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The Pros & Cons of ESOPs: Weighing Your Options

By Michael McGinley

When it comes to choosing an ownership transition strategy, owners of closely held businesses have a lot to think about. What transition options are available? And which of these options are a good fit for the goals of both the owner and the company? Clear and cogent answers to these questions can be elusive.

From our experience, we know that exit options can include a sale to a third-party, a management buyout (“MBO”), transition to family, or an Employee Stock Ownership Plan (“ESOP”). For many business owners, an ESOP can be an attractive alternative among these options. A host of factors will influence which option is best for each owner’s unique situation, but for those seriously considering an ESOP, it is important to begin with a basic understanding of the pros and cons of an ESOP.

What Is an ESOP?

An ESOP is a qualified employee benefit plan that provides an internal transition of ownership with financial rewards for the business owner and the

employees. In many ways, an ESOP is similar to a profit-sharing plan. In general, an ESOP trust is established to purchase stock of the subject company. Shares are subsequently allocated to individual employee accounts. This allocation can be based on their compensation levels, tenure at the company, or some other formula. A vesting schedule can be used such that as employees accumulate seniority, they become increasingly vested in their accounts.

Notably, the ESOP trust may borrow money to facilitate the purchase of stock of the company. This loan can be repaid by either contributions or distributions the ESOP receives from the company.

The Pros

An ESOP can help to ensure the continuation of the business, which is important to many owners who have worked so hard for so many years to grow their businesses. An ESOP is scalable over time and offers a great degree of flexibility and advantages, a number of which follow.

- For a business owner, an ESOP allows for a greater deal of internal control over the transaction and can take less time to implement when compared to an external sale.
- With an ESOP, the business owner can decide if he/she wants to sell all ownership or instead transition ownership gradually over time. Utilization of an ESOP to create liquidity for a minority stake does not preclude an owner from selling the company to a third-party in the future.
- ESOPs can help business owners gradually begin the process of converting their closely held ownership over to liquid, diversified capital.
- An ESOP is a powerful way to vest employees in the company and boost morale. The opportunity to share in company growth and performance gives employees a sense of ownership, with the potential to invigorate their contribution to the success of the business.
- Finally, there can be a number of attractive tax and investment benefits with an ESOP. For example, the principle amount of an ESOP loan can be tax-deductible, so a loan used to finance the ESOP transaction can be repaid by the company with pre-tax dollars. A selling shareholder can elect Section 1042 tax deferral treatment and may be able to indefinitely defer capital gains taxes associated with the sales of his/her shares, upon the satisfaction of certain requirements. Finally, for companies who elect S-Corp status, the ESOP's share of recognized earnings is usually exempt from income taxes.
- Current shareholders are unlikely to maximize proceeds from a sale to an ESOP, as the ESOP is a financial buyer, not a strategic buyer. The ESOP can pay up to full fair market value but nothing more, whereas a strategic buyer may be able to pay more.
- If selling 100% of the company, outside lenders may be unwilling to finance the full purchase price of the company stock, which may require seller financing to cover the balance.
- An ESOP requires ongoing administrative costs, including annual valuation, plan administration, legal, and possibly trustee fees.

Proper Guidance Is Key

ESOPs can be a highly effective tool for ownership transition with a host of advantages for business owners. Most often, the tax, financial and cultural advantages far outweigh the effort and cost of implementation. The professionals at Prairie Capital Advisors, Inc. have performed over 350 middle market transactions with closely-held corporations throughout a wide variety of industries. Leveraging our experience, business owners can make an informed ownership transition decision that will leave them happy now and for the long term.

For more information, contact:

Michael McGinley, Director

Prairie Capital Advisors

mmcginley@prairiecap.com

404.809.2443

The Cons

Although there are numerous benefits to an ESOP, they do require the assistance of professionals with an understanding of a unique combination of fields such as business valuation, transaction dynamics, tax law, regulatory compliance under ERISA and more. Even the perceived complexity of an ESOP can prove to be a detractor, when deciding whether or not to implement an ESOP. Other detractors can include the following: