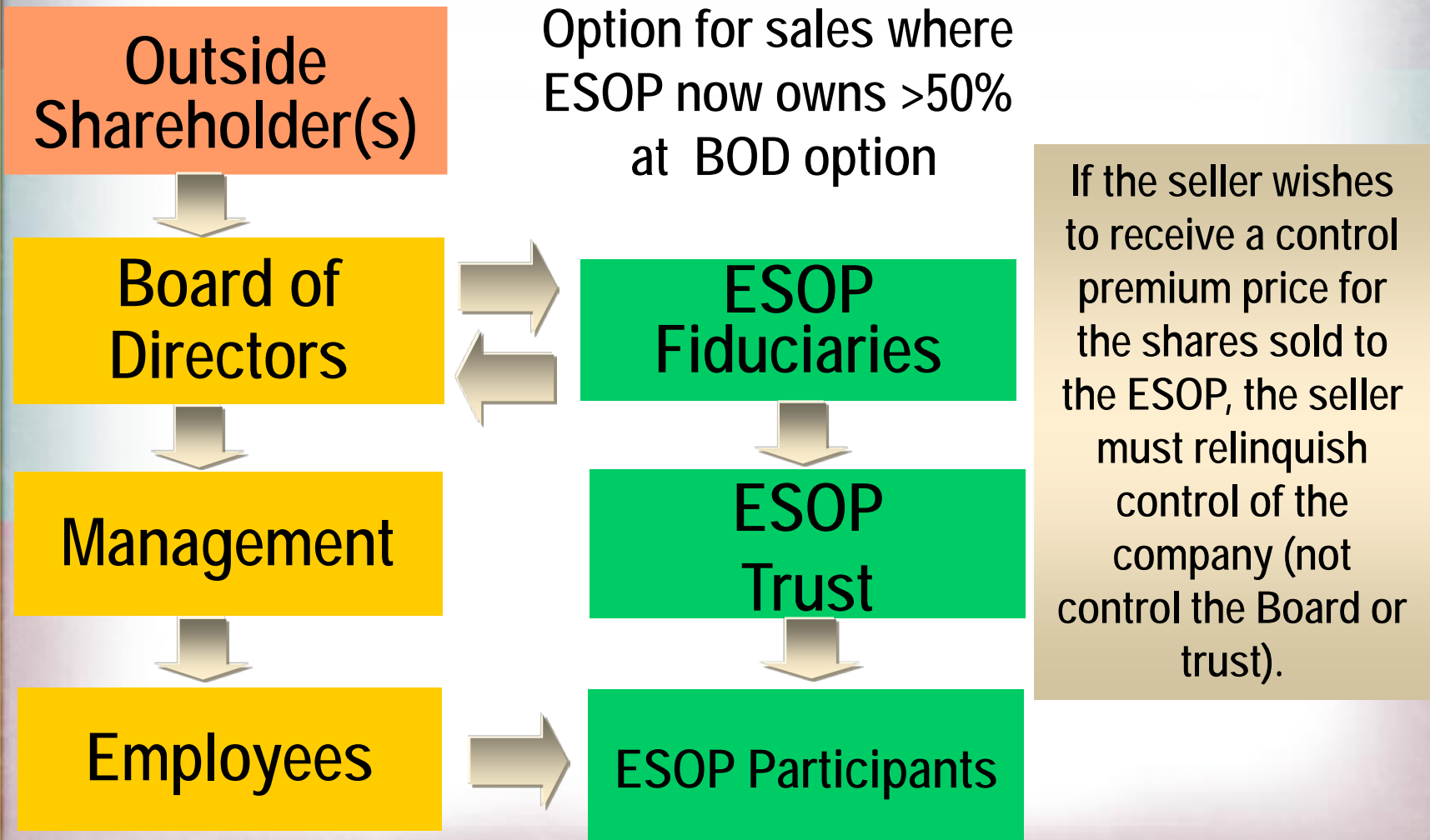


- ▶ Bill initially owns 100%.
- ▶ Bill sells 60% to ESOP with no control premium.
- ▶ Bill appoints himself as the BOD and ESOP fiduciary.
- ▶ Bill votes his own remaining 40%.
- ▶ As the plan committee and trustee, Bill also votes the 60%.
- ▶ Hence, Bill still votes 100%.

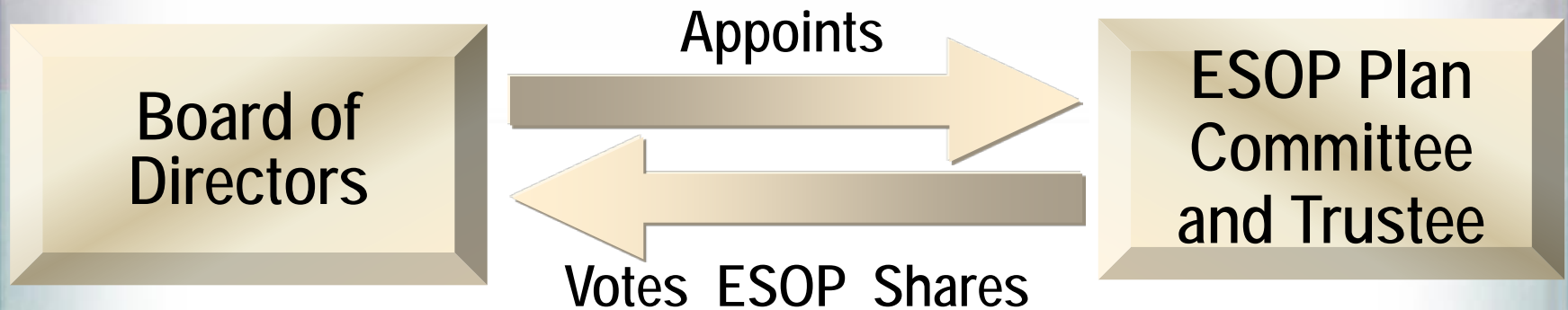
# Independent Fiduciaries

- ▶ 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



# 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

# Required Disclosure to Participants

	<u>YES</u>	<u>NO</u>
Individual's balance/vested amount	<input checked="" type="checkbox"/>	
Per share value of stock	<input checked="" type="checkbox"/>	
ESOP Summary Plan Description	<input checked="" type="checkbox"/>	
Company financial statements		<input checked="" type="checkbox"/>
Officer salaries		<input checked="" type="checkbox"/>
Company valuation		<input checked="" type="checkbox"/>

# 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%

	<u>Before ESOP</u>	<u>After ESOP</u>	<u>% Change</u>
Sales	\$10,000,000	\$10,200,000	2%
Expenses	\$9,600,000	\$9,400,000	-2%
Profits	\$400,000	\$800,000	100%

# 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.



MENKE & ASSOCIATES, INC.  
ESOP ADVISORS AND BANKERS

Confidential  
ESOP  
Questionnaire

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For a free ESOP analysis, mail or fax this information to:

255 California Street, 10<sup>th</sup> Floor  
San Francisco, CA 94111  
Phone: 415-362-5200  
Fax: 415-398-2260

Over 2,000 ESOPs ESTABLISHED SINCE 1974

# 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

## Leveraged ESOP

Month 1: Design

Month 2: Valuation

Month 1-3: Financing

Month 4: Documentation

Year 2+: Admin

Year 2+: Valuation

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



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Our other ESOP webinars:  
ESOPs 202:  
Designing an Effective Employee  
Incentive to Increase Productivity



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Our other ESOP webinars:  
ESOPs 301:  
Advanced Strategies for  
ESOP owned companies'  
managers and advisors



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# Questions & Answers



MENKE & ASSOCIATES, INC.  
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To Determine if an ESOP is feasible for  
your company or your client's company,  
please call or email us.

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