

Employee Stock Ownership Plans (ESOPs): A Vehicle for Business Succession in SMEs

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A recent Commission Communication from 2006¹ stated that with the aging of Europe's population, "one third of EU entrepreneurs, mainly those running family enterprises, will withdraw within the next ten years". This portends an enormous increase in business transfer activity which could affect up to 690,000 small and medium-sized enterprises and 2.8 million jobs *every year*. It is anticipated that as a consequence of the new forms of business finance now coming into use, transfers within the family will decrease, while sales to outside buyers will rise. The entrance of international investors into what used to be primarily domestic markets will broaden the range of potential buyers for European small and medium-sized enterprises. This process is likely to threaten the successful regional structure of European (family-owned) businesses and will profoundly affect the European Community itself – its values, its vision and its effectiveness.

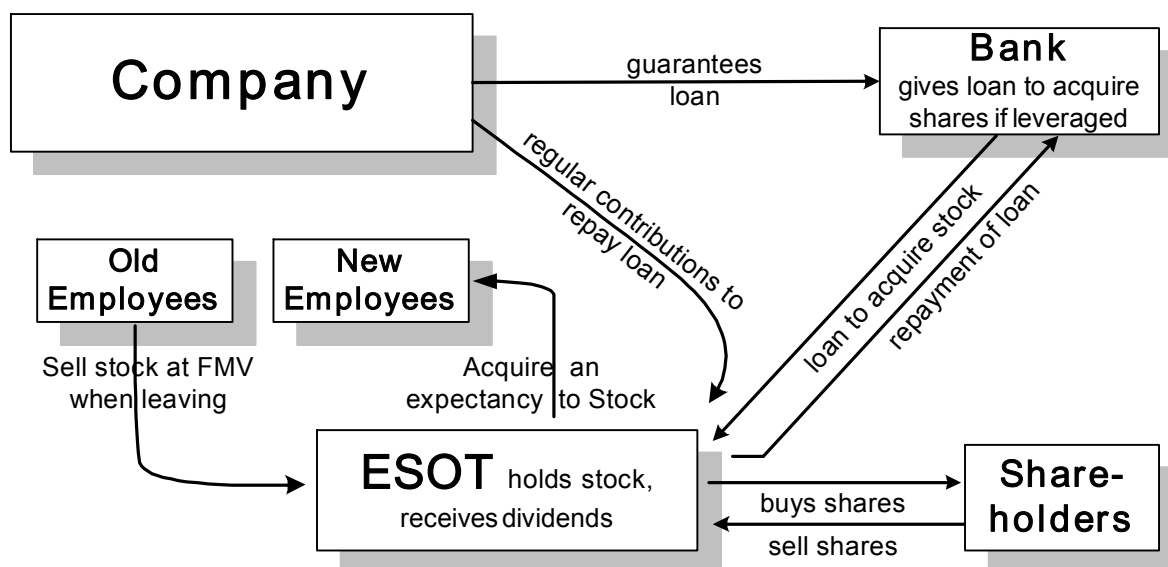
A full or partial ESOP buy-out provides an ideal vehicle to facilitate transitions in ownership and management of closely-held companies. An ESOP usually involves a loan to an employee benefit trust, which acquires company stock and allocates it through periodic contributions to each employee's ESOP account. The loan may be serviced by payments from the company out of company profits, out of dividends paid on the stock held by the ESOP or (in rare instances) from employee salary reductions. In the United States over half of all the *Fortune* 500 companies and over 40% of *Inc* magazine's 100 fastest growing private companies now sponsor ESOPs. As of 2007 there were approximately 11,000 ESOPs in the U.S., covering approximately 10 million employees. The vast majority of ESOPs are sponsored by privately-held companies, of which about 3,500 are majority and about 2,000 100% owned by the ESOP.

This field of action has been highlighted as one of the main objectives of the Council Recommendation of 7 December 1994 and recently by the European Commission, explicitly stressing the importance of ownership transfers to employees as a specific measure for facilitating business succession in SMEs.

➤ **Creating a market for retiring shareholders' shares**

The ESOP creates a market for retiring shareholders' shares, which is of major importance to unlisted SMEs having no other ready source of liquidity. ESOPs may easily buy-out one or more shareholders while permitting other shareholders to retain their equity position. This is one of its major advantages from the shareholders' perspective. At the same time, ESOPs give business owners the opportunity to diversify their investment portfolios without the costly process of going public. Furthermore, there is no dilution in equity per share of current stockholders since no new shares are issued and all shares are bought at fair market value. If the ESOP borrows money to buy shares, the company repays the loan by combining any dividend income of the trust with its own tax-deductible contributions to the plan. As the loan is repaid, a number of shares equal to the percentage of the loan repaid that year is allocated to employee accounts, usually on the basis of relative compensation. In this way the ESOP creates a market for retiring shareholders' shares at a price acceptable to the owner - a market which otherwise might not exist. At the same time, when a change of control is appropriate, ownership is transferred to motivated employees who have a vital interest in the company's long-term success.

¹ Implementing the Lisbon Community Programme for Growth and Jobs, on the Transfer of Businesses – Continuity through a new beginning, from 14.03.2006 COM (2006) 117 final.



Thus the ESOP may be an attractive alternative to selling the business to outsiders, especially when there is a desire to keep control of the business within a family or a key-employee group.² As a trustee plan, the ESOP is designed to separate control over the shares in the trust from the “beneficial owners”. The trustee exercises the voting rights while the employees are the financial beneficiaries of the trust. The trustee may, in fact, be the very person who has just sold some or all of his shares to the trust. For smaller firms especially, it is much easier to contemplate a gradual transfer of ownership by creating a market for the shares of those who wish to sell at the present moment, while enabling those who wish to hold their shares to retain their equity interest permanently or at least until some later date. The result is the opportunity of gradually cashing out without giving up immediate control.³

➤ **Avoiding additional risk while increasing company profitability**

While share ownership generally involves additional risk for employees, the ESOP avoids this consequence. Although employees, as in other share ownership schemes, are encouraged to allot part of their wealth into the shares of their own companies rather than those of other companies, resulting in concentrated rather than diversified risk, there is this fundamental difference: ESOP debt is funded by appropriately timed contributions from the company to an employee trust (ESOT). Thus the scheme provides an additional benefit to basic wages. The employee’s salary remains unaffected.

Furthermore, ESOPs make employees more motivated and productive while at the same time making enterprises more competitive.⁴ Finally, there is an additional advantage to the company: shares are not sold to outsiders; thus there is no risk of loss of control and the company remains local. As such ESOPs could be an important tool for solving the problems of business succession in family-owned enterprises, strengthening bonds between enterprise and community, while keeping jobs local and more wage income spent at home.

² The ESOP may also be used to buy out dissident shareholders.

³ Once the loan is paid off, of course, most companies make some arrangement for the presence of employee representatives on the plan committee.

⁴ For a recent, comprehensive overview of the positive economic evidence (esp. for ESOPs) see *J. R. Blasi, D. Kruse, A. Bernstein, “In the Company of Owners”, Basic Books, New York 2003*; they find an average increase of productivity level by about 4%, of total shareholder returns by about 2% and of profit levels by about 14% compared to firms without PEPPER schemes.