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ESOP Nuts and Bolts: What You Need to Know About Employee Stock Ownership Plans

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ESOP Plan Designs that Work

Presented by:

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Background

- There is no one-size-fits-all ESOP plan
- The right plan depends on many factors
- Initial factfinding is needed to establish the best plan for a particular ESOP
- Objective today is to cover a variety of topics in ESOP plan design
  - Goal is to think about areas that can cause confusion or issues down the road
  - Best practice is to deal with these issues up front
- Thinking about what an ESOP will look like before drafting any legal documents is helpful to avoid pitfalls

Background

- Objective today:
  - Discuss steps to set up an ESOP
    - Will help outline areas to think about when designing the ESOP plan
  - Other employee ownership plans
  - General ESOP plan considerations
  - Specific areas of ESOP plan design
  - Summarize plan design best practices

Steps to Set Up an ESOP

- The company and current owners should decide if an ESOP is right for them
- Steps to consider when establishing an ESOP:
  - Owners' willingness to sell
  - Feasibility study
  - Conduct a valuation
  - Hire an ESOP attorney
  - Secure funding
  - Form an ESOP Team

Steps to Set Up an ESOP – Willingness to Sell

- If the ESOP is being sought out by the company, determine whether the owners are willing to sell
  - If the assumption that the owners desire to sell is incorrect, it can cause problems down the road
  - Do your due diligence up front before proceeding to any later steps
  - Communication will be a common theme and starts here

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Steps to Set Up an ESOP – Feasibility Study

- Feasibility study
  - A sound financial plan is necessary to establish an ESOP
  - Understand how financing the ESOP will impact the company's:
    - Profitability
    - Cash flow
    - ESOP's ability to fund debt payments
    - Ability to fund the repurchase obligation

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Steps to Set Up an ESOP – Preliminary Valuation

- Conduct a Preliminary Valuation
  - Critical step.
  - Touches on communication with owners again.
    - If the price is too low, the seller will not want to sell.
    - If the price is too high, the company/ESOP may not be able to afford financing payments.
  - Valuation should be conducted by independent third party.
  - Will help with planning repurchase obligation
    - Not an issue early on but initial valuation can help project the repurchase obligation in the future
      - How much of a burden will the repurchase obligation present?

Steps to Set Up an ESOP – Hire an ESOP Attorney

- Hire an ESOP attorney
  - Once the first three steps are completed successfully and an ESOP is still desired, a plan can now be drafted and submitted to the IRS
  - Evaluate your options (discussed in more detail later) and tell your attorney how you want your plan to be set up
  - The ESOP attorney is a critical member of the ESOP team
  - The ESOP attorney can also help answer any plan questions you have
    - ESOP law and best practices are evolving
      - Selecting a diligent and competent attorney is important

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Steps to Set Up an ESOP – Secure Funding

- Secure funding for the plan
  - Bank financing
    - Sometimes cheaper than other financing options
    - Banks are friendly toward ESOP companies
  - Seller financing
    - Sometimes more expensive than bank financing
    - May provide more flexibility on terms
    - Tax advantages for sellers
  - Company sponsored
    - Relies on company cash to fund the ESOP plan
    - Saves on interest expense
    - Cost is opportunity cost of funds not invested

Steps to Set Up an ESOP – Form ESOP Team

- Most likely have an ESOP attorney by now
- Need to fill out the rest of the ESOP team
  - Trustee
    - Trustee will select valuation firm for transaction and ongoing valuations
    - Internal is more cost effective
    - External provides greater expertise
  - Consider plan administrators
  - Establish ESOP committee
    - Usually primarily management
    - But inclusion of non-managers can help drive employee engagement

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Other Employee Ownership Plans

- A tax-qualified ESOP brings excellent benefits for employees
  - May consider other plans before establishing an ESOP
- Other employee ownership plans:
  - Stock appreciation rights (SARs) Plans or Phantom Stock Plans
  - Qualified and non-qualified stock purchase, stock option and bonus programs
  - Qualified retirement plans or stock bonus programs

ESOP Plan Considerations

- Interaction with preexisting plans
- Communication
- Financial & cash flow planning
- Future ESOP purchases
- Other plan design issues

ESOP Plan Considerations – Preexisting Plan Considerations

- Depending on plans and interaction with ESOP, preexisting plans can impact administrative burden
  - Important to give this careful thought
  - Limitation year – if operating multiple plans, Section 415 of the Internal Revenue Code limits benefits allocated to individual employees' accounts
    - Multiple plans with different limitation years can cause violations
    - Best to keep all limitation years defined the same in all plans

ESOP Plan Considerations – Preexisting Plan Considerations

- Addition and contribution limits
  - Payroll deductions can be effected for ESOP plans depending on other plans in place
    - Employee deferrals into retirement plans and other employee contributions to other plans (retirement, stock bonus or profit sharing) affect contribution limits

ESOP Plan Considerations – Communication

- Start the communication process early and communicate often
  - Establish regular communication schedule
  - Provide updates and new information on a regular and consistent basis
- Management responsible for making decisions
  - Sometimes will not communicate with employees until the ESOP is implemented
  - ESOP implementation is a lot of information to take in all at once
  - Commit early to ongoing communication with employees
    - Early communication can uncover issues or employee misgivings and allow management time to address these issues

ESOP Plan Considerations – Communication

- Employee input
  - Helpful in getting buy-in on plan design
  - Allow for enough time for all parties (particularly employees) to get a handle on what to expect
    - Make sure employees are generally comfortable with what to expect from the ESOP
    - Communicate the benefits to the employees of employee ownership

ESOP Plan Considerations – Financial & Cash Flow Planning

- A feasibility study should be conducted as part of the initial ESOP plan discussion
- Other financial feasibility issues include:
  - Projected financial statements
    - Ideally, an integrated three-statement financial projection will be prepared
      - At a minimum, a projection of the income statement, capital expenditures and working capital needs will assist the consultant in performing the feasibility study
    - Understand limits and deductibility of ESOP contributions

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ESOP Plan Considerations – Financial & Cash Flow Planning

- Projections should be achievable.
  - Overly optimistic projections can lead to false sense of security to meet funding obligations.
  - Overly pessimistic projections can understate value growth and lead to poor understanding of future repurchase obligation.
- Other cash flow considerations
  - Cash needs to support growth
  - Risk inputs – where is the risk to the projection?
  - Cyclical industry vs. defensive industry
    - In a downturn, where will cash flow come from to support the business?
  - Repurchase obligation
    - Typically low early in the life of the ESOP
    - Increasing later in the projected period

ESOP Plan Considerations – Future ESOP Purchases

- Where less than a total buyout is made, an understanding of the impact on the remaining shareholders is important
  - If the ESOP is leveraged, the equity value of the shares owned by the remaining shareholders can decrease
    - Understand future exit plans of remaining shareholders
    - Communicate potential issues of exiting their position in the near-term
    - The decline in share price is usually expected to be short-lived, all else equal
  - Again, communication is key
  - Independent valuation professionals or ESOP consultants can help with this issue early on in the process

ESOP Plan Considerations – Other Plan Design Issues

- Understand corporate governance structure
  - ESOP as a shareholder – the ESOP is usually
    - a majority shareholder or
    - a significant shareholder
  - Voting protocols
    - Understand how the ESOP may impact corporate governance
  - Keep up to date retirement plan governance procedures
  - Helpful to understand if any corporate procedures need changing such as the number or timing of board meetings

Specifics of ESOP Design

- Eligibility
- Basis of allocation of contributions
- Release of shares from the suspense account
- Dividends and how dividends will be applied
- Vesting schedule and forfeiture
- Distribution and repurchase policies

Specifics of ESOP Design – Eligibility

- Who is able to participate in the plan?
- No automatic criteria to determine who is eligible
- Options to determine eligibility
  - Able to set low thresholds to maximize number of employees
    - Risk is part-time or seasonal employees may increase the administrative burden on the plan
  - Able to set higher thresholds to lower administrative burdens
    - Common to see a minimum of 1 year of service with a company and 1,000 hours of annual service
    - Common to see continued employment at plan year end as a requirement

Specifics of ESOP Design – Basis of Allocation of Contributions

- Typically, compensation is the basis for allocation of contributions
- Definition of “compensation” can vary
  - Includes or excludes bonuses?
  - Includes or excludes commissions?
  - If another qualified plan is in place along side the ESOP, are pretax deferrals included or excluded?
- May use a different basis of allocation as long as it is non-discriminatory

Specifics of ESOP Design – Release of Shares from Suspense Account

- When company stock is purchased by an ESOP funded by an exempt loan, the shares are put into an ESOP suspense account
  - The shares in the suspense account serve as collateral to the loan
- The ESOP loan provides a predetermined share allocation to ESOP participants over the term of the ESOP loan
  - Best practice is to structure the ESOP loan to assist a company in obtaining their desired benefit level to ESOP participants
- Release formula can either be (1) General Rule or (2) Special Rule
- General Rule
  - Principal and interest method
  - Even payment or self-amortizing loans, provides for even release of shares over the term of the loan
- Special Rule
  - Based only on principal payments
  - Must satisfy other regulatory requirements if using the Special Rule

Specifics of ESOP Design – Dividends and how Dividends will be Applied

- Dividends provide a direct benefit to employees
  - In ESOPs, dividends can provide unique tax benefits
  - If used to repay ESOP loans in a C corporation, dividends are tax-deductible
  - Generally, do not count toward limits on how much stock can be allocated to employee accounts

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Specifics of ESOP Design – Dividends and how Dividends will be Applied

- From the NCEO – Special Rules for Repaying Loans with Dividends
  - Dividends on both allocated and unallocated shares can be used to repay a loan. Dividends paid on allocated shares must release shares to employee accounts at least equal in value to those dividends. Dividends paid on unallocated shares can be distributed to employee accounts based on the allocation formula for other contributions or on the prior account balance. They can also be passed through to employees.
  - Dividends paid on shares not acquired by an ESOP loan (such as shares the ESOP owned before) cannot be used to repay that loan.

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Specifics of ESOP Design – Dividends and how Dividends will be Applied

- From the NCEO – Special Rules for Repaying Loans with Dividends (cont'd.)
  - Dividends must be "reasonable." The IRS has not defined what reasonable means, however. In the one private letter ruling on this issue, a 70% dividend was ruled unreasonable. Dividends that are within the range of those paid by other companies with similar earnings clearly would be reasonable, but beyond that, no one knows.
  - Accounting treatment for dividends paid on ESOP loans is complex. Previous rules indicated dividends used to repay a loan would be charged to retained earnings. New rules will require them to be charged to compensation expense, with the charge measured by the value of the shares released. The application of these rules requires detailed guidance from a specialist.

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Specifics of ESOP Design – Vesting and Forfeiture

- Vesting refers to the amount of time an employee must work before acquiring a nonforfeitable entitlement to his or her benefit
- Vesting may be unfamiliar to some ESOP participants
  - Employees who leave the company before being fully vested will forfeit their unvested benefits
  - Clear communication of what vesting is, how it works and how it will impact the employees' account balances is important
- Vesting schedule and treatment of forfeitures will impact the cash needs of the plan

Specifics of ESOP Design – Vesting and Forfeiture

- An ESOP must comply with one of the following two minimum schedules for vesting (plans may provide different standards if they are more generous to participants):
  - No vesting at all in the first years, followed by a sudden 100% vesting after not more than three years of service ("cliff" vesting); or
  - Twenty percent vesting after the second year of service, with 20% more each year until 100% vesting occurs after the sixth year of service ("graded" vesting).
- A "year of service" generally refers to a plan year in which a participant has 1,000 hours of service; it may include past service.

Specifics of ESOP Design – Vesting and Forfeiture

- The policy around forfeitures may impact ESOP planning
  - A forfeited share is not a liability (unless the employee is rehired)
  - Delaying the reallocation of forfeited shares may help manage the repurchase obligation
    - But, if the plan is terminated, the shares may need to be repurchased

Plan Design Best Practices

- Thoughtful plan governance procedures
- Communication – frequent, objective, neutral
- Be proactive
  - Monitor the company's financial health
  - Regularly understand the repurchase obligation
  - Appropriately plan valuation timing
  - Communicate foreseeable issues as soon as possible
- Form a strong ESOP team
  - Includes knowledgeable trustee, ESOP attorney, valuation firm, and ESOP committee
- Independent fiduciaries
  - Avoids conflict of interest of internal ESOP trustee
  - Board monitors activity of independent fiduciary

Questions ?

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