# WHAT'S DRIVING ESOP MOMENTUM?

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# INTRODUCTION

Employee Stock Ownership Plans (ESOPs) are experiencing a salient surge throughout the United States. The unique structure allows the majority shareholder in a business to sell their shares to an ESOP trust, which in turn allocates ownership among the employees. While ESOPs were conceived in the late 20th century, adoption has steadily increased over the last 36 months. As more business owners turn to employee ownership, exploring the forces and driving factors offers critical insight to understanding ESOP momentum.

# MOVEMENT IN RECOGNITION

According to the National Center for Employee Ownership (NCEO), there are approximately 7,000 employee-owned companies in the United States today.[1] While 7,000 is a small fraction of privately-held businesses in the United States, the number of ESOPs continues to grow—and with it—the awareness of ESOPs as an exit strategy.

After monitoring news alerts over the past several months, an average of roughly two daily press releases announce a partial or full sale to an ESOP in the United States. As a result, news readers are hearing more and more about employee ownership; but why now? Two major factors in the equation: recognizability and legislation.

## *Recognizability*

Although ESOPs first found use in manufacturing and other industrial sectors, more well-known companies in diverse industries are turning to employee ownership. As recognizable companies pique interest from other corporations down to their own consumers, their brands have become indirect marketing tools for ESOPs. Owners of familiar grocery chains, craft breweries, and restaurants candidly shared their stories of ESOP success. Sometimes these success stories seem too good to be true: low employee turnover, high productivity, becoming a tax-exempt entity, and deferral or exemption from taxes on capital gains paints an unfamiliar picture. Curious to report on these stories, big names in media have published content and brightened the spotlight on ESOPs. All of this attention garners public interest in the potential benefits of an ESOP.

# MOVEMENT IN LEGISLATION

## *Brief History of Legislation*

Recent legislative agendas also contribute to the expansion of ESOPs. Despite a slight decline in laws enacted by Congress since 2002, ESOPs originate from a rich legal history. The Employee Retirement Income Security Act (ERISA) enacted in 1974 was the first formal piece of legislation to recognize ESOPs.[2] Throughout the '80s and '90s, Louis Kelso and his counterparts created over 20 pieces of ESOP legislation, mostly amending ERISA. A major turning point occurred in 1998 when employee ownership, formerly solely applicable to C corporations, extended coverage to S corporations,. Shortly after this legislation passed, the number of S corporation ESOPs increased. Many of these ESOPs were small businesses excited to explore the benefits of the structure; however, it became clear that some of these companies were using the S corporation ESOP structure solely to abuse the tax advantages.[3] Consequently, federal legislation went into effect in 2002 that placed more qualifying limitations on ESOPs.

## *Current Status*

In the early 2000s, the number of ESOPs declined. Poorly structured plans created with the intention of tax exploitation quickly fell apart. ESOPs gained a reputation for being messy and complex, and legislators turned their focus away from ESOPs. Enter the recession. Many industries experienced significant financial stress, and were forced to make tough decisions for the sake of survival. At the same time, according to a study conducted by Georgetown University in 2008, S corporation ESOPs performed more consistently than non-S corporation ESOPs.[4] Instead of laying off employees, S corporation ESOPs hired workers as well as contibuted capital to their retirement savings.  After the dust settled, lawmakers were eager to introduce new legislation promoting a healthier economy. Due to their proven stability, ESOPs once again gained traction in the House and Senate.

*Bipartisan Support*

While countless bills face obstacles due to party tension, ESOPs found bipartisan support by offering a unique opportunity to serve the interests of both parties. ESOPs can alleviate retirement concerns as they create a pool of qualified capital available for the employee participants. By allowing employee owners to accumulate retirement income separate from their ordinary income, ESOPs reduce the disparity in wealth concentration. The plan allows employees who depend primarily on their wage compensation with an opportunity to build wealth, ultimately mitigating the effects of income inequality. By meeting both parties' agendas, lobbying against pro-ESOP legislation has drastically reduced. Bipartisan interest has resulted in the following pieces of both federal and state legislation in favor of ESOPs:

**S. 1589***

**Promotion and Expansion of Private Employee Ownership Act of 2017**

- Originally H.R.2092
- Proposed by congressmen Ron Kind (D-WI) and Dave Reichert (R-WA)
- Ammendments:
  - Extend tax deferral through sale to an ESOP to ALL domestic companies
  - Introduce a 50% tax deduction for S corporations on interest incurred on loans sponsored by an ESOP to purchase more than 50% employer securities
  - Department of Treasury creates an S Corporation Employee Ownership Office

**S. 1081***

**Work Ownership, Readiness, and Knowledge Act (WORK Act)**

- Proposed by Senator Bernie Sanders (D-VT)
- Ammendments:
  - Establishing an employee ownership participation initiative to encourage states to support ESOPs
  - Federal grants for states to establish ESOPs
  - General support for programs

**H.B.17-1214****

Encourage Employee Ownership of existing small businesses in Colorado

**HF.2085****

Capital Gain Deduction for the Sale to an Iowa ESOP

**HOUSE BILL 2030****

The Stock Ownership Deduction Tax Act

**Massachusetts****

Refunding Massachusetts Employee Ownership Center. (effort not attached to a bill but is a budget requirement)

**H.B.4171***

ESOP-owned companies can be considered Historically Underutilized Businesses for Texas state set aside programs

* indicates pending   ** indicates passed

*Source: www.congress.gov*

# We asked legislators...

**_WHY DO YOU THINK THERE HAS BEEN AN INCREASE IN MOMENTUM FOR LEGISLATION CONCERNING EMPLOYEE-OWNED COMPANIES THROUGH THE EMPLOYEE STOCK OWNERSHIP PLAN VEHICLE?_**

*"This bill [H.R.2092] empowers companies to become employee-owned, create new employee-owners, and provide retirement security to more American workers. Growing our economy and adding jobs is a priority and employee-ownership is a proven model to do just that."*

**Congressman Rob Kind**
**Democrat - WI**

*"From a legislator's point of view, we've seen that ESOPs are a successful model that provide several important benefits to employee owners, especially through uncertain economic times. For instance, ESOP companies tend to provide their employees with more job stability and financial security through increased retirement savings. Encouraging companies to start an ESOP will, in our view, help provide these benefits to more middle-class Americans. Because that goal is a strongly bipartisan one, momentum has increased around the bill and other ESOP bills, and we hope that S. 1589 will move forward in this Congress."*

**Senator Ben Cardin**
**Democrat - MD**

*"Employee ownership rewards hard-working Americans for committing themselves to the success of the company they work for, creating jobs and growing the economy along the way. Our bill [H.R.2092] encourages this pride in ownership and gives employees the power to retire on their own terms. American workers deserve to have confidence in their financial security from their prime working years through their retirement."*

**Congressman Dave Reichert**
**Republican - WA**

# DISCUSSION

In addition to the increased recognition and favorable bipartisanship, psychographic factors are also influencing business owners to adopt an ESOP.

## *Traditional Exit Strategies*

When looking into selling a business, there are several options an owner may consider. If there is a natural heir to the business (usually a spouse, relative, or child) the business ownership may simply transfer to that person. Other common succession strategies include selling to the company's management team, a competitor/strategic buyer, or a private equity group. Selling to a strategic buyer will allow business owners to maximize cash at closing; however, the acquiring company will likely eliminate duplicative staff and systems, thereby impacting the selling shareholder's legacy in the community. Selling to a private equity group will allow the business owner to achieve fair market value for the business, but may not provide as high a valuation as some strategic buyers. Selling the business to key executives often preserves the selling shareholder's legacy, but the purchasing party will likely not be in a financial position to offer top dollar for the company. Although these strategies may appeal in some situations, owners are continually looking for strategies that meet all of their objectives.

## *Legacy Preservation*

After the hardships of the recession, business owners developed an even greater appreciation for their loyal and productive employees. Subsequently, business owners place greater emphasis on their employees' welfare when choosing their exit strategy. For example, owners in less populated geographies contemplate the economic impact as they analyze their succession alternatives, similar to Mr. Waller

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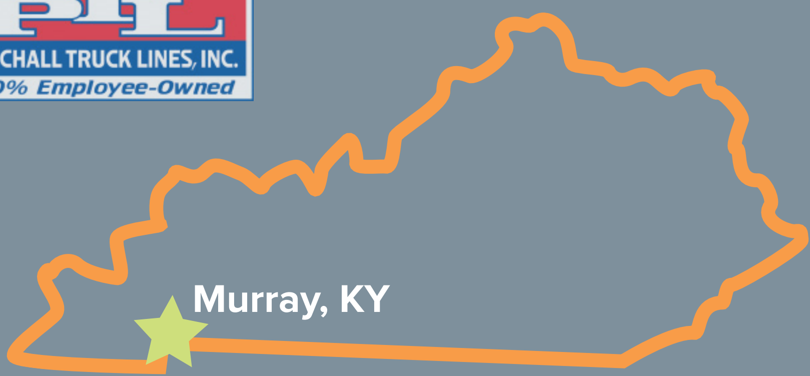
of Paschall Truck Lines, Inc. (PTL). Businesses like PTL in smaller communities are often one of largest employers of local residents. If the business is relocated by an outside buyer, the local economy would likely experience a major downturn. Many long-term employees could end up out of work, consequently tarnishing the owner's legacy within the community. A business owner's relationship with their employees matters more when they're members of the same community—family, neighbors, friends—who depend on the business for their livelihood. Instead of pursuing an exit strategy focused solely on the highest outside bidder, business owners are looking for a comprehensive strategy that provides for employees, fosters growth, and continues their legacy.

PTL
PASCHALL TRUCK LINES, INC.
100% Employee-Owned




*Mr. Waller knew that he would eventually need a plan to transfer the ownership and management of the business. In 2011 he began examining a number of options to sell his ownership in the company. Most of his options would mean that at some point in the future PTL could leave Murray, KY. Mr. Waller did not want to risk that. On October 29, 2013 he announced he had opted to preserve local ownership and further strengthen Paschall Truck Lines, Inc.'s strong future by selling 100 percent of his stock in the company to its employees through an Employee Stock Ownership Plan ("ESOP").*

# CONCLUSION

More than ever, today's business owners have a greater opportunity to incorporate many of their aspirational motivations into their succession planning. These motivatons are driving them to identify alternative options such as employee ownership. As a result of more prominent media coverage and recognizable companies pursuing employee ownership, the public awareness of ESOPs has heightened. Legislatively, ESOPs are favored more and more after proving their reliability through the hardships of the recession. Both political parties support ESOPs, increasing the momentum further. The combination of these factors is building a substantial foundation for continued interest in employee ownership, and as such, the future for ESOPs looks promising.

# SOURCES


[1] https://www.nceo.org/articles/esops-by-the-numbers

[2] http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1004&context=crs

[3] https://www.nceo.org/articles/recent-employee-ownership-legislation-u-s

[4] http://www.in.gov/tos/files/SESOPPerformanceStudy.pdf