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# ESOPs: A Powerful Tool for Closely Held Banks

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An Employee Stock Ownership Plan (ESOP) is a powerful and effective tool that can be used for addressing many different issues facing closely held banks. For shareholders in a closely held bank, an ESOP can be used as a succession planning or liquidity vehicle. For the bank's employees, it can provide enhanced benefits useful in attracting, motivating and retaining employees. For the sponsoring bank or bank holding company, an ESOP can facilitate tax-efficient capital enhancement. Most bank sponsored ESOPs own less than 25 percent of the sponsoring bank's stock. However, a few banks are 100 percent ESOP-owned. An ESOP is not an isolated, stand-alone vehicle. To be successful, it must be integrated into the bank's overall strategic plan.

## Succession Planning and Liquidity for Shareholders

ESOPs are especially useful as a tool for shareholder succession planning and liquidity. Shareholders in a closely held bank often:

- desire to implement a succession plan to pass ownership of the bank on to the next generation
- need liquidity in their estate plan to facilitate payment of taxes or to provide cash for family members
- need cash for lifestyle changes
- are nearing retirement age and wish to sell their interests in the bank
- want to resolve shareholder disputes

ESOPs are a tax-efficient vehicle and can provide tremendous flexibility to a shareholder wanting to dispose of all or a portion of his or her stock in the bank. Often, the transaction can be structured so that a controlling shareholder is able to retain control of the bank following the sale. Depending on the circumstances, the price paid by an ESOP may exceed what a third-party strategic buyer would pay.

If you are a controlling or substantial shareholder of a bank and are considering selling some or all of your stock, you should consider an ESOP as part of any succession planning or liquidity strategy.

## Enhanced Benefits for a Bank's Employees

Banks frequently use ESOPs to provide enhanced benefits for their employees. The ESOP often supplements an existing benefit plan, such as a 401(k) plan. It can be a very effective tool for attracting, retaining and motivating employees. Studies have shown that employees of ESOP-owned companies are more productive than non-ESOP-owned companies because they have ownership stakes in their employers.

An ESOP is a special kind of qualified retirement plan designed to give employees an ownership stake by investing primarily in the stock of the employer. The stock is owned by a trust, which is managed by a trustee. The stock is usually allocated to participants' accounts over time, and participants are entitled to a distribution of their accounts on their retirement, death, disability or other termination of employment. The individual participants do not directly own the shares of stock and do not have access to the company's financial records. Generally, the trustee has the right to vote the shares in its discretion. However, certain corporate transactions – such as mergers, reorganizations and the sale of a significant portion of the company's assets – may require "pass-through" voting, which means the participants must be given the right to instruct the trustee as to shares allocated to their account. The administration of an ESOP is very similar to the administration of other qualified defined contribution plans, such as 401(k) plans.

## Enhancement of Bank's Capital

ESOPs are often used by banks to raise additional capital or to restructure existing capital using pre-tax dollars. Under this strategy, the bank makes tax-deductible cash contributions to the ESOP, and the ESOP then uses the cash to purchase shares of stock from the sponsoring bank or holding company. Generally, an ESOP must purchase common stock that has a combination of voting and dividend rights at least equal to the class of the bank or holding company's common stock with the greatest voting power and dividend rights. The ESOP can also purchase preferred stock, but only if the preferred stock is convertible into the bank or holding company's common stock.

**Example 1:** Assume a bank contributes $10,000 in cash to an ESOP. The contribution is tax-deductible to the bank, providing the bank with a $4,000 tax savings (assuming a 40 percent combined federal and state income tax rate). Further, assume the ESOP uses the cash to purchase newly issued common shares from the bank, thereby increasing the bank's common equity by $10,000. The net after-tax cost to the bank of this $10,000 increase in equity is $6,000.

ESOPs may also provide a tax-efficient strategy for a bank or holding company wanting to redeem some (or all) of its non-convertible preferred stock. Under this strategy, the bank or holding company contributes funds to the ESOP, and the ESOP then uses the funds to purchase newly issued common shares from the bank or holding company. The bank or holding company then uses the funds received for the newly issued stock to redeem the preferred shares.

**Example 2:** Assume the bank contributes $10,000 in cash to the ESOP. Further, assume that the ESOP uses the $10,000 to purchase newly issued common stock from the bank. The bank then uses the $10,000 received from the ESOP to redeem the preferred stock. As in the above example, the net after-tax cost of the redemption of $10,000 of preferred shares is $6,000.

## Tax Benefits

ESOPs are often used for the tax benefits they provide. As the above examples illustrate,ESOP strategies can be very tax efficient. Generally, an ESOP transaction is structured in such a way that the bank makes tax-deductible contributions to the ESOP, and the ESOP uses the contributions to acquire the bank's stock or, if the transaction is leveraged, makes payments of principal and interest on the loan that was used to finance the ESOP's acquisition of stock. This pre-tax aspect of an ESOP transaction is what makes the use of an ESOP highly attractive to banks. A shareholder's sale of stock to a non-ESOP buyer or a bank's stand-alone redemption of its stock does not generate any deductions to the bank and is not tax-efficient.

An additional tax benefit is available if the bank is an "S" corporation that is partly or wholly owned by an ESOP. In these situations, neither the bank nor the ESOP pays any income taxes on the bank's income that is allocated to the ESOP. In fact, if the bank is an "S" corporation which is 100 percent owned by an ESOP, neither the bank nor the ESOP will pay any income taxes. Because a bank that is 100 percent owned by an ESOP pays no income taxes, its cash flow is considerably increased.

There are other tax benefits available to the bank and its shareholders, depending on whether the bank is taxed as a "C" corporation or an "S" corporation. For example, if the bank is a "C" corporation and the ESOP owns 30 percent or more of the bank's stock, a shareholder who sells his stock to an ESOP may be eligible to defer (and possibly eliminate) income taxes on his gain on the sale.

### Leveraged or Non-Leveraged

An ESOP can be leveraged or non-leveraged, depending on how the ESOP obtains the funds it uses to acquire the bank or holding company's stock.

A leveraged ESOP uses borrowed funds to purchase stock. The usual steps in a leveraged ESOP transaction are: a) a third-party lender makes a loan to the bank or holding company (often referred to as an "outside" loan); b) the bank or holding company loans the funds to the ESOP (often referred to as an "inside" loan); c) the bank makes annual contributions to the ESOP in an amount necessary for the ESOP to make the annual payments on the "inside" loan; d) the ESOP makes the payment to the bank on the inside loan; and e) the bank makes a payment to the third-party lender on the outside loan. As an alternative to obtaining financing from a third-party lender, the ESOP can acquire the stock of the bank or holding company by having the selling shareholders "seller-finance" the purchase of stock.

A leveraged ESOP is often used to enable the ESOP to acquire a block of stock from a selling shareholder as part of the selling shareholder's succession planning or liquidity strategy.

A non-leveraged ESOP purchases stock using existing plan assets, assets of other qualified plans of the bank – such as 401(k) plans – or bank contributions to the ESOP. It is often used by a bank to supplement its employee benefits program. The non-leveraged ESOP uses its own funds or cash contributions received from the bank to acquire small blocks of the bank or holding company's stock. In a non-leveraged ESOP, no borrowed funds are used.

### Is Your Bank a Good ESOP Candidate?

An ESOP can provide substantial benefits to a bank, its owners and its employees. However, not all banks are good candidates for adopting an ESOP. Only banks that are structured as a corporate entity can adopt an ESOP. Banks that are structured as partnerships and limited liability companies are not permitted to sponsor an ESOP, although there are often ways to structure the transaction so that a non-corporate bank can benefit from an ESOP.

Banks that are good ESOP candidates generally have a) solid operating performance, b) stable or predictable cash flow, c) a good senior management team and d) payroll sufficient to support the contributions necessary to fund the repayment of the ESOP loan (if the ESOP is leveraged).

If a bank or selling shareholder is interested in undergoing an ESOP transaction, a feasibility study should be done to confirm that the bank is a good ESOP candidate. Generally, the feasibility study is performed by an outside consultant and includes:

- a preliminary valuation of the bank to determine the approximate price the ESOP would need to pay to acquire the bank's stock
- an analysis of the effects of the proposed ESOP on all of the shareholders and the financial statements of the bank
- an analysis of various ESOP plan designs and financing strategies
- an analysis of the bank's liquidity to determine the bank's ability to repurchase the stock allocated to the accounts of ESOP participants upon the participants' retirement, death or other termination of employment

Implementing the successful ESOP is a team effort, involving the bank's management and major stockholders as well as the bank's accountants, attorneys, financial advisors and existing (or new) lenders. It may also include various ESOP advisors, such as a valuation firm, special ESOP counsel, trustees and investment bankers.

## Summary

ESOPs provide a powerful estate planning, financial and employee benefits tool for banks and their shareholders. The flexibility of ESOPs and the ability to use pre-tax dollars to finance ESOP purchases make sales of stock to an ESOP a preferred solution for many planning situations.

For more information on ESOPs or to discuss an issue affecting your bank or its shareholders, contact a member of Holland & Knight's ESOP Team or Financial Services Practice Group.