ISSUE BRIEF #2

How to Establish an ESOP

A company interested in establishing an Employee Stock Ownership Plan (ESOP) has a wide range of options in tailoring a plan that is best suited to its particular needs and goals. A large, publicly traded company, for example, would handle the creation of its ESOP somewhat differently than would a smaller firm. Here are some basic guidelines for the steps a company might take in creating its ESOP. Attached to this *Issue Brief* is the ESOP Advisors Group summary of the steps in the implementation process.

<u>Exploring The ESOP Concept</u>

The first step in the process of establishing an ESOP is to develop an idea of the type of plan that will best serve the company's interests. ESOPs can be good for the business owner, the corporation and the employees. Companies have used them as a tax-advantaged exit strategy for the business owner, a financing tool for the corporation and an employee benefit. They can be used to help a business owner convert his or her ownership interest, an otherwise non-liquid asset, into cash. An ESOP can be used as a tax-advantaged tool to restructure corporate debt or finance mergers and acquisitions. Properly designed and communicated ESOPs create an "ownership culture" within the company as well as a retirement benefit, motivating employees to higher levels of productivity.

<u>Designing The Specifics</u>

Potential new ESOP transactions begin with a feasibility assessment. ESOP Advisors Group has designed an ESOP Feasibility Questionnaire to collect key information required to properly assess the feasibility of any given ESOP transaction. (You may download the Feasibility Questionnaire from our website ***www.esopadvisorsgroup.com***). The questionnaire asks vital questions including:

- Who will participate in the plan?
- What is the current ownership structure of the company?
- What is the eligible payroll? What is the debt capacity of the company?
- What are the goals and objectives of the owners?

The ESOP Advisors Group team will work to integrate the ESOP goals with applicable laws and regulations and will conduct an analysis to assure that any financial commitments posed by the ESOP will not exceed the ability of the firm to meet such obligations.

In the case of a privately held company, the feasibility and design phase of the process is not usually complete until three additional points have been addressed. First, the firm's stock must be valued by an independent appraiser before shares are put into the ESOP. Initially, the appraiser should carefully estimate the value of the company based on information provided in the Feasibility Questionnaire and from the financial statements. This initial or preliminary valuation is used as a working figure in the feasibility and design process. It typically takes fifteen to twenty business days to complete after the required financial data is submitted with the questionnaire. Only when the design process is completed and ready for implementation will a final and formal valuation report be prepared. We will discuss valuation in more detail in our future *Issue Brief* #15, "The Valuation of ESOP Stock." A publication entitled *Valuing ESOP Shares* is available from the ESOP Association for $12.00 (member price).

Second, you should estimate the ESOP's effect on existing stockholders. Stockholders will want to know how the ESOP will affect the value of their stock and the company's financial condition. An ESOP has the potential to dilute their equity interest in the corporation.

Finally, while not a requirement for establishing an ESOP, ESOP Advisors Group highly recommends that privately held companies establish a plan for meeting their obligations to repurchase the stock of departing employees. This "repurchase obligation" arises from the fact that in privately held companies, ESOP participants have a put option when leaving the company. The repurchase obligation and its growth over time may be affected by factors like the size of the annual ESOP contributions, the change in the value of shares between the dates of contribution and repurchase, the vesting and distribution provisions of the ESOP, and employee turnover. Additionally, for shares contributed after December 31, 1986, repurchase liability is affected by the choices eligible employees make about their diversification option.

Companies may plan for and meet their ESOP repurchase obligation in a variety of ways, including making substantial cash contributions on an annual basis and buying insurance to cover the plan's obligations. ESOP Advisors Group recommends that the company establish a strategy for funding its repurchase obligation. The funding approach selected will be determined by the company's strategy to either reduce the liability on a controlled basis over time or perpetuate the liability by reallocating shares in the plan as participants depart. If the likely growth of repurchase obligation over time is projected at the outset, however, the company will be in the best possible position to plan for it and design the ESOP accordingly. The first step in planning is to quantify and project the liability into the future by conducting a repurchase liability study. We will discuss repurchase liability in more detail in our future *Issue Brief* #5, "The Repurchase Liability Obligation."

Putting The ESOP In Place

When the process of analyzing and designing the ESOP is complete, the company will typically have an attorney prepare a formal plan document setting forth the specific terms and features of the ESOP. An appraiser will then prepare a formal valuation report, based on data preferably no more than 60 days old at the date the ESOP is created.

The plan document should include language addressing the plan's purpose and operation, eligibility requirements, participation requirements, company contributions, investment of plan assets, account allocation formulas, vesting and forfeitures, voting rights and fiduciary responsibilities, distribution rules and put options, employee disclosures, and provisions for plan amendments. Depending on the particular circumstances of the ESOP, it may be prudent to address any further contingencies in the plan document.

The company establishing an ESOP also must decide who will administer the plan and who will serve as its trustee. The stock (as well as any other assets) held by the ESOP must actually be held in the name of the trustee, who usually has fiduciary responsibility for the plan's assets. Increasingly, plan sponsors are turning to professional trustees, such as a bank or trust company, although companies sponsoring an ESOP can and do handle this role in-house. The plan administrator is responsible for maintaining all the individual records of the plan, keeping track of the participants, the percent each participant is vested, and the content and value of each participant's account. The administrator must keep current on all applicable Department of Labor, ERISA and IRS ESOP regulations. The plan sponsor can handle the ESOP administration function, but ECSG recommends that it be outsourced to a professional administration firm.

In leveraged ESOPs (an ESOP using borrowed funds to acquire employer securities), the company should arrange the financing needed to complete this transaction. Banks, savings and loans, investment banking firms, mutual funds, and insurance companies may all qualify as ESOP lenders. Lending institutions are becoming increasingly familiar with how ESOP loans are structured. ESOPs are particularly attractive to lenders because ESOP debt is repaid with pre-tax dollars. The company makes a tax deductible contribution to the ESOP, which includes the payment for principal and interest. Lenders consider the same financial criteria as other corporate loans when they evaluate an ESOP loan. The company's existing lender may be able to provide the necessary funding. Or, it may be more desirable to consider an alternative lender with ESOP lending expertise.

The company must formally adopt the plan and trust documents that establish the ESOP and its attendant trust. Also, the company usually submits a copy of these documents to the Internal Revenue Service with an application for confirmation (called "determination") of the plan's tax-qualified status (Form 5500). The plan must be a qualified ESOP under sections 401 (a) and 4975 (e)(7) of the Internal Revenue Code in order to be eligible for the various tax benefits associated with ESOPs. It is not normally necessary, however, to wait for a letter of determination from the IRS to begin the plan. If there is nothing unusual in the plan's design, any required changes will almost certainly be small ones, which can be made after the plan has begun operation.

A company must adopt an ESOP by the end of its fiscal year to claim a deduction for its contribution for that year. Contributions and leveraging for a given year, however, may occur up until the company files its corporate tax return, including extensions.

Conclusion

Establishing an ESOP is complicated, but that should not discourage interested firms from investigating employee ownership. The process is understandable and manageable, and the many benefits that flow from ESOP's (such as increased employee motivation, a market for existing shareholders' shares, and tax and financial advantages to the sponsoring company and its owners) are substantial.

ESOP Advisors Group provides one stop ESOP design formation and implementation services. Visit the ESOP Advisors Group website at ***www.esopadvisorsgroup.com.*** *Or call Mel Duffey (650) 468-5465.*

Portions of this *Issue Brief* were reprinted with the permission of **The ESOP Association**, a non-profit association located in Washington, D.C., dedicated to the concept of employee-ownership.