ESOP: Is it a House of Cards?

Are ESOPs, or Employee Stock Ownership Plans, More Trouble Than They’re Worth to Contractors?

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Recent legislative changes have brought ESOPs, or Employee Stock Ownership Plans, back into the limelight as a tool for selling stock to the employees of a construction firm. Most of the recent publicity has been aimed at encouraging the installation of ESOPs. For most construction companies, not only are ESOPs not the best choice as a method of stock transfer, but they are potentially counterproductive. The questions and answers below outline the most common contractor concerns:

Question: What is an ESOP?
Answer: An ESOP is an IRS approved, qualified employee retirement plan which is similar to a profit-sharing plan except that the ESOP invests primarily in the stock of the employer corporation.

Question: If ESOPs are just another employee benefit plan, why are they receiving so much attention?
Answer: Several reasons. First, the ESOP puts stock in the hands of the workers. Second, it allows the company to transfer stock to employees using pre-tax dollars. Third, companies can borrow through an ESOP and deduct both principal and interest portions of the loan. Fourth, a provision in the 1984 tax act allows owners who meet certain requirements to sell part
Candidates for ESOPs are those firms who have a relatively large net worth, are consistently profitable, have excess cash, have an excellent management team, and have a need for broad employee ownership. Unfortunately, these characteristics do not describe the typical contractor. Why don’t all companies have one?

**Answer:** From strictly a tax standpoint, an ESOP is the most efficient way to transfer stock. Any other method of transfer uses after-tax dollars. In addition, the new roll-over provision allowing deferral of gain recognition makes selling a large block of stock by a major shareholder to an ESOP very appealing to a major shareholder. Despite all the tax benefits, ESOPs present many risks to both the sponsoring contracting company and its employees.

**Question:** What kinds of risks?

**Answer:**

- **Cost:** Establishing an ESOP can cost a firm anywhere from $12,000-$30,000 initially and $2,500-$5,000 annually thereafter for updates of the stock valuation and administration fees.

- **Nondiscrimination Requirement:** Essentially all nonunion employees must be eligible to participate in the plan. This includes the sponsoring company and any employees of a “controlled group” of companies.

- **Stock Valuation:** In a closely held company, a value must be placed on the shares which are transferred to the ESOP. The IRS has the final say-so over whether or not the stock price is too high. In effect, this makes the IRS the final arbiter over the value of the company. An annual appraisal by an independent third party is recommended.

- **The Need for Profits:** If a company is unprofitable, tax savings are of no benefit. The tax deductibility feature is exactly what makes stock transfer through an ESOP so attractive. Consistent and reliable profits are necessary.

- **Repurchase Obligation:** Companies whose shares are not publicly traded are required to repurchase shares from employees who retire, are disabled, die or terminate employment for any other reason. The departure of even a small

of their stock to an ESOP and defer the capital gains tax on the proceeds. This last item in particular has brought about renewed interest in ESOPs. **Question:** It sounds like an ESOP is the best way to get stock to employees.
group of employees at once can create a severe strain on cash flow.

Risk to Employees: Employees who are participants in conventional retirement plans have their funds invested in a diversified portfolio of assets. For the ESOP participant, the only investment is employer stock. The employee’s entire retirement benefits will depend on the fortunes of his employer. The ESOP puts employees in the position of being entrepreneurs, therefore, risk takers.

A company considering an ESOP must think long and hard about each of these factors, and whether or not the downside can be offset by the tax savings and other potential advantages of wide-spread employee ownership.

Question: Sounds like ESOPs aren’t all they’re cracked up to be. What other issues should a contractor be aware of?

Answer: It’s important to look at several factors which are unique to the construction industry. The requirement that the ESOP include all employees can be a problem, particularly for an open-shop contractor. Turnover in the field is usually high, so keeping track of ex-employees can be an administrative headache. Another problem is the volatility of the industry. Wide swings in profitability significantly affect the value of the company’s stock. Employees retiring during a down cycle can find the value of their stock dramatically lower than it was just a few years earlier. This phenomenon is difficult for employees to understand, particularly those employees in the field.

The volatility of the industry also makes planning for the repurchase of employees’ stock extremely difficult. Many contractors tend to be undercapitalized and having to take cash out of the company for share repurchase can cripple a company.

One final consideration is bonding. Most owners of construction firms provide personal indemnification for surety and bank credit. The surety or bank becomes concerned if an owner is planning to have his entire company owned by an ESOP since there will be no guarantor who has significant personal financial resources.

Companies which are candidates for ESOPs are those firms who have a relatively large net worth, are consistently profitable, have excess cash, have an excellent management team and have a need for broad employee ownership. Unfortunately, these characteristics do not describe the typical contractor. In fact, for probably nine of ten construction companies, an ESOP just isn’t a good idea.

Question: How does a contractor decide if an ESOP will work for his company?

Answer: First, he should read everything possible about ESOPs. Second, he needs to find an attorney, accountant or consultant who is knowledgeable about ESOPs and who can help him address all the issues discussed earlier. Finally, he should carefully evaluate the myriad of alternatives available for the transfer of ownership of a closely held contracting firm. In practically every case, he will discover an alternative more appropriate than an ESOP.