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 tranches, 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.

Action Items

- Gather co-sponsors for the bipartisan American Ownership and Resilience Act (AORA).
- Work with social impact investors and 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.

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.

A great example of such a program is the American Ownership and Resilience Act (AORA) introduced in the Senate by Sen. Chris Van Hollen (D-MD) and Sen. Jerry Moran (R-KS) and cosponsored by Sen. Tammy Baldwin (D-WI), Sen. Todd Young (R-IN), Sen. Jeanne Shaheen (D-NH), Sen. Eric Schmitt (R-MO), and Sen. Peter Welch (D-VT). It was introduced in the House by Rep. Lori Trahan (D-MA) and Rep. Blake Moore (R-UT)

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and cosponsored by Rep. Dusty Johnson (R-SD) and Rep. Bill Foster (D-IL). AORA would significantly enhance U.S. supply chain resilience, help retain production capabilities domestically and provide workers with the opportunity to build substantial retirement assets. AORA establishes a zero-subsidy investment facility within the U.S. Department of Commerce, modeled after the successful Small Business Investment Company (SBIC) program at the Small Business Administration. This facility enables licensed private investment entities, known as Ownership Investment Companies (OICs), to mobilize private capital for the purchase of privately held businesses transitioning to ESOP ownership. This approach would help address a critical financing gap in ESOP transactions, allowing business owners to sell their companies to their employees rather than selling outside of their communities, possibly to a foreign entity, or closing entirely.

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.