EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS): BENEFITS AND CHALLENGES

By Adam Gamble, President, Russ Davis Wholesale, Inc.

Russ Davis Wholesale started out as a very small family business. After putting everything they had into the company for nearly forty years, the family decided to use an ESOP as their exit strategy. Over a period of seventeen years, the family sold shares of the company to the ESOP. In 2008 we finally purchased the last of the family's stock and became 100% employee owned. The company is a great example of how employees and family owners can benefit from the transition to an ESOP. Many of you would be surprised by the growing number of ESOP companies, some with very familiar names in our industry, who are partially or wholly owned by an ESOP. For example, HyVee in IA, Publix in FL, and Brookshire Bros in TX are all retailers that have ESOPs. Also among the country's largest ESOPs, you can find names like KeHe Distributors out of IL and Schreiber Dairy out of WI. The unique ownership structure of an ESOP has become more attractive to many organizations over the last few decades, and that trend will likely continue unless changes in legislation make it more difficult to succeed as an employee-owned business.

ESOP, pronounced just like it is spelled, is an acronym for Employee Stock Ownership Plan. Most ESOPs come into being because of the desire for an exit strategy for families or individuals that own a business. Some organizations will convert all ownership to an ESOP, while others sell portions of ownership to the ESOP at different times. Unlike many profit sharing plans, ESOPs are a type of ownership structure recognized by the IRS just as Corporation, Partnership, LLC, and Sole Proprietor are. Under this ownership structure the shares are held by the Plan rather than individuals. Employees have accounts within the Plan that have cash and shares allocated to them. In this way, the ESOP acts as a qualified retirement plan at the same time as being part or all of the organization's ownership. Companies fund their ESOPs through cash contributions and dividends. This is perhaps an oversimplification of the mechanics of the system. For detailed information on ESOPs or technical questions you can find resources available from the ESOP association (https://www.esopassociation.org/explore/how-esops-work/learn-about-esops), or there are numerous financial services companies that specialize in them.

There are numerous intangible benefits, along with many tax-related benefits, to converting ownership to an ESOP versus selling to another corporation or investor. Some of these benefits include:

Tax benefits
Unlike a publicly traded organization, ESOPs are not forced into C-corp status. As an S-corp organization, ESOPs enjoy a lack of corporate income tax costs. Additionally, owners enjoy tax benefits of selling to an ESOP rather than other buyers.

Company Culture
Employee performance and retention often improve due to employees' belief in long-term success.

Employee retention
Vesting periods, Plan performance, and ESOP contributions give employees additional reasons to stay with the organization.

While ESOPs have some distinct benefits, they can also face some unique challenges such as:

Expenses
ESOPs are costly to set up. Depending on company performance and how the plan is financed, the payments and repurchase obligations can be significant costs in perpetuity.

Complicated
They are complex forms of ownership and can pose potential legal risks along with the possible need to outsource administration and hire independent trustees.

Limited
Because of the valuation process and shareholder rights, ESOPS are commonly limited to a market value stock price purchase. If an owner has a potential buyer that would pay a premium for strategic reasons they may be able to get more for their business than an ESOP could pay. For the same reasons an organization with an ESOP can be challenging to sell.

New ESOPs that have great success in their industries may see extreme stock value increases. While this is great for employees that got in at the right time, it can create a serious challenge for the organization down the road. Some mature ESOPs that grew quickly and then plateaued, have faced obligations from long-time employee retirements that have been crippling. It is a risk that can be mitigated with continual forecasting and strategic management of contributions and dividends. Many organizations that are handed down from one generation to another have owners that care about their long-term employees and the business's identity enough to take that into consideration when planning an exit strategy. Possibly the most significant benefit of starting an ESOP is the likelihood of sustaining the organization and its identity. While not impossible, it is less likely for an ESOP to be sold or broken up than most other forms of ownership.

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