



# Access to Capital

## A Barrier to ESOP Creation

### Background

When an ESOP is created, the ESOP buys shares from the business owner and the cash for the transaction is “loaned” by the Company to the ESOP. Those funds typically come from three sources: the company's cash on hand, loans from a bank or another outside lender, and loans from the selling stockholder. Senior lenders (such as a bank) typically only finance a portion of the debt needed, especially when forming a new majority ESOP. Even with smaller transactions, in multi-phased conversions to ESOP, senior lenders may not finance 100% of the debt needed to complete each transaction. This means that buyers either need to access higher cost loans (such as mezzanine debt) or sellers need to self-finance the gap. Particularly for sellers looking to retire and wanting to be fully cashed out of the business at the transaction's close, this financing gap can often eliminate the option of converting to ESOP.

To foster more ESOPs, greater access to capital is critical. Mezzanine lenders are typically much more expensive, causing the burden of debt to become too risky for the transaction. To close the gap, when sellers will accept less than 100% cash on close, sellers often provide financing, either with or without warrants, earn outs or other mechanisms that go beyond straight amortization with interest. However, these elements are now under increased scrutiny by the U.S. Department of Labor.

To remove access to capital as a barrier to ESOP conversion, either sellers need to be better motivated to accept less than 100% cash on close, or better structured funding sources need to be identified or created that allow sellers to receive 100% cash on close. ESOPs must be protected from lenders and equity investors who seek to abuse the system, taking advantage of ESOP tax treatment to capture more than their fair share in the process.

### Possible Solutions

Capital to fund ESOP conversions comes in two forms, debt and equity. Incentives to create more debt capital might include tax credits, sinking loan funds, or subsidized debt and these might be with or without government backed guarantees.

### Action Items

- Gather co-sponsors for the bipartisan sponsored Employee Equity Investment Act bills in the House (HR-3383) and Senate (S-1618).
- Work with ESG-focused private equity firms, institutional investors, and family offices interested in minority, non-controlling stakes in ESOPs to foster employee ownership.
- It should be a goal to either advance the 2028 starting point for S-corporation ESOP 1042 benefits, or increase the 10% limit to gain parity with comparable C-corporation 1042 tax treatment.
- Work with congressional leadership to develop clear rules to govern DOL oversight of ESOP transactions, focused on warrants and interest rates for seller financing.

[Continued on the Back >](#)

#### POINT OF CONTACT

Greg Facchiano

Vice President of Government Relations and Public Affairs

[gfacchiano@esopassociation.org](mailto:gfacchiano@esopassociation.org)

202-293-6268



A great example of such a program is the Employee Equity Investment Act, recently introduced in the Senate by Senators Chris Van Hollen (D-MD) and Marco Rubio (R-FL), and in the House by Representatives Dean Phillips (D-MN) and Blake Moore (R-UT). This significant new legislation would use the current Small Business Investment Company (SBIC) program at the SBA to motivate private capital investment with federal loan guarantees to specifically support ESOP formation and recapitalization. The bill would create an Employee Ownership specific facility in the SBIC program to provide capital to finance the voluntary sale of privately-held small and medium-sized businesses to their employees. The program would also license existing SBICs to allow for the creation of new SBICs as Employee Equity Investment Companies (EEICs) to make a range of debt and equity-like investments in eligible employee ownership transactions that generate market-rate returns. EEICs would offer a standard debt security that is federally guaranteed, operating without taxpayer subsidy cost.

Incentives to create more equity capital might be directed to family office, institutional, and PE investors but should include protections for ESOPs to prevent equity investors from flipping companies, wresting control, or selling off assets. Protections for any debt or equity incentives scenarios should also include limits on cost of capital, returns on investment, and might be structured similarly to enterprise or opportunity funds.

Selling stockholders are also important sources of capital because they can elect to receive debt instead of cash in return for a portion of the sale of their ownership. If a senior lender is already providing debt and has first call on the Company's assets, the selling stockholder typically will need added incentives to take on the risk associated with providing subordinated financing. This usually takes two forms: a higher interest rate or warrants that provide added returns based on the performance of the stock after it is sold to the ESOP. While these practices are common for mezzanine lenders in the broader marketplace, the Department of Labor has begun scrutinizing interest rates and warrants in their investigations, further impeding the motivation of sellers to provide financing.

Another motivation to incentivize sellers is "1042 Treatment" (under IRC Section 1042), which allows sellers to defer capital gains taxes by rolling over the proceeds from a sale of stock to the ESOP into certain domestic securities. While this has been helpful to close the gap between a 100% cash up-front sale to a third party, until 2022 section 1042 only applied to the sale of stock of C-corporations, while many small to medium sized businesses are S-corporations. The SECURE 2.0 Act of 2022 allowed, for the first time, S-corporations access to section 1042 benefits, but not starting until 2028 and only at a limited (10%) level. Parity between S- and C-corporations in this matter would be ideal.