Dynasty Capital Advisors
ESOP Capital Group

Thank you for your interests in Dynasty Capital Advisors. This booklet will outline the services we offer and the markets in which we participate. For a confidential interview, please feel free to give us a call.

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Hammond, Louisiana   New Orleans, Louisiana   Chattanooga, Tennessee   Houston, Texas

A message to business owners--

The decision to sell your company can be a difficult one, fraught with emotion and confusion. Finding the right buyer, one who will regard the company and its employees as you do, can be tough. Finding a buyer who will pay fair value, in cash, and who can close within the next few months may seem virtually impossible.

In your search for the right buyer, you may overlook one of the most favorable buyers available, the Employee Stock Ownership Plan. By selling your shares to an ESOP, you ensure the company will be in good hands, long after you're gone. Plus, the ESOP will pay fair market value for your shares, and can close in as little as 120 days. You will also enjoy the opportunity to fully defer, or even avoid taxes on the sale.

Often business owners associate ESOPs with large publicly-traded corporations. But the fact is, most ESOPs are found in companies with fewer than 100 employees. In fact, it can be feasible for an ESOP to acquire a company with just 10 employees.

A qualified ESOP advisor can provide a systematic approach to selling your company, one that adds form and structure to a normally disjointed process. Our approach follows a specific five-step procedure, which avoids the hit and miss exercise normally associated with selling a business.

While most ESOP advisory firms concentrate their efforts on the larger end of the transaction spectrum, Dynasty Capital Advisors has distinguished itself by focusing its ESOP services on smaller companies. We serve as the transaction quarterback, managing each step to a successful close. If you have seriously considered an exit strategy, and the foregoing sounds interesting, we would like to hear from you.

Sincerely,

Rogers Smith
President
Dynasty Capital Advisors

"Why should I consider selling my company to an ESOP?"

- ✓ The sales proceeds are sheltered from taxes
- ✓ The sale price is full fair market value
- ✓ Rapid turnaround time, in as little as 120 days
- ✓ The ability to sell stock rather than assets
- ✓ The ability to sell all or part of the company
- ✓ The ability to maintain control after the sale

The Decision to Sell

The decision to sell or transfer ownership of a company can be a difficult, emotionally-charged decision every business owner must ultimately face. When considering an exit strategy, the business owner needs solid, straightforward advice regarding the complex process of divesting a business interest.

Dynasty Capital Advisors is a full-service middle-market ESOP advisory firm catering to the needs of corporate owners. Our services include developing a valuation of the shares being sold, providing financing for the transaction, developing complete transaction documents, and leading the sale to a successful close. Our staff includes some of the industry's top professionals.

In fact, we are the only specialty ESOP transaction advisor within the Louisiana, Alabama and Mississippi markets. This specialization allows us to offer powerful tax-favored solutions to the corporate owner contemplating an exit strategy.

The ESOP Alternative

The Employee Stock Ownership Plan offers the business seller an alternative to selling his or her business interests to an outside third party. Such a transaction offers extremely powerful tax advantages compared to a third-party sale, in addition to allowing the seller the ability to liquefy fractional interests in the company, while maintaining complete management control.

Moreover, the seller receives cash for the full fair market value for his or her shares of corporate stock, which may otherwise be nonmarketable or difficult to sell on the open market. Likewise, apart from the largest of private sales, most third-party acquirers demand to buy assets rather than stock. ESOPs allow the seller to sell stock rather than assets, relieving the seller of future corporate liability.

ESOPs by Comparison

Generally, a business sale to a corporate acquirer is transacted through a combination of cash and stock to the seller. Likewise, a sale to a private investor normally requires the seller to finance part of the transaction. In order to analyze the effects of selling a business interest to an ESOP, versus selling to another corporation or private investor, we will establish the following assumptions:

- The seller desires an all-cash transaction.
- Buyer demands 10% discount for an all-cash sale.
- The business seller wishes to sell the entire company.
- The value of the company is $10 million.
- The combined Federal and state capital gains tax rate is 20%

Moreover, aside from the largest of privately-held business sales, buyers will normally require the transaction to be an asset sale rather than a stock sale. Part of the gain realized from an asset sale is generally taxed at the seller's ordinary income tax rate, making an ESOP sale even more favorable to the corporate seller.

	ESOP Sale	Third-party Sale
Initial Sale Price	$10,000,000	$10,000,000
Cash Discount	0	1,000,000
Negotiated Sale Price	10,000,000	9,000,000
Capital Gains Taxes	0	1,800,000
Sales Proceeds to Seller	$10,000,000	$7,200,000

Hence, by selling to an ESOP, rather than to a third-party acquirer, the seller realizes an immediate increase in sales proceeds of $2,800,000. Taxes on the sale are fully deferred. Likewise, when the seller spends a portion of the proceeds, only that portion is taxed, and then at only the lower capital gain tax rate.

Familiar ESOP Names

While Employee Stock Ownership Plans are not part of the every-day vernacular, there are over 11,000 ESOPs in place today. Some of the more familiar employee-owned companies include:

- Acadian Ambulance
- American Cast Iron Pipe
- Andersen Windows
- Ferrell Gas
- Fraenkel Furniture
- Graybar Electric
- Okonite Company
- Publix Supermarkets
- W.L. Gore Associates (Gore-Tex)

Surprisingly, most ESOPs are found in smaller companies; although the larger companies make most of the headlines. In fact, companies with as few as seven employees are enjoying the benefits of ESOP ownership.

The DCA Process

Dynasty Capital Advisors' buyout process follows five distinct steps, adding form and structure to a normally disjointed process. These steps include:

1. Feasibility Study: The results of this study determine if the proposed transaction is viable. It explores traditional due diligence areas such as market, organizational, management, operational, financial, and legal issues.

2. Financing: Dynasty Capital arranges financing for the proposed transaction. Financing may be in the form of debt instruments, equity investments, or a combination of the two.

3. Plan Development: Dynasty Capital's legal team develops the ESOP plan document, tailoring it to fit the individual needs of the client company.

4. Independent Valuation: In accordance with ESOP statutes, a business valuation is performed by an independent valuation analyst. Dynasty Capital Advisors maintains ties with some of the Country's leading ESOP valuation firms.

5. Closing: At the close of the transaction, the business interest is sold to the ESOP; and the selling shareholder receives a check for the fair market value of the shares sold.

The Initial Analysis

Our ESOP buyout process follows five individual steps. However, prior to formally engaging in any transaction, we offer our clients a free preliminary valuation analysis to determine a value range for the shares being sold. We then compare our findings with our client's value expectations. If our values are materially different, we will generally forego the transaction, or suggest other alternatives.

The laws governing employee stock ownership plans require that the ESOP pay no more than fair market value for the shares it acquires. Accordingly, our free preliminary valuation analysis alerts us early in the relationship to any valuation concerns.

Firm Background

Dynasty Capital Advisors was founded in 1998 in Hammond, Louisiana with the mission to fill a professional void in the deep south for a national-caliber mergers and acquisitions intermediary specializing in Employee Stock Ownership Plans. Since then, Dynasty Capital has added offices in New Orleans, Chattanooga, and Houston.

Dynasty Capital Advisors is a middle-market ESOP advisory firm with clients spanning evenly across industry sectors. While most of our clients have been concentrated in the Louisiana and Alabama markets, our reach is rapidly extending nationwide.

Our ESOP advisory services focus on leveraged employee buyouts, wherein favorable tax treatment on the gains resulting from a corporate sale is of interest to sellers of privately-held businesses. Dynasty Capital Advisors is the only specialty ESOP advisory firm operating in Louisiana, Alabama, and Mississippi.

Our Principals

The professionals and staff of Dynasty Capital Advisors include some of the industry's top experts, each possessing unique, yet complimentary backgrounds and specializations. Each team member carries hands-on experience in a range of industry sectors, with engagement experiences spanning from the Fortune 500 multinational to the seed-stage start-up.

G. Rogers Smith, Jr., President. Prior to founding Dynasty Capital Advisors, Mr. Smith held positions with two leading management consultancies and one of the region's largest banking firms. His specialized areas of practice include employee buyouts and mergers & acquisitions consulting. A frequent lecturer, Mr. Smith has instructed classes at Tulane University and at the University of New Orleans. He holds memberships in the National Center for Employee Ownership, the American Society of Appraisers, and the National ESOP Association. Mr. Smith received his Master of Business Administration with a concentration in finance from Louisiana State University, and his B.A. in finance from Southeastern Louisiana University.

Martyn F. E. Walker, Vice President. Mr. Walker's practice focuses on leveraged employee buyouts via Employee Stock Ownership Plans, and post-transaction integration. Prior to joining Dynasty Capital Advisors, Mr. Walker held senior and board level positions with one of England's leading management consultancies. A British national, fluent in four languages, Mr. Walker has represented clients in more than eight countries. He holds memberships in the National Center for Employee Ownership and in the National ESOP Association. Mr. Walker earned a B.S. in computer science from the Massachusetts Institute of Technology, and an HND from the Essex School of London.

Jeffrey P. Fabre, Vice President. Mr. Fabre manages the firm's research and analysis activities. Prior to joining Dynasty Capital Advisors, Mr. Fabre held marketing research and analysis positions with one of the nations largest banks and a financial services firm. Mr. Fabre received a Master of Business Administration and a B.A. in Management from Southeastern Louisiana University.

James A. West, Vice President. Mr. West develops new business opportunities and secures new clients for Dynasty. Prior to joining Dynasty Capital Advisors, Mr. West operated a Mergers and Acquisitions firm in Tennessee preceded by a 20 year career in commercial real estate. Mr. West is fluent in Spanish and is also a professional trombonist.

Vaughn S. Lane, Regional Director. Mr. Lane manages the firm's business development and client service activities in the southeastern region. Mr. Lane's background includes 25 years of experience in corporate finance and management consulting. Further, Mr. Lane has owned several industrial service corporations, in addition to an independent management consultancy. Between 1967 and 1972 Mr. Lane was a helicopter pilot and combat mission commander in the U.S. Army. He received his Master of Business Administration from Stetson University, and his B.S. in management from Embry-Riddle University.

Everett Stewart, Vice President. Mr. Stewart is responsible for business development and new client selection. Prior to joining Dynasty Capital Advisors, Mr. Stewart was a vice president with VR M&A in Nashville, and a senior consultant with Deloitte Tohmatsu in Tokyo, Japan. Prior to this Mr. Stewart managed the sales efforts of Excel Global Logistics in Africa, the Middle East, and India. With his notable international experience, Mr. Stewart is fluent in Japanese and knowledgeable in French and Mandarin. Mr. Stewart received his Master of Business Administration with concentrations in operations and finance from Vanderbilt University, and his B.A. with honors in economics and East Asian language & culture from Indiana University.

ESOP Advisory Services

Employee Stock Ownership Plans have become an integral part of the American financial landscape over the last 25 years. Almost unknown until 1974 when Congress gave ESOPs a formal statutory structure, the number of companies having ESOPs has grown to more than 11,000.

Dynasty Capital has become the Southeast's premier ESOP advisor by leveraging the benefits and tax incentives provided by ESOPs in the mergers and acquisitions environment. For an owner of a privately-held corporation contemplating a divestiture of his or her interests, an ESOP can provide a market for the shares, while allowing the seller to defer or even avoid taxation on the gains.

Moreover, employees are not required to contribute personal funds, borrow for the acquisition, or provide any personal guaranties. Rather, the purchase is conducted in the form of a contribution, similar to other tax-qualified plans. In the end, the company owner receives a check for the fair market value of the company; and the employees receive a solid retirement plan invested in the company's shares.

Dynasty Capital offers turnkey ESOP solutions to business owners' transactional needs. Typically an employee buyout requires the services of an array of professional teams including attorneys, accountants, bankers, and valuation analysts. We maintain associations with some of the Nation's leading ESOP professionals. Accordingly, we are able to quarterback each transaction seamlessly from the initial consultation to a successful close.

Non-ESOP Support

Should an ESOP transaction not be feasible or desired, Dynasty Capital Advisors maintains ongoing relationships with several industry-leading business intermediaries and brokers. Therefore, we are available to make a private introduction to one of these firms should the seller so desire.

Likewise, we maintain ties to some of the Country's top private equity firms. These firms make financial and strategic investments in select middle-market companies throughout the Southeast. We are available to introduce sellers to such firms should an ESOP transaction not be undertaken.

This flexibility allows us to provide our clients with solid, honest exit strategy solutions…even if it means we don't get the job.

ESOP Articles and Information

- *Ten Fables About Selling Your Company to an ESOP*, by Rogers Smith
- *Employee Stock Ownership Plans can Benefit Owners, Workers Alike*, by Jane Applegate
- *How ESOPs Work*, by Corey Rosen

Ten Fables About Selling Your Company to an ESOP

BY ROGERS SMITH

As a business owner, the thought of selling your company probably produces a number of emotional responses: fear, excitement, nervousness, exhilaration, confusion. Likewise, introducing an exit vehicle which is conceptually new to most small business owners, such as an Employee Stock Ownership Plan (ESOP), can be downright frightening. Therefore, I feel the best way to introduce discussion about ESOPs is by outlining what ESOPs are not.

There are many misconceptions about ESOPs being fielded today, both in the press, and by professionals from various fields. More importantly, we as business owners sometimes shun ideas that are new to us; or we build our own points of view from sometimes-imperfect information. For this reason, I will attempt to dispel ten misconceptions or fables about selling your company to an ESOP.

ESOP Fable #1: ***It would be easier just to sell my company to a third party.***

Business owners will often have the following belief: "When the time comes to retire, I will simply sell my company to an interested buyer." Unfortunately, it's not that easy. Finding a qualified buyer for a privately-held business can be a daunting task. In fact, the entire business brokerage industry devotes most of its energies to simply finding qualified buyers for business sellers. A qualified buyer is one that can afford to acquire the business, and is ready and willing to pay a fair price. Finding such a buyer generally involves advertising the business for sale, interviewing potential candidates, weeding out the unqualified prospects, and negotiating a selling price and other terms.

Even if you have been approached in the past by parties expressing interests in buying your company, getting an actual commitment to purchase can often be discouraging. Likewise, a little research often reveals that many of those "interested parties" are simply the result of over-zealous business brokers seeking new clients, rather than genuine qualified buyers interested specifically in acquiring your company.

Herein lies one of the key benefits of selling your company to an Employee Stock Ownership Plan. There is no need to find a qualified buyer, or to otherwise put your company on the market. The ESOP actually makes a market for your stock. The ESOP will pay fair market value for your stock, in cash. And consummating the sale can take considerably less time than a typical third-party sale, often in less than 120 days. Moreover, an ESOP provides a systematic approach to selling your company, one that adds form and structure to a normally disjointed process.

ESOP Fable #2: ***ESOPs are only applicable to very large corporations.***

There is a commonly held notion that the benefits offered by Employee Stock Ownership Plans are available only to the largest of corporations. In reality, most ESOPs are found in companies with fewer than 100 employees. Of course, the larger ESOPs from companies such as Publix Supermarkets, United Airlines and W.L Gore of Gore-Tex get the headlines; but ESOPs can be found in companies with as few as ten employees.

ESOP Fable #3: ***If I sell to an ESOP, I will loose control of the company.***

One of the major concerns a business owner can have is a perceived loss of control after selling an interest in his or her company to an ESOP, particularly if only a partial interest is sold. However, in most ESOP sales, the selling owner will elect to be the Trustee of the ESOP. The ESOP Trustee is empowered to vote all of the shares of stock owned by the plan. This means if you sell your shares to an ESOP, you can maintain full control of the company, for as long as you choose.

Only in certain circumstances, such as the liquidation of the business, do employees actually vote their shares of stock. Thus, a major headache of theoretically having to consult employees and have them vote on every corporate decision is effectively removed, leaving the issues instead to the Trustee.

ESOP Fable #4: ***My employees cannot afford to buy my company.***

One sentiment we encounter often in the field can be paraphrased as, "How can my employees even consider buying my company…most live paycheck to paycheck." The answer is simply, the employees do not have to pay for the company. The employees do not contribute personal funds, or even provide credit for the transaction. Funding is provided by specialty lending institutions whose focus is solely on funding ESOP buyouts.

Over time, ownership is passed from the ESOP to the employees in the form of a contribution, in exchange for their dedication and loyalty to the company. The longer the employee remains with the company, the larger will be his or her ownership stake. The ESOP is, in essence, a retirement plan, funded by stock in the company.

Therefore, the motivational aspects of these plans can be extremely powerful for the employees. In fact, most ESOP companies experience lower employee turnover after implementing the plans; and according to several national studies, ESOP companies tend to be 8-12% more profitable than their non-ESOP counterparts.

ESOP Fable #5: ***An ESOP won't pay me what my company is worth.***

Most business owners have ideas of what their companies are worth. And many feel by selling to the employees through an ESOP, they will not realize full value for their shares. The truth is if you sell your company to an ESOP, you will be paid full fair market value. The determination of just what is fair market value will be made by an independent valuation analyst. This removes the need to endlessly negotiate the sale price of the shares being sold.

The business valuation profession uses sophisticated yet standardized techniques to determine the fair market value of a business interest. Independence of the valuation analyst is required, which effectively removes any biases in favor of either the buyer or the seller. Therefore, you can be confident you will receive a fair price for your company when selling to an Employee Stock Ownership Plan.

Moreover, by selling your company to an ESOP, you will have the opportunity to fully defer all taxes on the sales proceeds. This means not only will you receive full value for your company, but you will also enjoy powerful tax advantages as a result of selling to an ESOP, which otherwise would not have been available through selling to a third party.

ESOP Fable #6: ***ESOPs are new and untested.***

When first introduced to the concepts of employee ownership and ESOPs, business owners are often skeptical of the idea, considering such transactions as new and untested. Yet, ESOPs have been around for more than 25 years. The statutory framework for today's ESOP was developed by Congress in 1974 to broaden the ownership of capital, and to provide employees with a stake in the ownership of their employers. To induce companies to create ESOPs, Congress developed powerful tax incentives for both existing owners and their companies. In 1974 there were less than 200 ESOPs. Today there are more than 11,500 ESOPs in place, covering more than 10 million employees, and controlling over $400 billion in company stock, or roughly 8% of all U.S. stocks. By comparison, 401K plans control roughly half this amount, or $200 billion in company stock.

ESOP Fable #7: ***Lenders won't be interested in financing my buyout.***

One concern of business owners we frequently encounter is whether a lender would be interested in financing the buyout of their businesses. The answer is yes, if you have the right lender. As a general rule, conventional business lenders will not be interested in financing an ESOP buyout. This can be attributed to their lack of ESOP knowledge, and to a general distaste for wandering outside of their core business practices.

Specialty lenders, on the other hand, are quite interested in financing ESOP buyouts. In fact, some specialty lenders focus their practices entirely on ESOPs and employee buyouts. And the loan terms for ESOP loans can be considerably more favorable than those of conventional loans. This is due, in part, to ESOP loans generally having lower default rates than those of any other type of commercial loan.

Further, your company will have the ability to deduct from taxes not only the interest paid on the buyout loan, but also the principal payments. This lowers the company's effective borrowing costs by roughly 30%. As a result, the ESOP can be in a better position to buy your shares when compared to a third party acquirer, who will not have access to such favorable tax treatment.

ESOP Fable #8: ***I am concerned with the thought of employees selling their stock to someone else.***

An obvious fear to business owners considering selling an interest in their companies is whether employee/shareholders can simply sell their shares to anyone on the street. This concern is addressed by specific restrictions placed on the shares in employees' stock accounts. Most plan documents give the company a specific right of first refusal on all stock contributed to employees.

What this means is your employees, upon distribution, must offer to sell their shares back to the company. This is the mechanism through which the employees receive their retirement funds; and it keeps shares from falling into the hands of unrelated companies or individuals. Further, all shares are distributed with a back-up liquidity measure called a put option. This put option allows the retiring employee to sell (or put) his or her shares back to the company at fair market value. Both the stock restriction and the put option ensure liquidity for the employee, and trade protection for the company.

ESOP Fable #9: ***I will not be able to sell a part of my company, while leaving the other part to my children.***

Often business owners would like to leave their businesses to their children; but must also fund their own retirement years. A logical solution would be to sell a partial interest in the company, and leave the rest to the children. However, selling a partial interest in a privately-held company can be nearly impossible, unless the seller will agree to a steep discount in price.

ESOPs, on the other hand, will allow you to sell an interest in your company to its employees, at fair market value, and donate or sell the remaining interest to your children. Under this scenario, your children can remain in control of the company, while you receive a lump sum distribution for the interest sold to the ESOP.

ESOP Fable #10: ***An ESOP will remedy all of my company's problems.***

While the Employee Stock Ownership Plan is a powerful financing vehicle, it is not a panacea. If your company has fundamental financial, organizational, or operational problems, an ESOP may not be the most effective remedy. ESOPs work best in healthy companies or in companies demonstrating potential for future success.

Likewise, installing an ESOP in a healthy company does not ensure improved performance. In order to realize the greatest performance improvement from an ESOP, the employees must be educated about the benefits offered; and this education process must be reinforced regularly. Otherwise, skeptical employees will consider the plan as just another management scheme.

The Employee Stock Ownership Plan has become one of the most powerful vehicles of corporate finance available to owners of privately-held businesses. Accordingly, its success can be measured by the rapid growth in the number of plans established, from less that 200 in 1974, to more than 11,500 today. By dispelling some of the most commonly held ESOP misconceptions, and by studying the opportunities offered by such plans, company owners will find the ESOP offers some significant advantages over selling a business to the general public.

Rogers Smith is the president of Dynasty Capital Advisors, an ESOP investment banking firm headquartered in Hammond, Louisiana. He can be reached by phone at (888) 823-5556, or by email at rogers@dynastycapital.net.

Employee Stock Ownership Plans Can Benefit Business Owners, Workers Alike

By Jane Applegate

When a small-business owner wants to cash out or pull some equity out of his or her business, there are several options. One of the best options for both employers and employees is an employee stock-ownership plan, or ESOP.

ESOPs allow business owners to sell company shares to employees at a fair price. ESOPs also provide significant tax benefits for owners while providing retirement benefits for workers.

Workers who own shares usually feel more loyal and driven to perform, so productivity increases and, as a result, their stock increases in value. An ESOP can also help finance the expansion of the business, so everyone benefits. ESOPs work especially well for small, stable companies with fewer than 100 loyal, long-time employees.

"The employees get all the economic benefits of being a shareholder without the liabilities."
- Steve Bohn, benefits expert

"The employees get all the economic benefits of being a shareholder without the liabilities," said benefits expert Steve Bohn, formerly of Merrill Lynch and now at Lazard Asset Management.

Bohn, who had 21 ESOPs in progress when we spoke, said there are about 200 to 400 ESOPs set up every year. They work well for a variety of companies in a wide cross section of industries.

ESOPs a popular choice

America has about 10,000 employee stock-ownership plans, according to the ESOP Association in Washington, D.C. In a 1995 study by the ESOP Association, 60 percent of member companies said productivity increased after the ESOP was put into place. Eighty-six percent of those surveyed said creating the ESOP was a "good decision"; only 2 percent said it was a "bad decision."

One huge perk for business owners is the ability to deduct both the principal and interest on any loan used to finance an ESOP.

"In essence, you are sheltering a bunch of income that you used to pay taxes on," said Bohn. "You can use the entire distribution tax-free."

If you are thinking of creating an ESOP, you'll need a team made up of an attorney, an accountant, and a banker or brokerage to provide the cash to buy the shares. You'll also need a skilled administrator to keep track of the paperwork and distribute shares when employees quit or retire. Most employees are vested in the plan after five to seven years.

"We were the ideal company for an ESOP," said Skip Musgraves, chief financial officer for Tesco Williamsen in Salt Lake City, Utah. "It doesn't work for everybody, but in our case it was a perfect fit."

The company, which began making covered wagons in the 1890s and now makes truck-mounted heavy equipment, had merged with another equipment maker in the 1980s and soon after hit a sales slump. "Two struggling companies came together, and it was a rough road," said Musgraves.

In 1994 the company president wanted to liquify some of his investment and was looking for tax benefits, Musgraves said. Tesco Williamsen did a leveraged ESOP, borrowing under $5 million from its local commercial bank to set up the plan.

Every dollar spent paying off the loan is tax deductible, "dollar for dollar," said Musgraves.

The 85 loyal employees each received stock in the company and are fully vested seven years from October 1, 1994, when the plan was created. "They not only have the money they make in salary but a piece of the action," said Musgraves.

He said it is important to explain the ESOP process to employees to make sure they fully understand the benefits. They also need to know it doesn't cost them anything, because only the company invests in the plan. "Make sure your employees understand what a wonderful, rich benefit it is," said Musgraves.

If you are interested in finding out more about ESOPs, contact the ESOP Association at 1726 M St., NW, Washington, D.C. 20036; (202) 293-2971.

Excerpted from **201 Great Ideas for Your Small Business**, *Copyright 1998 by Jane Applegate. Published by arrangement with Bloomberg Press.*

How ESOPs Work

The ESOP (Employee Stock Ownership Plan)

By Corey Rosen

Employee ownership can be accomplished in a variety of ways. Employees can buy stock directly, be given it as a bonus, can receive stock options, or obtain stock through a profit sharing plan. Some employees become owners through worker cooperatives where everyone has an equal vote. But by far the most common form of employee ownership in the U.S. is the ESOP, or employee stock ownership plan. Almost unknown until 1974, about 10,700 companies now have these plans, covering over 8.7 million employees.

Companies can use ESOPs for a variety of purposes. While most of the press attention has focused on ESOPs in public companies used as a takeover defense, this explains less than 2% of all ESOPs. Nor are buyouts of failing companies (1% of the plans) or exchanges of stock for concessions (3% of the plans) common purposes. Instead, ESOPs are most commonly used to provide a market for the shares of departing owners of successful closely held companies, to motivate and reward employees, or to restructure benefit plans to take advantage of special tax incentives. In almost every case, ESOPs are a contribution to the employee, not an employee purchase.

ESOP Rules

An ESOP is a kind of employee benefit plan, similar in some ways to a profit-sharing plan. In an ESOP, a company sets up a trust fund, into which it contributes new shares of its own stock or cash to buy existing shares. Alternatively, the ESOP can borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan. Regardless of how the plan acquires stock, company contributions to the trust are tax-deductible, within certain limits.

Shares in the trust are allocated to individual employee accounts. Although there are some exceptions, generally all full-time employees over 21 participate in the plan. Allocations are made either on the basis of relative pay or some more equal formula. As employees accumulate seniority with the company, they acquire an increasing right to the shares in their account, a process known as vesting. Employees must be 100% vested within five to seven years.

When employees leave the company, they receive their stock, which the company must buy back from them at its fair market value (unless there is a public market for the shares). Private companies must have an annual outside valuation to determine the price of their shares. In private companies, employees must be able to vote their allocated shares on major issues, such as closing or relocating, but the company can choose whether to pass through voting rights (such as for the board of directors) on other issues. In public companies, employees must be able to vote all issues.

Uses for ESOPs

1. *To buy the shares of a departing owner:* Owners of privately held companies can use an ESOP to create a ready market for their shares. Under this approach, the company can make tax-deductible cash contributions to the ESOP to buy out an owner's shares, or it can have the ESOP borrow money to buy the shares (see below). Once the ESOP owns 30% of all the shares in the company, the seller can reinvest the proceeds of the sale in other securities and defer any tax on the gain.
2. *To borrow money at a lower after-tax cost:* ESOPs are unique among benefit plans in their ability to borrow money. The ESOP borrows cash, which it uses to buy company shares or shares of existing owners. The company then makes tax-deductible contributions to the ESOP to repay the loan, meaning both principal and interest are deductible.
3. *To create an additional employee benefit:* A company can simply issue new or treasury shares to an ESOP, deducting their value (for up to 15% of covered pay) from taxable income. Or a company can contribute cash, buying shares from existing public or private owners. In public companies, which account for about 10% of the plans and about 40% of the plan participants, ESOPs are often used in conjunction with employee savings plans. Rather than matching employee savings with cash, the company will match them with stock from an ESOP, often at a higher matching level.

Caveats

As attractive as these tax benefits are, however, there are limits and drawbacks. The law does not allow ESOPs to be used in partnerships and most professional corporations. ESOPs can be used in subchapter S corporations as of 1998, but do not qualify for the rollover treatment discussed above and have lower contribution limits. Private companies must repurchase shares of departing employees, and this can become a major expense. The cost of setting up an ESOP is also substantial -- $15,000 to $20,000 for the simplest of plans in small companies and on up from there. Any time new shares are issued, the stock of existing owners is diluted. That dilution must be weighed against the tax and motivation benefits an ESOP can provide. Finally, ESOPs will only improve corporate performance if combined with opportunities for employees to participate in decisions affecting their work.