Transactional
Law Clinic
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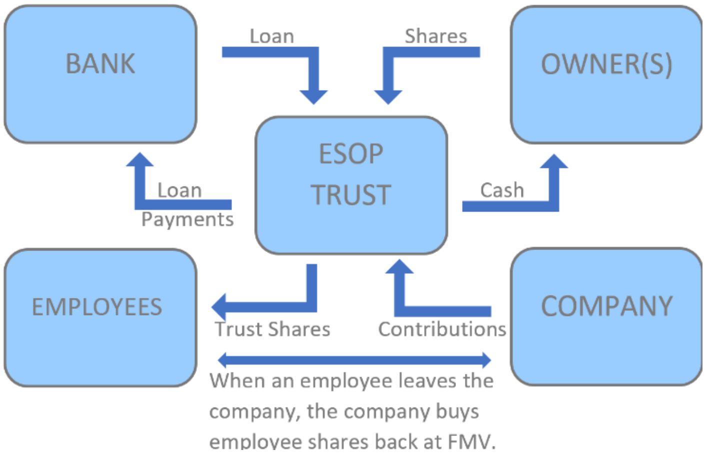
PROVIDING LEGAL RESOURCES FOR DMV SMALL BUSINESSES & NON-PROFITS DURING COVID-19

ESOPS

WHAT IS AN ESOP?

- An ESOP is an employee benefit plan that enables employees to own part or all of the company they work for. ESOPs are most commonly used to facilitate succession planning, allowing a company owner to sell his or her shares and transition flexibly out of the business. For an overview, check out the ESOP Association, a pro-ESOP organization, and its series of briefs on ESOPs, including "What is an ESOP?"
- ESOPs can create higher productivity, employee retention, tax advantages[1] and higher job satisfaction.[2] ESOPs are also attractive because they provide a financing tool for the company, who can sell its stock to the ESOP and use the cash to pay off debt, etc.[3]

HOW DOES AN ESOP WORK?



- The company sets up an ESOP trust.[4] Into that trust, the company can either contribute cash to buy shares of stock from existing owner(s) at no more than the fair market value, or if the owner does not want to sell shares, the company can issue new shares.[5]
- If the company doesn't have the cash to do this at the outset, the ESOP can take out a loan to buy new or existing shares while the company contributes money so that the trust can pay its loan.
- Employees get shares in the *trust*, usually distributed according to relative pay. As they work longer for the company, they get an increased right to the shares, also known as vesting. Generally, all full-time employees over 21 must be able to participate in the plan.[6] What does this mean? **Employees end up owning the business and have some control rights and voting rights within the business**.
- When an employee leaves the company, they receive their stock, which the company must buy back from them at fair market value (unless there's a public market for the shares). So, the employee receives the value of his or her shares from the trust, usually in the form of cash.

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[1] Lian Gravelle, *Demystifying ESOPs: Formation of an Employee Stock Ownership Plan*, 32 J. COMPENSATION & BENEFITS 4 (2016).
[2] https://www.bsllp.com/can-esops-benefit-disadvantaged-communities
[3] https://www.irs.gov/pub/irs-tege/epchd804.pdf
[4] https://www.nceo.org/articles/esop-employee-stock-ownership-plan
[5] This will dilute the ownership interest of existing shareholders, however.
[6] https://www.investopedia.com/articles/pf/07/esops.asp

SIGNS THAT A ESOP MIGHT BE A GOOD FIT

- Company has history of steady profitability, does not have a very high level of debt compared with equity, and has a good relationship with its lender.
- Management team is experienced and trusted.
- Company can cover the costs of initial setup and maintenance, which can be found here: How Small is Too Small for an ESOP. As a rule of thumb, ESOPs work best for companies with over 20 employees.

HOW TO SET UP AN ESOP

- If all owners of a company are willing to either sell shares or dilute their shares, then the next step is a **Feasibility Study**. A feasibility study, which can be conducted in-house, looks at how much extra cash the company has to give to the ESOP and whether this amount of cash is adequate for the purpose of the ESOP. Next, the feasibility study should determine if the company has adequate payroll for participants to make the contributions deductible. Finally, the study should estimate what the repurchase obligation (paying out the value of the shares to employees who retire) and how the company will handle it.
- The next step is to conduct a **Valuation** of the business itself. If the value is too low, the seller may not want to sell. If too high, the company may not be able to afford to buy these shares.
- Next, consult an attorney to help you draft and submit your **Plan** to the IRS. You will receive your letter of determination within months, but you can go ahead and start making contributions before determination. Usually, if the IRS rules unfavorably, you just need to amend the plan.
- Obtain **Funding** for your ESOP. This can come from many sources:
    - The ESOP can borrow money from a bank, seller, or other party.
    - The company can make ongoing contributions.
    - Employees can contribute to the plan, most commonly by wage or benefit concessions. Most ESOPs don't require this, but they are necessary in some cases and must be handled carefully to avoid a securities issue.
- Establish a **Process** to operate your plan. Choose a trustee, either someone in-house or an outside actor, to oversee the plan and be directed by an ESOP committee made up of managerial and non-managerial representation. Communicate the plan to employees to get them involved.

MORE RESOURCES

- IRS guide to evaluating ESOP Plans https://www.irs.gov/pub/irs-tege/epchd804.pdf
- NCEO https://www.nceo.org/articles/esop-employee-stock-ownership-plan
- Dept of Labor: Why ESOPs Merit Separate Treatment
- ESOP Association Briefs https://esopassociation.org/taxonomy/term/59
- Relevant Regulations in the CFR https://www.law.cornell.edu/cfr/text/26/54.4975-11
- Is an ESOP Right for your Small Business?
- National Center for Employee Ownership, *Employee Ownership: Building a Better American Economy*, https://www.nceo.org/assets/pdf/misc/Employee-Ownership-NCEO.pdf