ESOP BRIEF # 2

How to Establish an ESOP

By The ESOP Association

A summary of the key steps involved in designing and implementing an ESOP for a privately held company.

A company interested in establishing an Employee Stock Ownership Plan (ESOP) can select from a wide range of options to tailor a plan that is best suited to the company's particular needs and goals. A large, publicly traded company, for example, might make very different design choices than would a privately owned company.

Below is a summary of the key steps involved in designing and implementing an ESOP for a privately held company. (For information on the benefits of setting up an ESOP, please see ESOP Brief #1, *What is an ESOP?*)

Designing an ESOP and an ESOP Stock Purchase Transaction

Most companies will engage a qualified consultant to work with management to assess the feasibility of an ESOP for the particular company. (For help finding a consultant, see The ESOP Association website, which maintains a list of ESOP consultants located throughout the country.) The consultant will work to integrate the company-specific ESOP goals with applicable laws and regulations, and will conduct a financial analysis to ensure the company will be able to meet the financial commitments that result from implementing an ESOP.

The consultant sometimes will work with the company to prepare an estimate of the company's equity value for use as a working figure in the feasibility and design process. Other times, the consultant will work with a valuation firm engaged by the company to prepare the estimate of value.

If a stock purchase transaction is planned, the consultant will present different transaction structures for management and shareholders to consider, each of which generally will include analysis of the effect of the ESOP on company value and on existing shareholders. The consultant likely will introduce the company to a qualified ESOP attorney who can work with the consultant and the company to achieve the best possible ESOP outcome. The consultant also likely will introduce the company to a number of banks and other lenders with ESOP expertise.

The consultant, usually with the help of an ESOP attorney engaged by the company, will work with the company to design the specific provisions of the ESOP itself. The ESOP will be tailored to answer questions such as:

- Who will participate in the plan?
- How will stock be allocated to participants?
- What vesting schedule will apply to any employer contributions to the plan? (For more on vesting schedules, see ESOP Brief #1, What is an ESOP?)
- How will distributions of ESOP accounts be handled?
- How will voting rights be handled?
- Will the ESOP have an internal trustee or a professional independent trustee?

Increasingly, plan sponsors are turning to professional independent trustees, although many companies sponsoring an ESOP can and do handle this role in-house.

The answers to these and many more questions will lead to an ESOP that matches the company's goals in implementing the ESOP.

Repurchase Liability Studies

While not required for establishing an ESOP, companies should obtain a repurchase liability study that will evaluate the company's obligation to repurchase the stock of terminated ESOP participants. This "repurchase obligation" arises because privately held ESOP companies are required to make a market for the ESOP shares by buying back shares from terminated employees.

The repurchase obligation and its growth over time may be affected by 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.

If the repurchase obligation is projected at the outset, however, the company will be in the best possible position to plan for it and design the ESOP accordingly. In addition to plan design choices, companies can plan for and meet their ESOP repurchase obligation in a variety of ways, including making cash contributions to the ESOP on an annual basis or building up cash reserves outside the ESOP. (For more information, see ESOP Brief #20, *ESOP Repurchase Obligation* and the publication titled *ESOP Repurchase Obligation* available from The ESOP Association. Note: Members must sign in to the website to access the *ESOP Brief* for free and to purchase the publication at the member-discounted rate.)

Putting the ESOP in Place

Once the process of analyzing and designing the ESOP is complete, the company typically will have its ESOP attorney prepare a formal plan document that sets forth the specific terms and features of the ESOP.

The company must formally adopt the plan and trust documents that establish the ESOP and its attendant trust. A company must adopt its ESOP by the end of its fiscal year to claim a deduction for any company contributions for that fiscal tax year. Contributions to the ESOP for a given year, however, may be made up to the date required for filing the company's corporate tax return, including extensions.

To be eligible for the many tax benefits allowed for ESOPs, the plan must be a qualified ESOP under sections 401 (a) and 4975 (e)(7) of the Internal Revenue Code. The company's ESOP attorney will submit a copy of the plan documents to the Internal Revenue Service (IRS) with an application for a determination from the IRS that the plan meets the tax-qualification requirements.

Before shares are put into the ESOP, the ESOP trustee will engage an independent appraiser to value the company's stock. This appraisal likely will take several weeks or longer, since a significant amount of business data must be collected and analyzed by the appraiser.

(For more information, see ESOP Brief #14, *The Valuation of ESOP Stock*, and the publication titled *Valuing ESOP Shares*, available from The ESOP Association. Note: Members must sign in to the website to access the *ESOP Brief* for free and to purchase the publication at the member-discounted rate.)

At this time, the company will select a third party administrator ("TPA" or record keeper) to perform all of the record keeping for the ESOP. The TPA will maintain records for each ESOP participant, including the participant's vesting percentage and share allocations. The TPA also will perform all necessary nondiscrimination testing for the ESOP, prepare annual participant statements, and often will prepare distribution election forms for terminated participant distributions.

Implementing the ESOP Stock Purchase

If and when the company decides to move forward with a purchase of stock from one or more shareholders, a few more steps are necessary.

The trustee and its independent appraiser will evaluate the proposed transaction and, with the help of the trustee's ESOP attorney, negotiate the price and other terms of the proposed transaction with the selling shareholders, the company, and their attorneys.

At this time, arrangements must be made for securing any financing needed to complete the transaction. Banks, savings and loans, investment banking firms, mutual funds, and insurance companies in the business of lending money all may qualify as ESOP lenders. Many lending institutions are familiar with ESOP loan structures. If your local lending institution is unable to provide the necessary funding, your consultant or attorney may be able to help you locate a lender.

Conclusion

The process of setting up an ESOP is complex, but that should not discourage interested companies from investigating employee ownership. Most other business succession transactions—such as management buyouts or a sale of the business to a third-party buyer—also are complex. The ESOP process is understandable and manageable, and the many benefits that flow from ESOPs—such as increased employee motivation and substantial tax advantages—make the ESOP process worthwhile.

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