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THE ESOP AS A SOLUTION

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Employee Stock Ownership Plans ("ESOPs") can be a good choice for the right company because they can generate liquidity for the owners in a tax-advantaged form, allow the owners to retain de facto, if not legal, control, and provide employee ownership and the resultant productivity and retentive benefits to the business. Common uses of ESOPs include can have other uses as well, such as:

- Allowing an owner to exit his or her business but provide an incentive to retain existing management (who may be unable to buy)
- Allowing a shareholder to diversify his or her holdings through a partial (or total) sale to an ESOP;
- Providing a vehicle to efficiently redeem unwanted shareholders;
- Structuring management buy-outs;
- Providing a buyer for an estate holding closely-held stock;
- Closing out a private equity fund by selling a portfolio company to an ESOP; and
- Selling a division to employees.

Using an ESOP has certain advantages over more traditional approaches to address these issues, including:

- Both principal and interest paid on any leveraging required for the ESOP transaction are tax-deductible.
- In many circumstances, owners can rollover the proceeds resulting from a sale of their stock to an ESOP into other corporate securities free of federal (and most often, state) income taxes.
- Even in situations which are not eligible for the tax-free rollover, sellers can get capital gain treatment, rather than dividend treatment, on the sale to an ESOP.

- Unlike private equity, the ESOPs tend to be passive, longer-term investors.
- Since ESOPs can be shareholders of S-corporations, sharing ownership with employees through an ESOP avoids pressure on the limitation on the number of shareholders, as ESOPs are counted as one shareholder for this purpose, regardless of the number of employees participating in the ESOP.
- S-corporations that are owned by ESOPs are exempt from federal, and most state, income taxes.

ESOP companies come in many sizes, although given the costs associated with an ESOP transaction, very small companies are not always the best fit. Some characteristics of companies that may make good ESOP companies are:

- EBITDA of at least $5 million;
- Consistent earnings history;
- At least 10 employees;
- Strong management and employee-oriented culture; and
- Willingness to run company much like a public company (*e.g.,* disclosure of basic financial information, good corporate governance, and avoidance of conflicts of interest).

ESOPs can be complex and require some additional administrative know-how to maintain. There are many qualified administrators who can provide assistance. However, in the right context, they can provide the necessary liquidity and help retain and motivate employees of the company.

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