

Advisory | Employee Stock Ownership Plans (ESOPs)



July 2024

ESOP Company Transactions: An Alternative Exit Strategy for Founders

As mergers and acquisitions activity increases in 2024, middle-market dealmakers evaluating an exit and corporate founders planning for CEO succession are considering a variety of factors, including employee motivation, retention, incentives, interest rates, post-pandemic valuations, and tax laws. In a sale of the founder's equity to an employee stock ownership plan (ESOP), the interests of corporate employees and founders should align. The founder of a private corporation approaching retirement age and seeking to retain management control may consider selling equity in intervals while establishing a tax-efficient ESOP, concurrently strengthening employee engagement.

Although Congress enacted employee ownership tax incentives in 1974, employee ownership models are receiving increased attention as private equity advocates and academics have publicly championed social and economic benefits of employee ownership. This GT Advisory evaluates four reasons why an ESOP may be an attractive option in 2024 for a middle-market founder's exit and succession planning, while establishing an employee ownership stake and potentially enhancing corporate profitability through tax incentives.

1. Staging the Sale of the Corporation to an ESOP. In a higher-interest-rate market, ESOP sale structures have changed from those customary five years ago. Consider the founder of a middle-market corporation nearing retirement with no apparent successor CEO to lead the business. The founder desires to gradually transition the CEO function, continue managerial and board

oversight of the corporation, establish family succession planning and prepare for retirement while building shareholder value and providing employee incentives, all on the founder's timeline. Unlike other M&A financial or strategic sales of the business, the founder's sale of shares to the ESOP retirement plan can be staged in intervals over a number of months or years.

2. Succession Planning for Founder. The founders of a closely held corporation may consider employee ownership as an alternative option to a sale to a financial or strategic buyer that is driven primarily by economic and financial strategic factors. The closely held owner's decision to sell may, on the other hand, be equally or more influenced by other factors such as family dynamics and the need for long-term stability in the employee ranks. Through careful planning with ESOP tax specialists, the founder executive may sell his or her qualified shares in a corporation taxed as a C-Corp to an ESOP by electing Internal Revenue Code (IRC) 1042 capital gains tax deferral treatment and reinvesting the sale price of the corporation in qualifying replacement property. This tax deferral enables investment diversification for the founder's retirement and estate planning.
3. Financing Warrants. ESOP transactions may be structured for founders to retain equity incentives. Warrants may be used in the transaction to provide founder-sellers with additional value in consideration for debt financing of the transaction in the form of lower-interest-rate seller notes. The terms of the warrants are carefully designed to avoid overly dilutive terms affecting the ESOP valuations. Providing warrants to selling shareholders align founder incentive for corporate growth with the ESOP and the employee-owners and can save the corporation significant cash flow immediately following the closing.
4. Post-ESOP Sale Corporate Governance Flexibility. Founder-selling shareholders typically retain their board seat and management functions, ensuring stability during the transition period following the ESOP sale while the seller continues to have capital at risk in the corporation. The ESOP-owned company board of directors governs the corporation with oversight from a trustee that is a fiduciary for the retirement plan. The plan trustee may be directed or discretionary. A directed trustee follows the instructions of the board of directors, although they must also demonstrate in taking direction the exercise of good judgment that is proper in terms of the Employee Retirement Income Security Act of 1974 (ERISA). A discretionary trustee, conversely, acts independently of the board of directors and CEO and makes decisions independently as a fiduciary for the ESOP. Independent (non-management) directors are often appointed to the board of directors within several months of the sale to the ESOP. Audit, compensation, and ESOP committees are frequently a framework for board governance, with independent directors assuming committee roles involving reports to the board and trustee and determining if potential conflicts of interest are being identified and reviewed. Many founder-owned corporations do not have this type of corporate governance prior to a sale but should implement proper corporate governance when the corporation is sold to an ESOP.

An ESOP is a form of employee retirement benefit plan governed by the IRC and ERISA, designed to invest primarily in securities issued by the employer. Although closely held business owners ready to sell do not always consider an ESOP transaction, **studies show** ESOPs have significant potential to create economic stability, generate significant retirement benefits for employees, and increase corporate growth while enabling business owners to secure a gradual exit and a source of liquidity. It is possible for an ESOP-owned corporation to be exempt from federal income tax once the corporation is 100% owned by the ESOP.

Sales to an ESOP are complex transactions requiring advice from accountants, legal advisors, and bankers experienced in ESOP transactions. A closely held corporation must evaluate whether it is a viable candidate for an ESOP transaction. An explanation of the advantages and disadvantages of an ESOP sale transaction is beyond the scope of this GT Advisory.

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