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Maximize the Benefits of ESOPs

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An Employee Stock Ownership Plan ("ESOP") can be a very effective tool for transitioning ownership for construction companies. Unfortunately, many construction business owners are unaware of the benefits that ESOPs provide. As a result, many owners select alternative methods for transitioning ownership that fail to meet their own personal objectives, as well as the objectives of the company and its employees. These alternative strategies oftentimes result in the subject company being sold to a third party. In some cases, the result may be employee termination without cause, as well as consolidation of offices and plant operations (i.e. elimination of redundancies, etc.).

Tax Advantages

At a basic level, an ESOP is a qualified employee retirement plan governed by ERISA which functions as a tax-advantaged ownership transition vehicle for both business owners and sponsoring ESOP companies. Once the sponsoring company adopts the ESOP trust, the trust can then purchase shares of stock from the business owner using borrowed funds from the company, a bank or the selling shareholder(s).

There are two primary tax advantages related to ESOPs:

1. The first major tax advantage benefits the business owners who choose to transition ownership through an ESOP. If an ESOP acquires at least a 30% block of stock from the seller(s), and the company is a tax-paying C corporation at the time that the ESOP acquires the stock, the seller(s) may choose to defer paying capital gains taxes on their sale proceeds by electing section 1042 of the Internal Revenue Code.
2. The second major tax advantage of an ESOP benefits the sponsoring company. Companies can borrow money to fund ESOPs and repay these loans with pre-tax dollars, effectively making the cost of the entire transaction tax-deductible.

In addition to the deductibility of ESOP loan principal and interest, ESOP trusts themselves are tax-exempt entities. Therefore, if the sponsoring company elects to be taxed as a subchapter S corporation, the ESOP is exempt from paying federal income taxes on whatever percentage it owns of the company. In cases where the ESOP owns 100% of the stock, the company pays no federal and, in most cases, state income taxes.

In a nutshell, ESOPs are the most tax-advantaged ownership transition vehicles available to business owners today.

Selecting a Strong Advisory Team

Selecting a competent and experienced team of advisors that include fiduciary, financial, legal and administrative professionals is key to maximizing the benefit over the long term.

During the ESOP exploration process, a feasibility analysis should be performed to test various assumptions regarding the value of the company, the size of the transaction, financing options and the expected ESOP benefit delivered to employees over time.

Structural Considerations for Construction ESOP Transactions

Construction companies must take several factors into consideration before implementing an ESOP. Most construction companies have bonding requirements to bid certain projects, and leveraged ESOP transactions negatively impact the shareholder's equity. For this reason, it is important to discuss the transaction with the company's surety *before the transaction* to ensure that the appropriate bonding levels are maintained post-transaction.

Other critical factors that must be considered when exploring an ESOP transaction relate to project and customer mix as well as economic cycles. Most ESOP transactions result in the sponsoring company taking on non-productive debt to finance the transaction. As such, customer concentration and economic conditions are important to assess prior to the transaction.

ESOP transaction financing is non-productive in that it does not enhance the value of the business or provide growth opportunities. It is important that the management team understands the capital requirements necessary to operate and grow the business going forward.

Employee Ownership Culture

Creating a strong employee ownership culture is critical to ensuring the long-term success of the ESOP. ESOP committees function as internal advocacy groups and help to build employee morale and ownership culture. Though the only requirement to share financial information is in an annual employee participation statement, ESOP committees are oftentimes responsible for sharing important company information, spreading the employee ownership message and functioning as a resource for employees across the company. ESOP committee members are typically non-executive employees.

For employees to think and act like owners, they must understand what drives the business. In most instances, this boils down to understanding financial metrics and performance.

It is an excellent practice for ESOP companies to share certain financial information with all employees. According to John Case of *Inc. Magazine*, who coined the term "open-book management," "a company performs best when its people see themselves as partners in the business rather than as hired hands." The idea is to provide all employees with relevant financial information so that they can make better decisions about performing their own job functions. Research by the National Center for Employee Ownership ("NCEO") shows that companies that set up an ESOP increase sales, employment and productivity an average of 2.5% per year faster than would have been expected if they did not have an ESOP.

Planning for the Future

Developing the next generation of management is important to maximize value and perpetuate any business. Identifying, grooming and transitioning senior management professionals takes many years to accomplish. As such, it is a great practice to be constantly searching for and identifying future leaders of the company. The best ESOP companies have competent managers that execute based on a solid operating model.

ESOP participants have a mandatory "put" provision that requires the sponsoring company to purchase ESOP shares based on termination, retirement, disability or death. The company's requirement to meet this obligation is commonly referred to as ESOP repurchase liability.

ESOP repurchase liability is a future claim on cash flow and, therefore, must be managed alongside other ongoing capital requirements and retirement plan benefit expenses.

The time during which companies make ESOP account distributions is defined in the ESOP Plan and Trust agreement. It is important to revisit and reevaluate these distribution policies periodically to ensure that the policies that exist today are appropriate for the ever-changing dynamics of the business tomorrow.

Taking the First Step

One of the great features of an ESOP is the ability to provide business owners with an opportunity to transition ownership over a period of time rather than all at once. Many ESOP transactions are structured as minority interest transactions, whereby the ESOP acquires less than a 50% block of stock of the company. Minority interest ESOP transactions provide business owners with an opportunity to create liquidity and still control the company.

Many privately-owned construction companies are exceptional ESOP candidates due to the business owner's desire to reward longtime, dedicated employees as well as maintain independent operations and perpetuate the legacy of the business. There are about 650 construction companies with ESOPs today according to the NCEO. It is not enough, however, for business owners to just select an ESOP as a method for transitioning ownership. Rather, it is important that business owners understand ways to maximize the benefit of an ESOP to ensure the long-term success of the company and its employees.

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