ESOP™

Issue Brief

Issue Brief #2

HOW TO ESTABLISH AN ESOP

A company interested in establishing an Employee Stock Ownership Plan (ESOP) has a wide range of options in tailoring a plan that is best suited to its particular needs and goals. A large, publicly traded company, for example, would handle the creation of its ESOP somewhat differently than would a privately owned company. Presented below, therefore, is only a basic guideline summarizing the steps a company might take in designing its ESOP and bringing it into being.

Exploring The ESOP Concept

The first step in the process of establishing an ESOP is to develop an idea of the type of plan that will best serve the company's interests. Companies have created ESOPs as an employee retirement plan, for purposes of business continuity, financing, enhanced employee motivation or as a combination. The ESOP Association provides a wide array of information and other assistance to companies interested in exploring the potential benefits of an ESOP. Contact The ESOP Association to inquire regarding affiliate membership, which is designed to provide generalized help to those companies in the process of establishing an ESOP.

Designing the Specifics

Once the company has a general picture of the kind of ESOP it wants, a qualified consultant will work with the company's management to design the specifics of the ESOP. The actual feasibility of an ESOP needs to be established. Custom-tailored answers to the many questions need to be answered. Who will participate in the plan? How will stock be allocated to participants? What vesting schedule will be adopted and how will distributions of ESOP accounts be handled? How will voting rights be handled? The ESOP Association provides the names of such consultants throughout the country. The consultant will work to integrate the ESOP goals with applicable laws and regulations and will conduct a financial analysis to assure that any financial commitments posed by the ESOP will not exceed the ability to the firm to meet such obligations. The consultant may also offer possibilities previously overlooked. The consultant may also arrange to bring in other professionals, such as an appraiser, or a lending institution as appropriate.

In the case of a privately held company, the feasibility and design phase of the process is not usually complete until three additional points have been addressed. First, the firm's stock must be valued by an independent appraiser before shares are put into the ESOP. Initially, a careful estimate will be prepared for use as a working figure in the feasibility and design process. This initial appraisal will likely take several weeks or longer, since a significant amount of business data must be collected and analyzed. Only when the design process is completed and ready for implementation will a final and formal valuation report be prepared. For more information on valuing ESOP stock, see "The Valuation of ESOP Stock" Issue Brief #8, and the publication entitled Valuing ESOP Shares available from The ESOP Association for $12.00 (member price).

Second, the ESOP's effect on existing stockholders should be estimated. Stockholders will want to know how the ESOP will affect the value of their stock and the company's financial condition. Often an ESOP will cause a dilution of their equity interest in the corporation.

Finally, while not a requirement for establishing an ESOP, a plan for meeting the privately held company's obligations to repurchase the stock of departing employees should be projected. This "repurchase obligation" arises from the fact that in privately held companies, ESOP participants have a put option when leaving the company. The repurchase obligation and its growth over time may be affected by factors like the size of the annual ESOP contributions, the change in the value of shares between the dates of contribution and repurchase, the vesting and distribution provisions of the ESOP, employee turnover and, the choices eligible employees make about their diversification option.

Companies may plan for and meet their ESOP repurchase obligation in a variety of ways, including making substantial cash contributions on an annual basis, and buying insurance to cover the plan's obligations. If the likely growth of repurchase obligation over time is projected at the outset, however, the company is in the best possible position to plan for it and design the ESOP accordingly.

Putting the ESOP In Place

When the process of analyzing and designing the ESOP is complete, the company will typically have an attorney prepare a formal plan document which will set forth the specific terms and features of the ESOP. An appraiser will then prepare a finished and formal valuation report, based on data preferably no more than 60 days old at the date the ESOP is created.

The plan document should include language addressing the plan's purpose and operation, eligibility requirements, participation requirements, company contributions, investment of plan assets, account allocation formulas, vesting and forfeitures, voting rights and fiduciary responsibilities, distribution rules and put options, employee disclosures, and provisions for plan amendments. Depending on the particular circumstances of the establishment of the ESOP, it may be prudent to address any future contingencies in the plan document.

Other key decisions are who will serve as the ESOP's trustee and who will assume the functions of administering the ESOP? The stock (as well as any other assets) held by the ESOP must actually be held in the name of the trustee, who usually has fiduciary responsibility for the plan's assets. Increasingly, plan sponsors are turning to professional trustees, such as a bank or trust company, although companies sponsoring an ESOP can and do handle this role in-house. The job of ESOP administration is likewise a function which may be given to a professional administration firm or performed by an employee [s] of the sponsor. The administrator is responsible for maintaining all the individual records of the plan in order to keep track of exactly who are the current participants in the plan, what percent is each participant vested, what is the content and value of each participant's account, etc.

In the case of leveraged ESOPs (an ESOP which used borrowed funds to acquire employer securities), arrangements must be made for securing the financing needed to complete the transaction. Banks, savings and loans, investment banking firms, mutual funds, and insurance companies in the business of lending money may all qualify as ESOP lenders. Many lending institutions are familiar with how ESOP loans are structured. If your local lending institution is unable to provide the necessary funding, names of interested lenders is available from The ESOP Association.

The company must formally adopt the plan and trust documents which establish the ESOP and its attendant trust. Also, the company usually submits a copy of these documents to the Internal Revenue Service with an application for confirmation (called "determination") of the plan's tax-qualified status (Form 5500). The plan must be a qualified ESOP under sections 401 (a) and 4975 (e)(7) of the Internal Revenue Code in order to be eligible for the various tax benefits associated with ESOPs. It is not normally necessary, however, to wait for a letter of determination from the IRS to begin the plan. If there is nothing unusual in the plan's design, any required changes will almost certainly be small ones, which can be made after the plan has begun operation.

A company must adopt an ESOP by the end of its fiscal year to claim a deduction for its contribution for that year. Contributions and leveraging for a given year, however, may occur up until the company files its corporate tax return, including extensions.

Conclusion

The process of setting up an ESOP is complicated, but that should not discourage interested firms from investigating employee ownership. The process is understandable and manageable, and the many benefits, which flow from ESOPs, such as increased employee motivation, a market for existing shareholders shares, and tax and financial advantages, are substantial.

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