Employee Stock Ownership Plan (ESOP):

A Possible Succession and Exit Strategy

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Employee Stock Ownership Plan (ESOP)
A Possible Succession and Exit Strategy

Disclaimer

This presentation is not legal advice. We are not attorneys and do not offer legal or accounting advice. Neither the information contained on these slides, nor the accompanying talk and/or recording thereof construe legal advice. You should consult your own counsel and a reputable ESOP consultant to explore if an ESOP may or may not be appropriate for your unique situation.

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Employee Stock Ownership Plan (ESOP)
A Possible Succession and Exit Strategy

- **Objectives:**
- The participants will be able to understand the basic structure of an ESOP
- The participants will be able to understand the importance of legal / ESOP consultants during due diligence
- The participants will be able to state the business advantages of an ESOP
- The participants will be able to determine if the operational advantages of an ESOP fit your company culture and structure
- The participants will be able to gain an understanding of what the transition to an ESOP looks like

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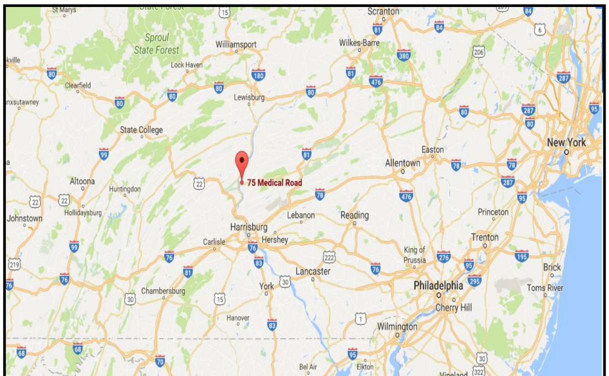

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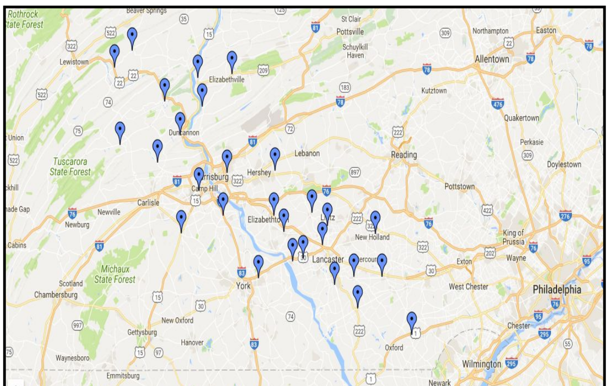

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Employee Stock Ownership Plan ESOP- Overview

- In the United States there are approximately 10,000,000 employees in over 10,000 companies (private and public) that are participants in ESOPs.
- 1950s- ESOP concept was developed by Louis Kelso, lawyer / banker

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Employee Stock Ownership Plan ESOP- Overview

- 1974- Federal legislation introduced a framework for ESOPs (Employee Retirement Income Security Act, ERISA) and ESOPs expanded dramatically after that time

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Employee Stock Ownership Plan ESOP- Overview

What is an ESOP?

- An ESOP is a "qualified" employee retirement benefit plan that invests primarily in the stock of the employer company
- Technically it is a variation of a stock bonus plan, or stock/money purchase plan option

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Employee Stock Ownership Plan ESOP- Overview

Details…

- ESOP Trust holds company stock (and cash) in accounts for the participants

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Employee Stock Ownership Plan ESOP- Overview

Details…

- “Qualified” plan relates to ‘tax-qualified’- meaning by following certain rules designed to protect the plan participants (employees), the ESOP sponsor (CPRS) receives certain tax benefits

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Employee Stock Ownership Plan ESOP- Overview

Details…

- “Defined contribution plan”- employer makes yearly discretionary contributions that accumulate to produce a benefit that is not defined in advance
- “Defined benefit plan” (i.e. traditional pension plans) by contrast is a plan where employees are guaranteed a specified benefit funded by the company through required contributions

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Employee Stock Ownership Plan ESOP- Overview

- Retirement Plan/ Trust
  - Can accumulate tax-free for up to 3 years to fund a deal, or pay off a loan to purchase shares
- Corporate sponsor gets a tax deduction for contributions

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Employee Stock Ownership Plan ESOP- Overview

- Value
  - Independently appraised “Fair Market Value” required
  - Plan must comply with IRS, DOL and ERISA regulations

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Employee Stock Ownership Plan ESOP- Overview

- Must be an S or C corporation
  - When ESOP acquires stock it becomes a single tax-exempt shareholder

"I'll be needing one of your legs as well!"

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Employee Stock Ownership Plan ESOP- Overview

- ESOP Trustees are the legal owners and vote the stock for most issues
  - Participants vote the shares in their accounts only in major corporation issues such as a sale or liquidation of the company
  - Control is not a concern in a properly designed plan

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Employee Stock Ownership Plan ESOP- Overview

- BOD of ESOP Trustees
  - Fiduciaries – need fiduciary liability insurance (not the standard ERISA plan)
  - Use of an independent corporate trustee for stock sales

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Employee Stock Ownership Plan ESOP- Overview

- ESOP can purchase any % of a company
  - Most are 25%-75% stock for many considerations(not just financial)
- Stock sale proceeds
  - S corp sellers can receive capital gains tax treatment
  - C corp can either pay capital gains, or if creating >30% ESOP can elect a tax-free rollover

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Employee Stock Ownership Plan ESOP- Overview

- ESOP retirement trust owns stock
  - Stock repurchase liability
  - Participants retire, terminate or die- obligation to pay account values in cash

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Employee Stock Ownership Plan ESOP- Overview

- ESOP can be part of a coordinated strategy for succession
  - Tax favors
  - Estate planning
  - Employee benefits
  - Key executive programs

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Employee Stock Ownership Plan ESOP- Overview

ESOP benefits for Participants (employees)

- Additional benefit to employee- retirement plan
- Employees are not taxed on the money until they take the distribution (retirement, 65 y/o, death, according to payout rules, etc.)
- Allows employees to share and participate in the growth / success of the company and engage in ownership mentality

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Employee Stock Ownership Plan ESOP- Overview

- Feasibility – Does an ESOP work for you?
  - > 25 employees
  - > $250,000 of adjusted pre-tax income
  - > $1,000,000 in enterprise value
  - Although there are some exceptions

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Employee Stock Ownership Plan ESOP- Overview

- Costs
  - Start around $20,000 for a simple plan
  - Annual appraisal
  - Record keeping and accounting
  - Typically about $15,000 to $25,000 for companies with < 100 employees.

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Employee Stock Ownership Plan ESOP- Overview

- ESOP is not a strategic buyer or investor looking to get out in a few years.
- Value is in long term dividend paying capacity or discretionary cash flows for stock purchases
- Funding derives from earnings, tax savings and employee benefit restructuring

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Employee Stock Ownership Plan ESOP- Overview

- ESOP can only pay what is fair and what the corporation can afford without impairing the long term viability and operation of the company
- Variable plans and transaction designs- requires guidance of an ESOP professional

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History of CPRS Physical Therapy and the transition to a ESOP

- CPRS was founded in 1983 by Rick and Vicky Tribbitt, they were husband and wife and two Physical Therapist.
- From 1983 to 1992, they grew CPRS to four clinics. In 1992 they were approached by a conglomerate and sold the business while carrying the note for the transaction. The company defaulted on the note and the Tribbitt's bought the business back in 1996.
- Once they gained control of the business, they started to grow it. In 1999, CPRS had 7 clinics and some key employees were concerned about the potential of being sold again. This is when the ESOP was put into place.
- The ESOP allowed the Tribbitt's to put an exit strategy in place that allowed them to transition their role and exit the business over time while selling their stock (stock of the business) to the employees via a stock and cash transaction.

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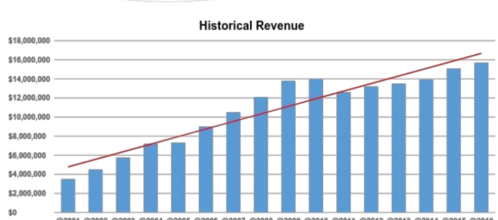
The Transition

- In 2000, CPRS had 10 Clinics; today CPRS has 28 clinics located throughout 8 Counties in Central PA.
- It has allowed us to recruit individuals with and ownership mentality and desire to provide skilled services with total autonomy.
- How do you feel about taxes?
  - The ESOP allows CPRS to be tax exempt; therefore, it allows for using the monies saved for significant and controlled growth.
  - Has allowed us to grow as you can see from our Revenue.

Historical Revenue



- Revenue growth has gone from $3.2 M to $15.8 M

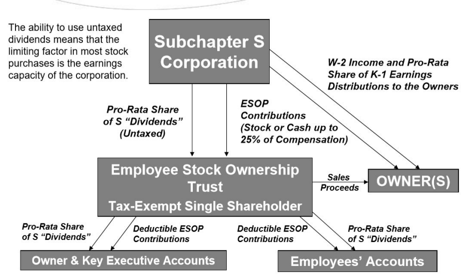
Designing and Implementing your ESOP

- **#1 MOST IMPORTANT**
- Hire an Administrator/Designer/Consultant that has experience in designing an ESOP that will meet your goals as the owner/seller and the goals of the ESOP long-term.
- Do your research on firms. Not all firms are the same.

Designing and Implementation

- One key for the successful carrying out of an ESOP as a succession plan is to put discriminatory plans in place for your Key Employees/Successors.
  - Discriminatory plans should be done pre-deal to keep key players on-board and appropriately rewarded for performance. You want to tie their selective benefits to ESOP success.
    - Some options are:
      - Restricted Stock
      - Deferred Compensation
      - Contingent Bonuses
  - An integrated strategy is the key.

ESOP Algorithm



ESOP Administration

- Yearly Valuation and Audit
  - The ESOP stock appraisal must be done by an entirely independent valuation firm, one with a multi-year history of appraising a few dozen ESOP's. The appraiser should know all relevant facts about the company. We do this through a yearly Business Profile.
  - An ESOP is a financial buyer not a strategic buyer looking to get out in a few years. **"We call it the Crock-Pot"**
    - Therefore, the key driver for value is the long-term dividend paying capacity or discretionary cash flows for stock repurchase.

ESOP Administration

- **A note to remember:** The owner/seller may want the maximum, but the ESOP can only pay what is fair and what the corporation can afford without impairing the long-term viability and operation of the company.
- Once the valuation is complete, it is audited by another entirely separate auditing firm to assure it is valid and credible with customary valuation protocols.
- Once a year, we have a company-wide meeting with all employees to review the valuation, where we are and where we plan on going. ALSO, each employee is given their prepared statement which reveals what their current ESOP balance is.

Business Advantages

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Business Advantages

- Tax Advantages
  - **Corporate level**
    - Contributions of stock are tax-deductible – issuing new shares
    - Cash contributions are tax-deductible – used to buy shares from the owners or build up cash reserves
    - Contributions to repay an ESOP loan (principle and interest) are tax-deductible
      - Financing the ESOP is done with pre-tax dollars
    - The extent to which the ESOP owns shares in an S corporation, that same percentage of the company's profits are not taxed
      - 100% ESOP companies – pay no federal income taxes
      - 50% ESOP companies – 50% of the company's profit is taxed

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Business Advantages

- Tax Advantages
  - **Seller**
    - S corp – stock sales taxed as capital gains
    - C corp – capital gains or tax-free roll over in some circumstances
      - ESOP must own 30% of the shares

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Business Advantages

- Tax Advantages
  - **Employee**
    - Profit distribution to the participants is taxed
      - Employees do not pay tax until they receive the distribution when they leave the company
      - Can be deferred by rolling over to IRA
      - If not, employer contribution is taxed as ordinary income, gains are taxed as capital gain
    - Dividends are tax-deductible

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Business Advantages

- Succession Planning
  - Who is the best buyer?
  - Creates a market for the owner to sell that might not exist
  - Tax advantages for the exiting owner on the sale

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Business Advantages

- Employee recruitment
  - Ownership mentality
  - Increased compensation
    - Long term outlook

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Business Advantages

- Employee Retention
  - Ownership mentality
  - ESOP account
    - Vesting schedule
  - Reward key employees
    - Restricted Stock
    - Contingent Bonuses
    - Deferred compensation
      - “Golden Handcuffs”

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Business Advantages

- Growth Potential
  - Ownership mentality
    - Key employees
  - Tax advantages provide more cash flow and/or cash reserves
  - Borrowing against the ESOP for funding
    - De Novo Clinics
    - Acquisitions

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Operational Advantages

- Ownership Mentality
  - Employees who work over 1000 hours per year have ownership
  - Concern and caring for the clinic they work in
  - Concern and caring of all other clinics
    - Fosters support and accountability across the company

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Operational Advantages

- Employee owners embrace the coming changes in healthcare
  - "In the future, successful doctors, hospitals, and health systems will shift their activities from delivering health services within their walls toward a broader range of approaches that deliver health." David A. Asch, M.D., M.B.A., and Kevin G. Volpp, M.D., Ph.D., N Engl J Med 2012; 367:888-889
- Staff are open to and willingly participate in new delivery models
  - Total Joint Bundled Payment pilots
    - Home visits and structured clinic program
  - Growing occupational health and wellness
  - Home Safety Assessments

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Operational Advantages

- Management and Leadership Development
- Staff asked for educational opportunities on 'business'- operations and leadership
  - Engaged employees in management training and mentoring in the clinics
  - Leadership development training at various times throughout the year on various topics

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Operational Advantages

- Community Involvement
- Fosters 'community minded' team members
- Participating / supporting local charities and foundations

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Operational Advantages

Article-published in 2013, 343 companies

- The results show that sales, employment, and productivity all grow faster in companies after they set up their ESOPs than would have been expected based on their performance relative to comparable companies prior to setting up their plans.
  - Joseph Blasi, Douglas Kruse, and Dan Weltman, Advances in the Economic Analysis of Participatory & Labor-Managed Firms, Volume 14, 2013, pp.109-124.

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