



# ESOP Plan Design & Operation

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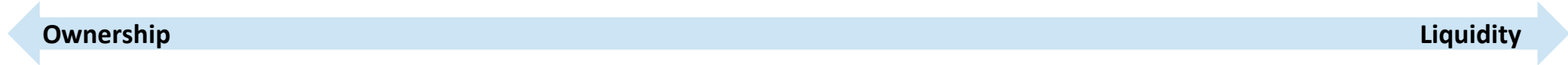


# Overview

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- Objectives of seller, company, and workforce
- Parameters of an ESOP transaction
- Feasibility
- Non-ESOP compensation strategies
- Operation of an ESOP
- Positive signs and red flags in plan design

# Ownership Transition Alternatives



|                       | Ownership   |  |   | Liquidity  |
|-----------------------|---|--|---|--|
|                       | <b>Dividend Recapitalization</b>  | <b>Leveraged Share Repurchase</b>  | <b>ESOP</b>   | <b>Sale to 3<sup>rd</sup> Party</b>  |
| <b>Benefits</b>       | <ul style="list-style-type: none"> <li>✓ Maintain full ownership</li> <li>✓ Relatively easy to execute</li> <li>✓ Low cost of debt relative to equity</li> <li>✓ Provide tax shelter</li> <li>✓ Allows for shelter diversification</li> </ul>   | <ul style="list-style-type: none"> <li>✓ Provides shareholder liquidity</li> <li>✓ Remaining ownership retains upside in growth</li> <li>✓ Value accretion opportunity</li> <li>✓ Liquidity for non-traded stock</li> </ul>                                | <ul style="list-style-type: none"> <li>✓ Maintain company legacy</li> <li>✓ Corporate and personal tax savings</li> <li>✓ Ownership incentives for employees</li> <li>✓ Flexibility on transition timeline</li> </ul> | <ul style="list-style-type: none"> <li>✓ Maximizes current payout</li> <li>✓ Eliminates business risk</li> <li>✓ Capitalizes on potential synergies and product expansion opportunities</li> <li>✓ Valuation not solely a result of capital markets environment</li> </ul> |
| <b>Considerations</b> | <ul style="list-style-type: none"> <li>✗ “Non productive” use of dry powder (i.e. no incremental cash flows)</li> <li>✗ Potentially limits flexibility for additional senior debt</li> <li>✗ Financial covenants</li> <li>✗ Provides only partial shareholder liquidity &amp; does not solve succession issues</li> </ul> | <ul style="list-style-type: none"> <li>✗ “Non productive” use of dry powder (i.e. no incremental cash flows)</li> <li>✗ Potentially limits flexibility for additional senior debt</li> <li>✗ Financial covenants</li> <li>✗ Selective liquidity</li> </ul> | <ul style="list-style-type: none"> <li>✗ Leveraged transaction</li> <li>✗ ESOP administration costs</li> <li>✗ Corporate obligation to repurchase shares</li> <li>✗ IRS/DOL scrutiny</li> </ul>                       | <ul style="list-style-type: none"> <li>✗ Industry performance and timing</li> <li>✗ Company positioning</li> <li>✗ Uncertainty of shareholders’ and management’s future roles</li> <li>✗ Integration and cultural issues</li> </ul>  |

# It is all about objectives...



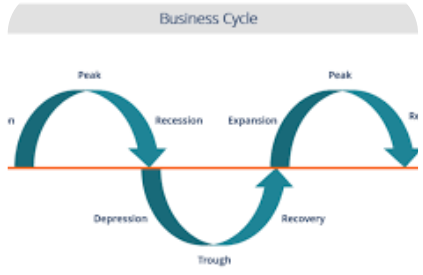
Timing



Future role in company



Key employees



Business cycle



How to get \$ out



Tax



Legacy



Employee & community benefit



Structure



Value and profitability

# Major ESOP Benefits

## Benefits to the Company

- Corporate tax savings
  - 100% ESOP owned S Corps **pay no federal income tax**
- Management team remains in place
- Preserves the culture, legacy, and employee base
- Recruiting and retention tool

## Benefits to the Seller

- Maintain company legacy
- Diversify wealth
- Flexibility on timing of exit
- Ability to defer capital gains tax in 1042 transaction (C Corp only)
- Can continue to be member of the management team or Board of Directors
- Creates a buyer for an eventual full exit

## Benefits to the Employees

- All full-time, U.S., non-union employees are eligible to participate
- Employees will receive allocation of company stock, at no cost to themselves
- Creates ownership mentality
- Management team can participate in certain non-qualified plans (i.e., phantom stock or SARs)

# What Makes a Good ESOP Candidate?

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*(... it depends on who you ask)*

1. Positive future cash flow
2. 3 to 5 year history of financial performance
3. More than \$1m in EBITDA
4. More than 20 employees
5. Seller expectations
  - ESOPs are financial buyers (as opposed to strategic buyers)
  - Willing to be paid out over time (in most cases)

# Responsibilities of key ESOP advisors

## Company Side Advisors – Engaged by Management

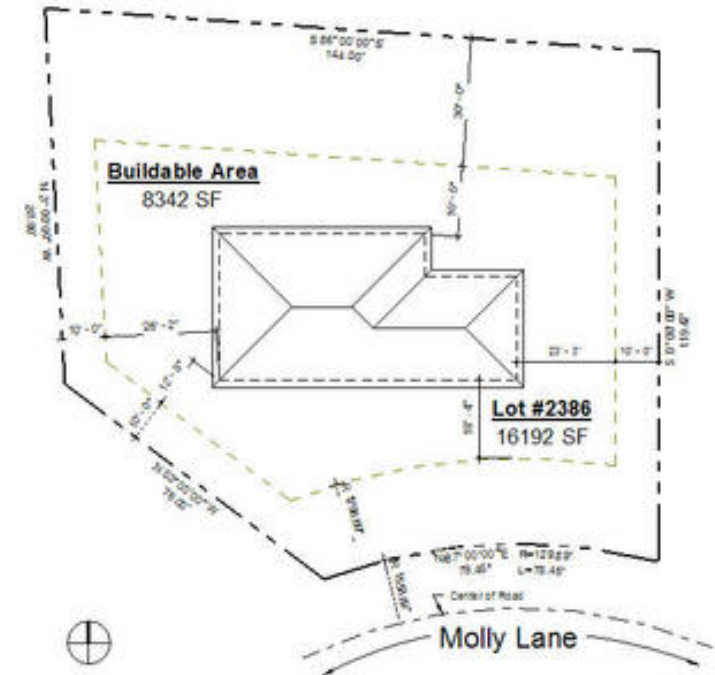
- **Financial Advisory Firm:**
  - Structure ESOP transaction
  - Negotiate with ESOP Trustee on key terms including valuation, seller note terms, and warrants
  - Advise Sellers on 1042 rollover structures
- **Lender**
  - Perform financial modeling of alternative scenarios
  - Advise on market terms for various financial instruments
  - Provide debt financing for formation and subsequent transactions
- **Company Legal Counsel**
  - Draft ESOP transaction documents including Plan document, ESOP loan agreements
  - Negotiate on behalf of company with lender and trustee on key legal issues
  - Prepares legal opinions as needed by bank and other parties
- **Third Party Administrator**
  - Provides recordkeeping for ESOP participants
  - Completes compliance testing
  - Can perform repurchase obligation analysis

## Trustee Side Advisors

- Trustee is engaged by Board of Directors
- Nominates individuals on the Board of Directors
- Serves as fiduciary on behalf of employees
- Sets the value of the stock at the time of the transaction and on an annual basis
- Votes most shareholder decisions unless passed through to participants. Votes unallocated shares for important corporate matters
- Manages assets of the ESOP trust
- **Trustee Legal Counsel (engaged by trustee)**
  - Negotiates with company on key terms
  - Reviews all legal documents
  - May prepare legal opinions
- **Trustee Financial Advisor (engaged by trustee)**
  - Issues fairness opinion on stock transactions opining on the company's fair market value and that the terms of the transaction and financing are fair to the buyer
  - Updates valuation on annual basis

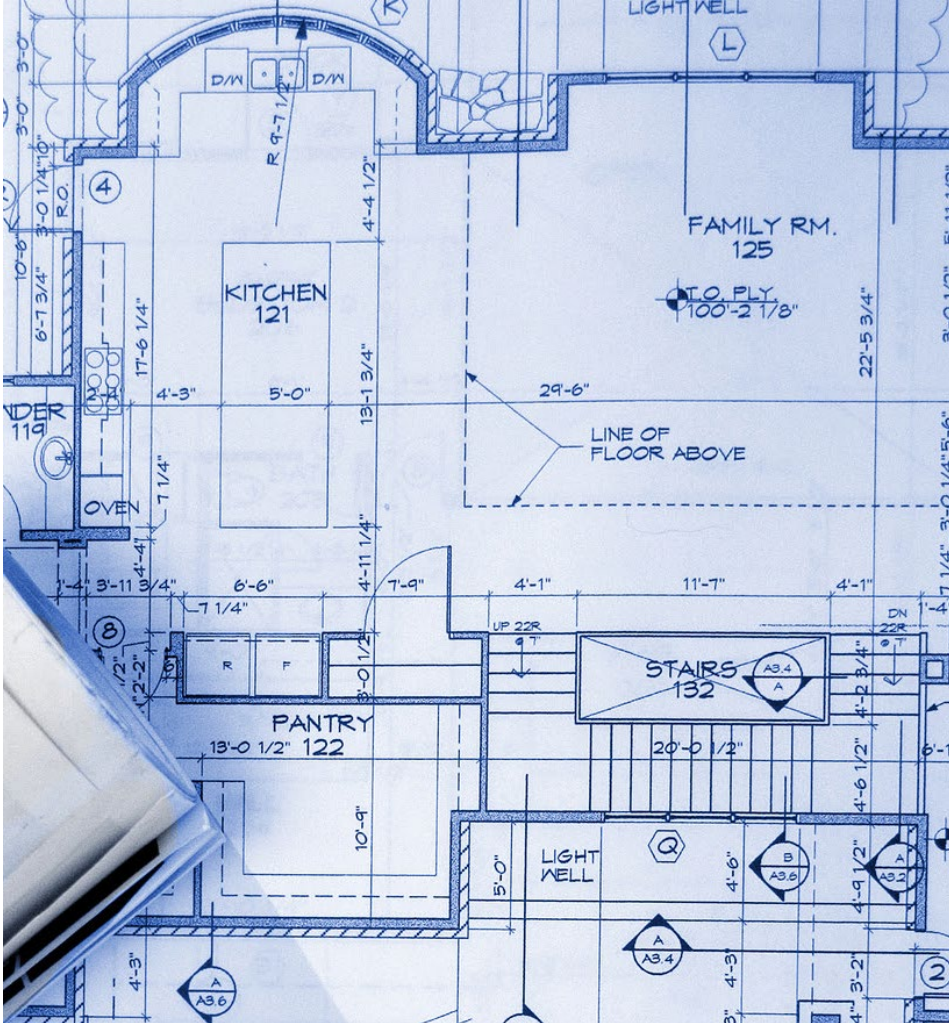
# Feasibility Analysis

- The purpose of a feasibility analysis is to provide the shareholders and company leaders with the information needed to reach good decisions
- Baseline financial model
  - How does the company look today?
  - 3 to 5 years of historical financial information
  - Project future cash flow
  - What do you want to accomplish with an ESOP?
  - Do you have the cash flow to fund the incremental leverage?





# Feasibility and Transaction Structuring



## Investigate

Weigh scenarios and options

- 30%, 50%, 100%?
- Amount of senior / bank financing?
- Warrants
- Equity incentive plans (next slide)

## Predict

Outcomes for:

- Company – Financing and cash flow
- Employees – Benefit level
- Shareholder – Payout and legacy

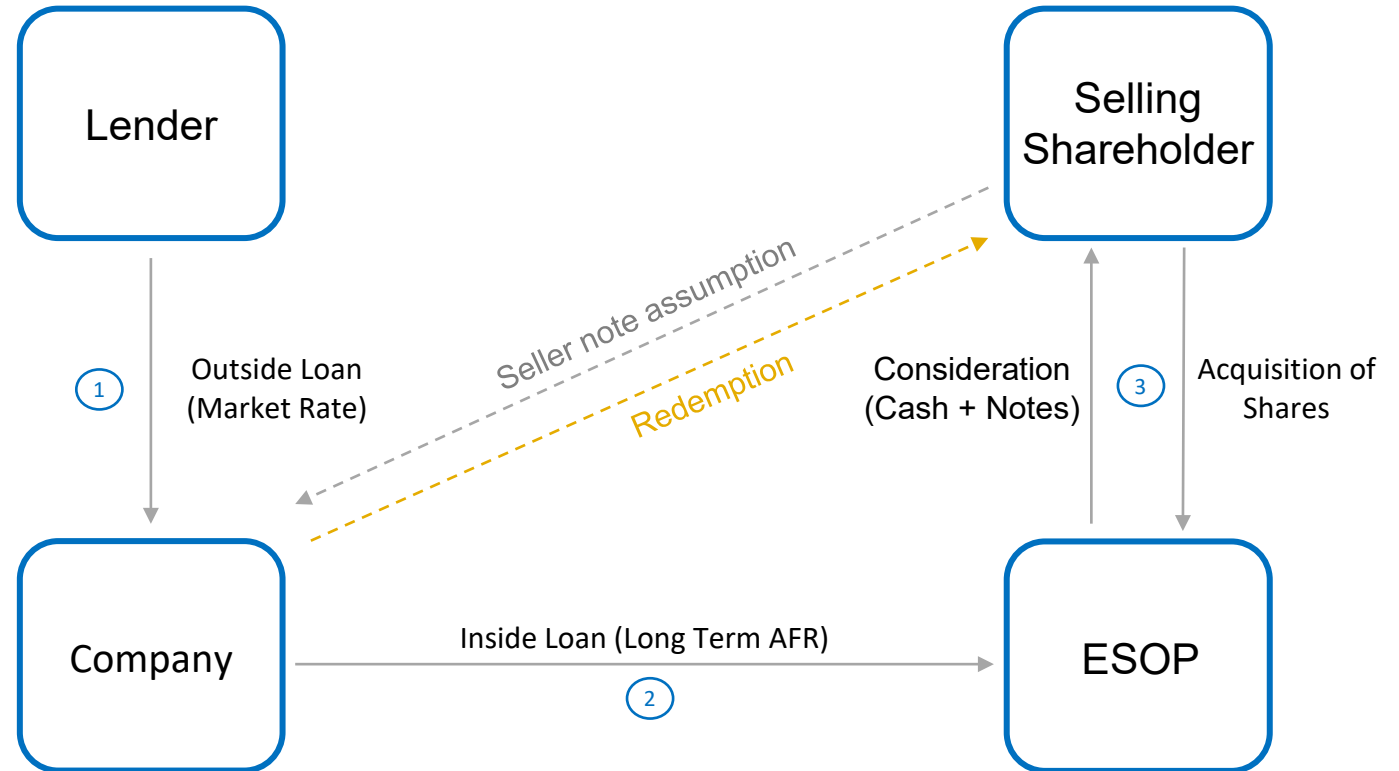
## Result

Feasibility phase provides blueprint to implement (or not)

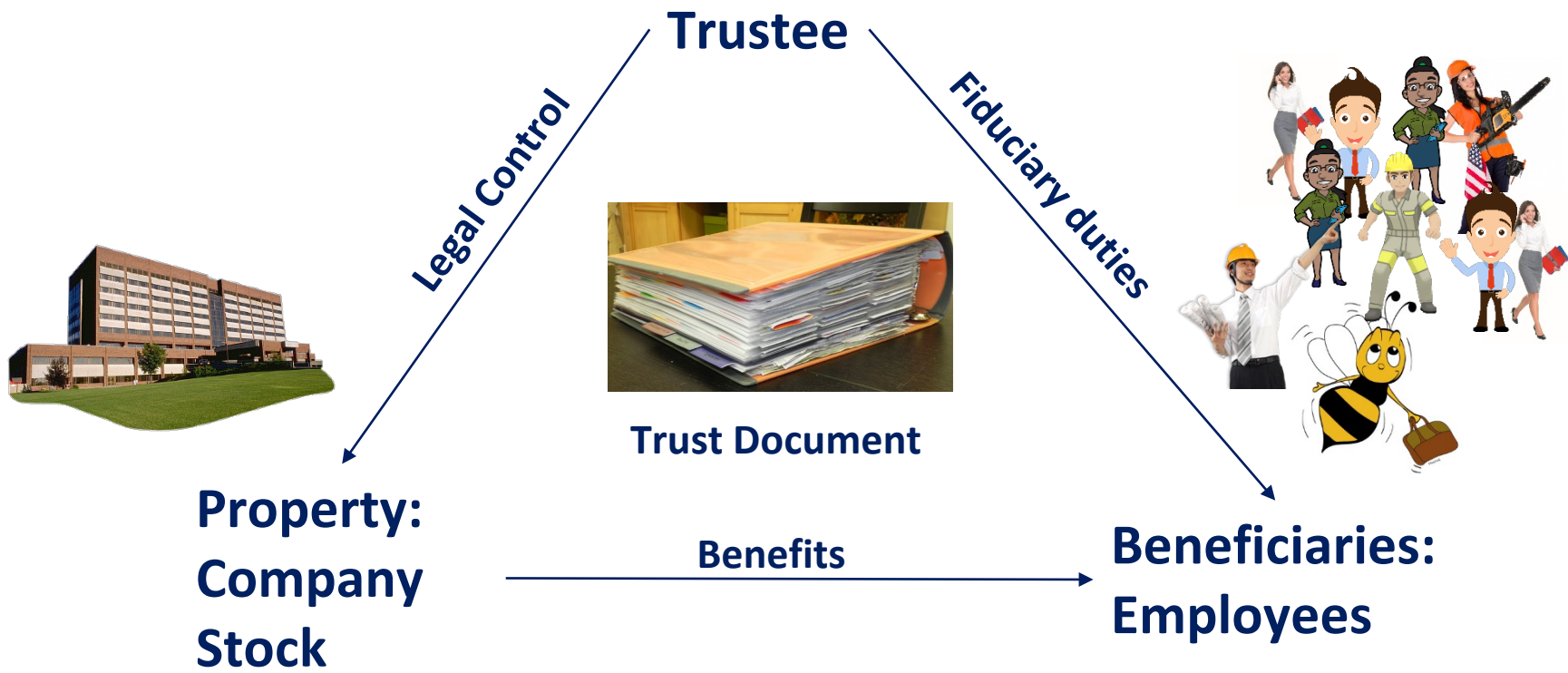
# Leveraged ESOP Transaction Structure

## Transaction Steps

1. A lender gives the sponsoring company cash in exchange for a market rate loan (outside loan)
  - a. It may be a combination of senior (bank) and subordinated financing
2. Company gives ESOP an inside loan
  - a. At long term applicable federal rate (intended to be cash neutral)
  - b. Determines benefit level to employees
3. The sale of shares to the ESOP:
  - a. ESOP buys shares from seller(s) at fair market value in exchange for cash and seller notes
  - b. The seller notes may be assumed on behalf on behalf of the ESOP by the company, increasing the size of the inside loan
  - c. **The company may redeem some shares directly from the selling shareholder**



# ESOP Trust Format



# Decisions in Plan Design

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- ERISA requires plans to be non-discriminatory
- Employee eligibility\*:
  - Age: 21
  - Hours of service: 1,000
  - U.S based
  - Employees subject to a collective bargaining agreement may be excluded
- Vesting\*:
  - 3-year cliff: (100% vested after 3 years) or
  - 5-year graded: (20% vested after first year, and 20% each year thereafter)

\*These limits can be made more favorable to employees if desired

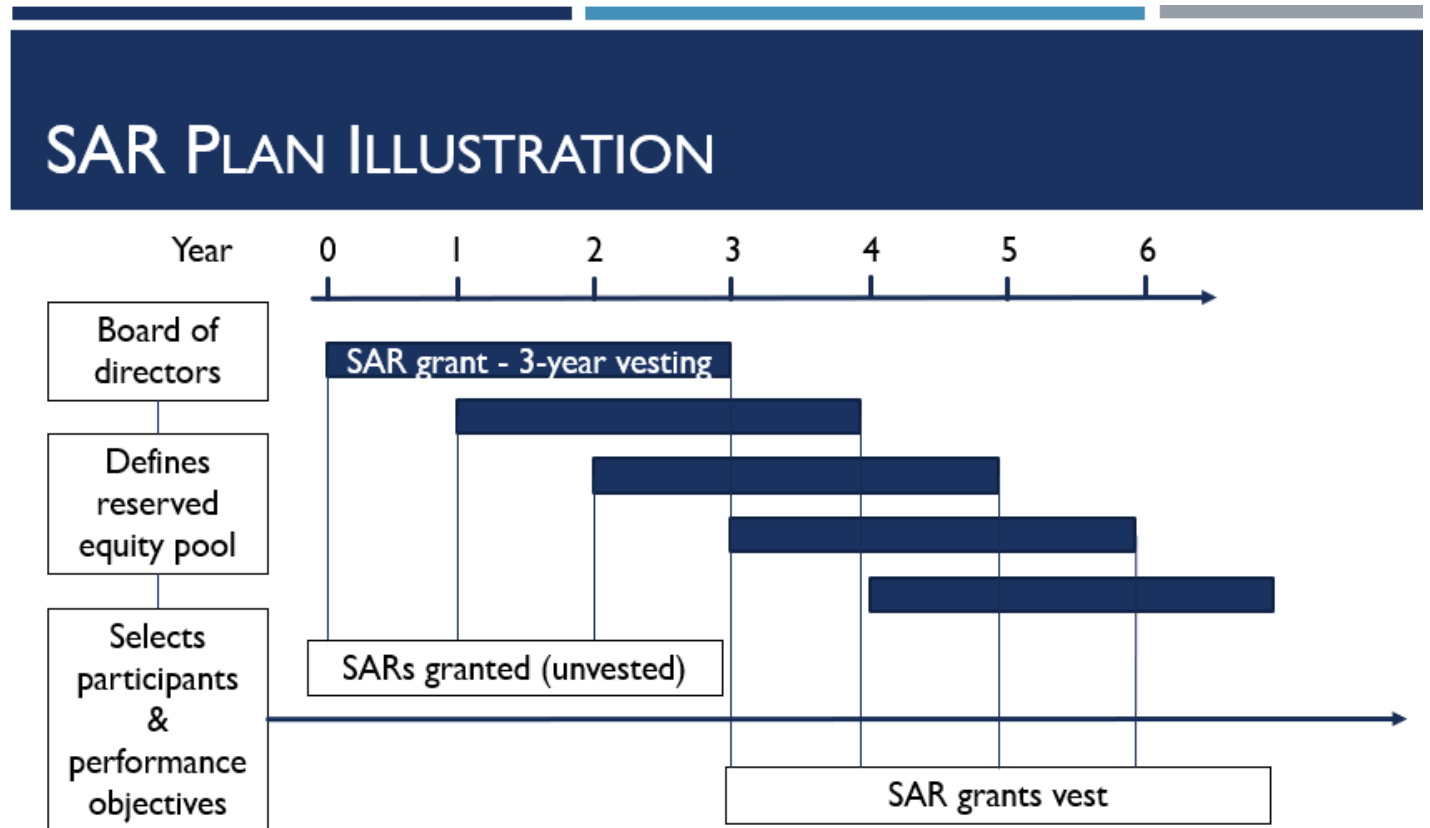
# Executive Compensation Strategies

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- Executive compensation is a board level determination
  - Compensation committee
  - Benchmarking
- Rank and file compensation is a senior leadership determination
- Compensation in general:
  - Short-term: Cash, cash bonuses
  - **Mid-term: Non-qualified deferred compensation, SARs, phantom stock**
  - Long-term: Retirement plans (including ESOP)

# Equity Incentives

- Synthetic equity is generally used with ESOPs
  - Stock appreciation rights (SARs)
  - Phantom stock
- Retention: keeping key management
- Performance: enhanced compensation based on company performance
- **Use a compensation committee!**



This is only one example of a SAR plan. There is considerable flexibility for plan design.

# Post-Implementation



TAKE A DEEP  
BREATH!



WORK WITH THIRD  
PARTY  
ADMINISTRATOR



EMPLOYEE  
ROLLOUT



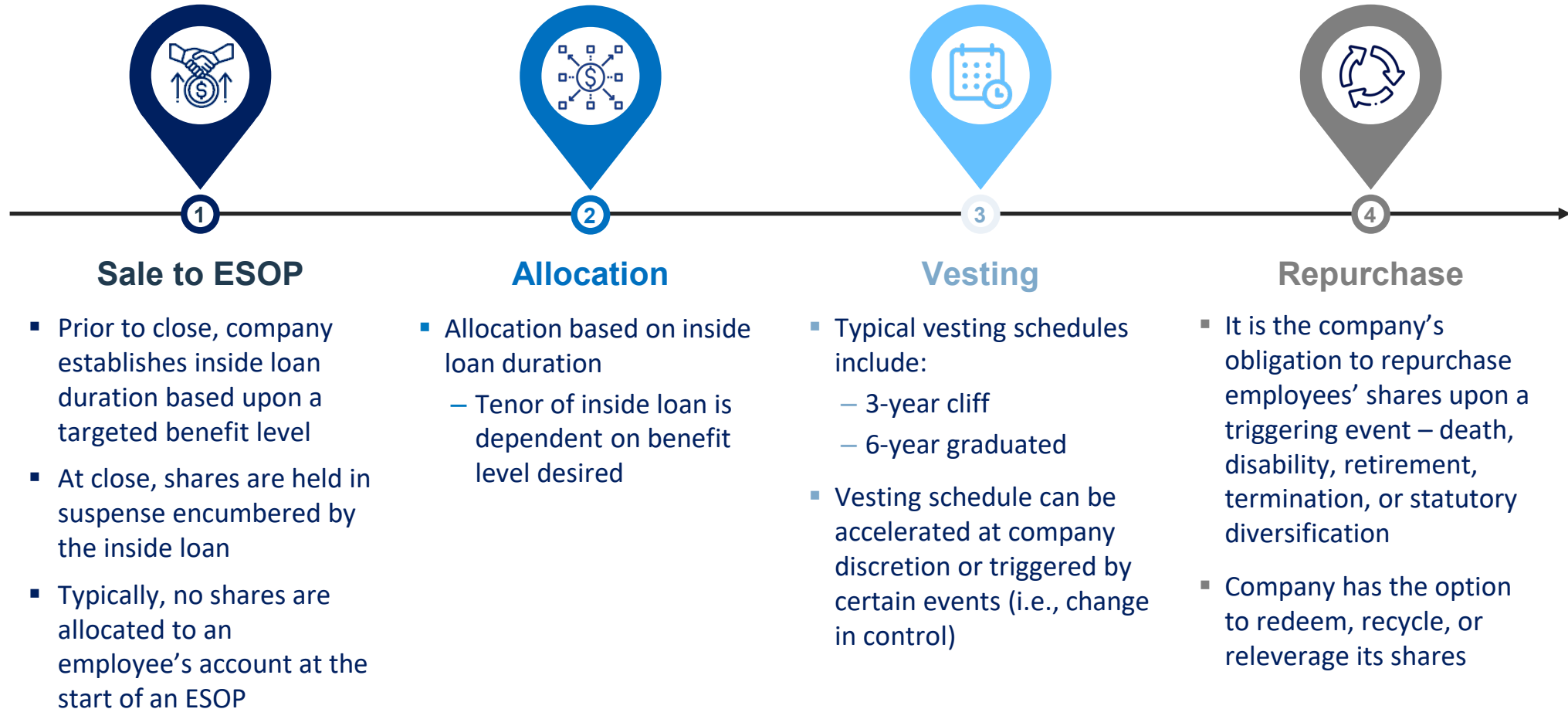
MANAGEMENT  
TRAINING



ESOP  
ACCOUNTING

# Allocating shares to the employees

Shares are allocated and vest over time

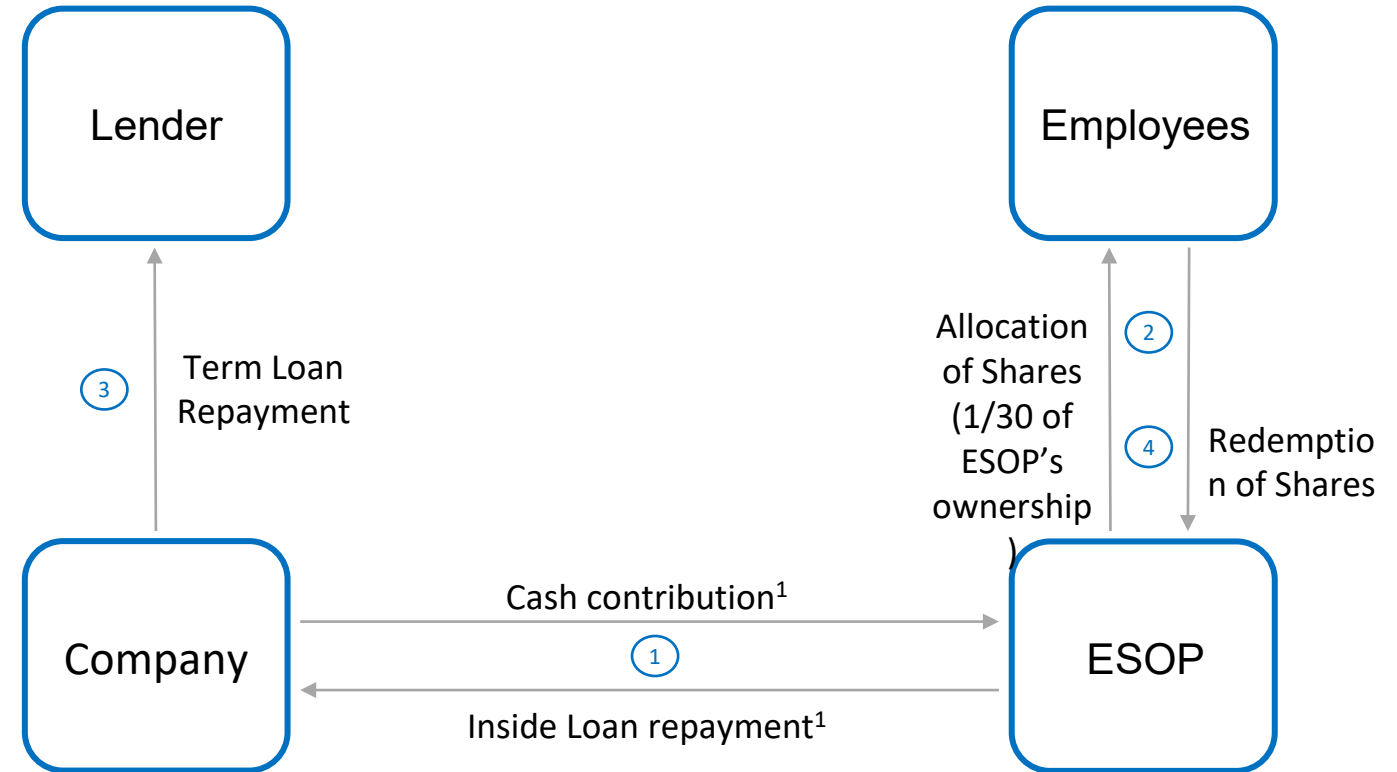




# Annual flow of funds after ESOP formation

## Post-Close Steps

1. The company makes cash contributions to the ESOP; the ESOP repays the Inside Loan to the company
  - a. The company makes a tax-deductible cash contribution to the ESOP
  - b. The ESOP immediately uses the cash contribution to repay the Inside Loan. The cash makes a round-trip and is repaid to the company
2. With every Inside Loan payment, shares are released from the ESOP Trust and allocated to individual employee's accounts, typically pro-rata based upon compensation
3. The company repays the Term Loan to the bank
4. On an ongoing basis, upon triggering events (death, disability, retirement, turnover, and diversification), the company has the obligation to buy shares from the eligible participants (repurchase obligation)



Financing terms assumptions:  
 1. Inside Loan tenor assumed to be 30 years

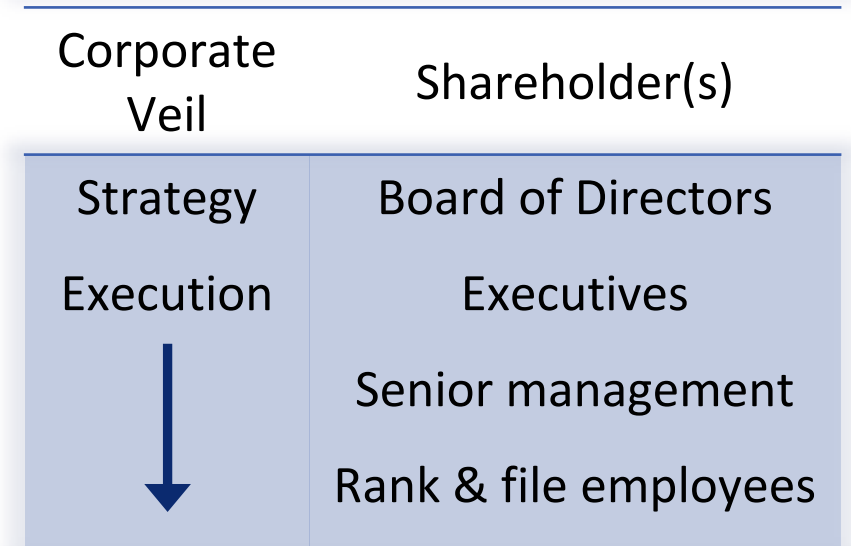
# Operation of ESOPs

- Administration
  - Annual valuation updates
  - Form 5500 and participant statements
  - Distributions/payouts
- Managing repurchase obligation
- Employee communications
- Corporate governance
  - Board structure and best practices
  - Compensation committee



# ESOP Governance

- Legally the same as any ordinary corporation, practically a little different
- Shareholder (ESOP Trustee) elects the board
  - Trustee is a passive investor
  - Duty to maximize plan benefits (prudence and loyalty)
- The board decides high level strategy, and holds top executives accountable
- Executives work with management to run day to day operations
- May also include aspects of “open book management” and democratic governance



# Positive Signs and Red Flags in Plan Design

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- Positive signs
  - Cash flow supports payout within expected timeframe
  - Tax synergies (100% S Corp ESOP is **income tax free**)
  - Legacy is important to seller
  - Benefit to employees is within reasonable range (2% to 20% of compensation)
- Red flags
  - Cash flow not supporting payout within reasonable time
  - Not enough employees
  - Cost of implementation and administration not offset by tax advantages
  - Benefit to employees is overly advantageous – repurchase obligation should be addressed at the time of formation

# Questions?

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