ESOP [Employee Share/Stock Ownership Plan]
– Why not?

Five Reasons Why You Should Not Do an ESOP - there are, alas, often sound reasons not to do an ESOP.

What Is an Employee Stock Ownership Plan?

Employee Stock Ownership Plans (ESOPs) are also known as Employee Share Ownership Plans. An ESOP business model provide a company's workforce with an ownership interest in the company. ESOPs allow companies to provide their employees with stock ownership, often at no up-front cost to the employees. Employee Stock Ownership Plan shares, however, are part of employees' remuneration for work performed.

How do ESOPs work?

ESOP shares are allocated to employees and may be held in an ESOP trust until the employee retires or leaves the company. The shares are then sold. ESOP plans are regulated by Employee Retirement Income Security Act (ERISA), a federal law that sets minimum standards for investment plans in private industry.

How does it benefit the company?

An ESOP is a technique of corporate finance as well as an employee benefit plan. An ESOP can be used to finance ownership transition, raise new equity capital, refinance outstanding debt, or acquire productive assets. ESOPs can also be used to increase cash flow by making plan contributions in stock instead of cash.

Since contributions to the ESOP are fully tax deductible, an employer can fund both the principal and the interest payments on an ESOP's debt service with pre-tax dollars.

Dividends on ESOP stock are tax deductible if they are applied to repay principal of the loan made to acquire the company stock on which the dividends were paid. Reducing loan principal with pre-

tax contributions and dividends generates significant tax savings, which in turn increases the ESOP company's cash flow. This favorable tax treatment means that ESOPs are effective vehicles for financing ownership transition.

Seven key points on how ESOPs work:

- ☐ ESOPs are highly tax-favored way for employees to share ownership in their company through a trust fund.
- ☐ Companies make tax-deductible contributions to the ESOP. ESOP contributions are either allocated to participant accounts or used to repay the ESOP loan.
- ☐ When a portion of the ESOP loan is paid, a portion of the shares is allocated to participant accounts.
- ☐ ESOPs allocate shares to each eligible employee every year, giving employees an increasing ownership stake as they gain seniority.
- ☐ The ESOP distributes these shares to employees to fund their retirement.
- ☐ All ESOP rules balance two competing interests—that they are flexible enough so that employers will be willing to set an ESOP, but not so flexible that they are easy to abuse.
- ☐ An ESOP company is worth what a willing buyer would pay for the company to have the rights to its future earnings and its current assets.

Why Not?

1. It's complicated.

ESOPs have complex operating rules and require significant oversight. Although outside advisors and ESOP Third Party Administration (TPA) firms can manage the details of the plan, the ESOP company needs an internal agent to champion the program and serve as an onsite resource. If the company does not staff the ESOP properly, they risk problems and potential violations. Small companies and those with unsophisticated accounting processes are particularly ill-suited to ESOPs because they lack the infrastructure to follow the protocols and provide the required support and information to employees.

2. It's got its ups and downs.

ESOPs are best suited to companies that have stable, predictable, secure patterns of revenue. Most ESOPs are leveraged, using some borrowed money to finance the exit transaction for the selling shareholder. Highly cyclical companies prone to volatility are poor candidates for deeply leveraged transactions and can be harmed by lender demands in a downturn. Moreover, cyclical companies

tend to shed people rapidly in the down part of the cycle and the ESOP can be seen as a poor employee benefit when the stock price drops rapidly.

3. It's lacking a successor.

If the current owner/executive wants to reduce his or her role significantly and there is no qualified replacement, then an ESOP is not the right fit. ESOPs effect an internal liquidity transaction with no third-party buyer–which means there is no infusion of new entrepreneurship and management. If the owner/key executive wants to retire soon, he or she will need a qualified successor to operate the company, handle the ESOP and manage the related transaction debt. If there is no successor immediately on the horizon, then an ESOP is an unsuitable strategy.

4. It's undercapitalized.

If the company requires significant additional capital to endure, they should avoid an ESOP. ESOPs use company cash flow to fund the purchase of shares from shareholders. If the company needs to use its cash flow for capital expenditures or additional working capital, the ESOP transaction can compete for this necessary capital, creating a diminished ESOP company.

5. It's incompatible with shareholders' wishes.

There may be another liquidity transaction that meets shareholder goals more effectively. Shareholders wanting to maximize cash at closing may find a third-party buyer such as a private equity fund or strategic buyer that offers a primarily cash deal. Such a buyer may be willing to pay a significant premium over the fair market value of the company on a financial basis. Companies and shareholders considering ESOPs should always examine whether there are other transactions that achieve their goals more effectively.

If any item in this quintet describes your company, then an ESOP is probably not the right option for your succession and liquidity.

Dennis Cagan, President of Caganco Incorporated, is a noted high-technology consultant, entrepreneur, executive, and board director. He has founded or co-founded over a dozen different companies, taken some public, been a CEO of both public and private companies (including a Unicorn), a venture capitalist, a private investor, and a long-time professional board member – over 68 corporate fiduciary boards. He founded his first software firm in 1968. In 1976 he founded his fifth company. In 1980 it was ranked #32 on the first *Inc. 100*. His first public board seat was when he took the company public in 1981. In 2011 he was inducted into the IT Hall of Fame - Channel Wing, administered by CompTIA. Mr. Cagan can be contacted at dennis@caganco.com.

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