

# Navigating the Exit: Employee Stock Ownership Plans (ESOPs)

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Deciding how to transition out of your business is one of the most consequential decisions you will face as an owner, one that affects not only your personal financial future, but also the trajectory of the company and the livelihoods of the people who helped build it. Among the transition options available to business owners, the Employee Stock Ownership Plan (ESOP) occupies a unique position.

An ESOP is a qualified retirement plan in which a trust, established and funded by the company, purchases some or all of an owner's shares on behalf of its employees. Unlike a sale to a third party, there is no outside buyer at the table, and the business remains an independent. When properly structured, an ESOP can offer meaningful tax advantages, flexible deal terms, and a path to liquidity that preserves the company's culture and continuity.

ESOPs are not the right fit for every company or every owner. They work best under specific financial, organizational, and personal circumstances, and they involve trade-offs that deserve the same rigorous analysis applied to any other exit alternative.

## An Exit Path Worth Exploring

While some exit options, like third-party sales, management buyouts, and family succession, are (for the most part) well understood, ESOPs remain less familiar to many business owners. That gap in understanding often means they are either overlooked entirely or evaluated based on incomplete information. For owners seeking to balance competing priorities like maximizing value, managing tax exposure, ensuring continuity, and preserving the culture behind the company's success, ESOPs offer a distinctly different approach, one that combines elements of a capital markets transaction with the structural framework of a qualified retirement plan. They are complex, highly regulated, and not right for every situation. But for the right situation, few transition tools offer the same combination of flexibility and tax efficiency.

### What Is an ESOP?

An Employee Stock Ownership Plan is a qualified, defined-contribution retirement plan designed to invest primarily in the stock of the sponsoring employer. Governed by the Employee Retirement Income Security Act (ERISA) and subject to oversight by the Department of Labor and Internal Revenue Service, an ESOP functions as a unique business transition option that sits somewhere between a direct sale to a third party and an internal transfer to family or key management.

In an ESOP transaction, company shares are sold to an ESOP trust. The trust becomes the legal shareholder, while employees participate as beneficial owners through individual retirement accounts allocated over time. Employees do not purchase stock directly or invest any of their own capital to participate in the plan. Unlike traditional retirement plans that might invest in diversified portfolios of stocks, bonds, or mutual funds, an ESOP is designed to invest primarily or exclusively in the stock of the sponsoring employer—meaning participant account values are directly tied to the performance of a single company rather than a broad market index.

### The Hybrid Nature of ESOPs

ESOPs occupy a unique middle ground in the spectrum of exit strategies. They can be structured as either partial or 100% transactions, giving owners significant flexibility in their transitions. In a partial ESOP, an owner might sell 30%, 50%, or any other percentage to the ESOP trust while retaining the remainder. In a 100% transaction, the ESOP trust becomes the sole shareholder of the company.

One of the distinguishing features of an ESOP is that the trust operates as a single shareholder, even though employees are the beneficiaries. This structure simplifies governance while providing employees with the economic benefits of ownership. The transition typically unfolds over four to six years, allowing for a measured handoff rather than an abrupt change in control.

### What an ESOP Is Not

An ESOP is not a technique to pass the business on to the next generation of family members. If your primary goal is keeping the business within your family lineage, other succession planning tools would be more appropriate.

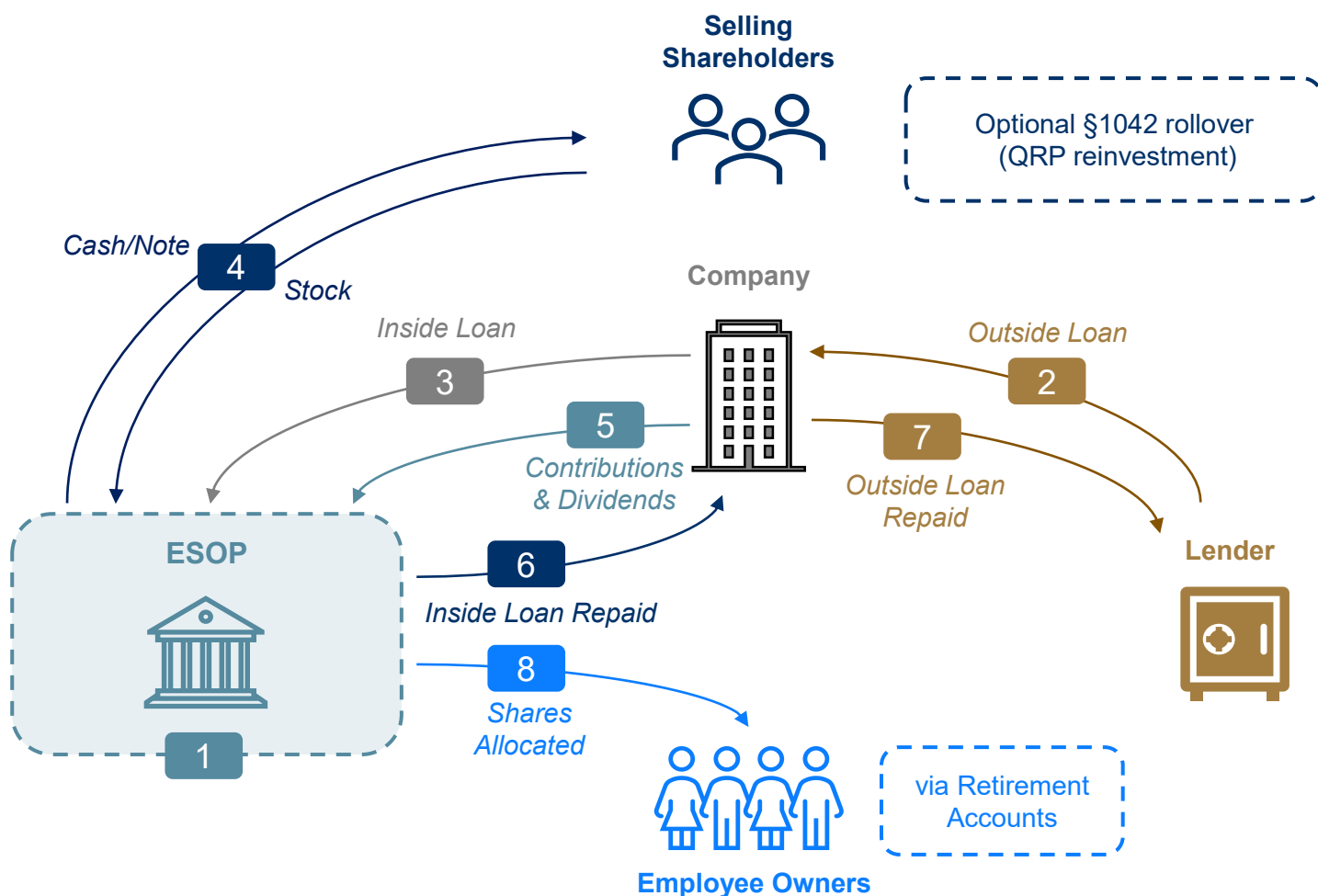
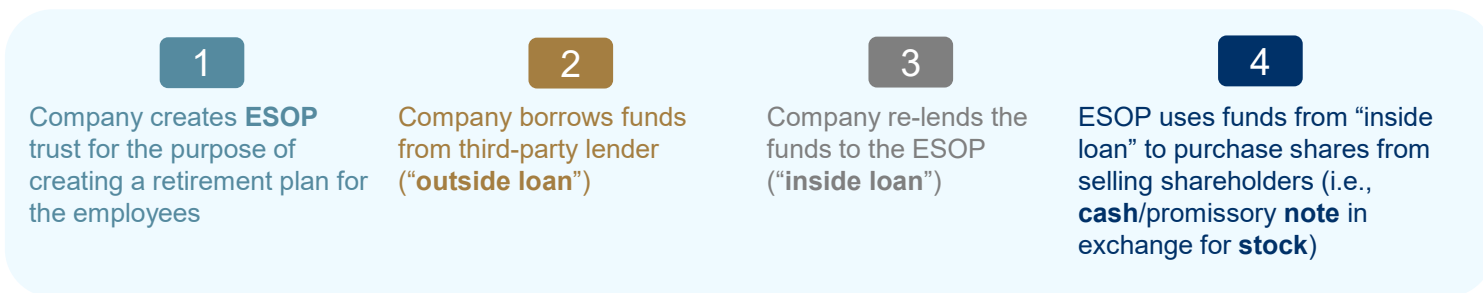
An ESOP is not a technique to provide ownership to a limited group of employees, such as senior management. The plan must be available to employees broadly, serving as a retirement benefit, although the plan can include standard eligibility requirements such as completing one year of employment.

An ESOP is not a structure for giving employees direct control over day-to-day business decisions. The ESOP trust holds shares on behalf of employees, and a trustee—not individual employees—exercises shareholder rights. Employees are beneficiaries of the trust, not direct stockholders managing the enterprise.

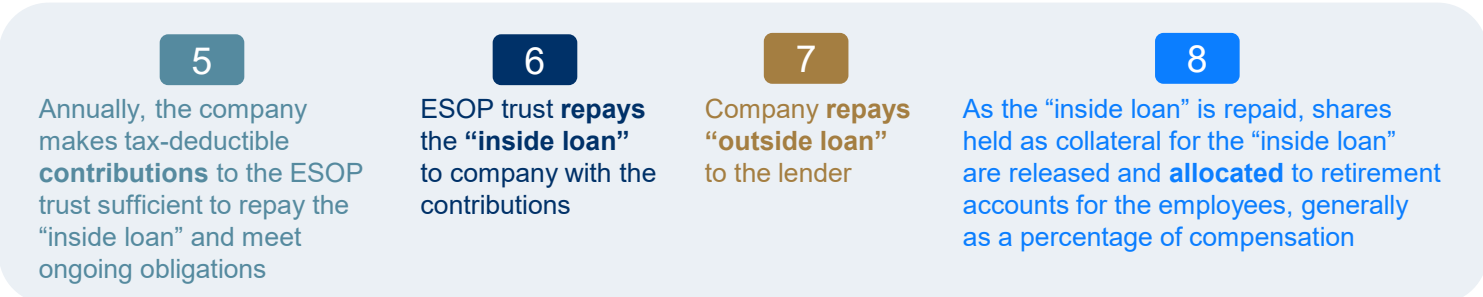
## The Basic ESOP Structure

At its simplest, an ESOP transaction involves the following:

### Initial Structuring



### Ongoing Administration



## An Alignment of Interests

An ESOP transaction has the potential to create value for all parties involved: the selling shareholders, the employees, and the company.

### Benefits to Selling Shareholders

**Tax Mitigation.** One of the most compelling financial benefits available to selling shareholders of C-corporations is the capital gains tax deferral under Internal Revenue Code Section 1042. To qualify, several conditions must be met: the securities being sold must constitute "qualified securities" — defined as common stock carrying voting power and dividend rights equal to or exceeding the most senior class of common stock outstanding, and the shares must not have been acquired through compensatory arrangements (such as incentive stock options, employee stock purchase plans, or other equity-based compensation programs); the ESOP must own at least 30% of the company's outstanding stock following the transaction; the seller must have held the shares for a minimum of three years; and the seller must reinvest proceeds into Qualified Replacement Property (QRP) within the prescribed reinvestment window. When all conditions are satisfied, the seller can defer the entire capital gains tax — often representing 20% or more of the sale price at the federal level alone.

**Transaction Flexibility.** Few exit strategies offer the structural versatility of an ESOP. Owners can choose to sell all of their shares in a single transaction or take a staged approach, selling an initial tranche and retaining the remainder for a future sale. A partial ESOP provides immediate liquidity and potential tax benefits while preserving a meaningful ownership stake, allowing the owner to continue running the business, drawing compensation, and participating in future growth. When the time is right, additional tranches can be sold on terms negotiated at that time, reflecting the company's updated valuation.

For owners who proceed with a full sale, control does not have to disappear overnight. Most ESOP transactions are structured with a transition period during which the selling owner remains involved operationally and at the board level, allowing the business to stabilize, management to develop confidence, and the owner to step back on a timeline that makes sense for the company rather than one dictated by an outside buyer. Transactions can also include warrants, giving sellers the ability to capture

future upside if the company grows significantly post-close. Taken together, these features give business owners a degree of control over the terms, timing, and economic structure of their exit that most other strategies simply do not offer.

### Qualified Replacement Property (QRP)



To complete a Section 1042 election, the selling shareholder must reinvest proceeds into QRP within a window that begins three months before and ends twelve months after the sale date. QRP is defined as stocks, bonds, or other securities of domestic operating corporations—meaning U.S. companies that derive more than 50% of their revenue from active business operations rather than passive investments.

Mutual funds, government bonds, and securities of the selling company itself do not qualify. In practice, many sellers work with QRP specialists to construct diversified QRP portfolios or utilize structured QRP instruments, such as floating-rate notes issued by domestic corporations, that are specifically designed to meet the statutory requirements while providing liquidity and income. Careful QRP planning is essential, as failure to reinvest within the required window—or investing in non-qualifying securities—can trigger the deferred tax liability.

Given the complexity of QRP eligibility rules, reinvestment timing requirements, and the consequences of a misstep, engaging a dedicated QRP specialist with deep, demonstrated experience is not merely advisable—it is, as a practical matter, a necessity.

**Legacy and Values.** For many business owners who have built their companies over decades, preserving their legacy matters deeply. ESOPs allow owners to reward the employees who contributed to the company's success, maintain jobs in the community, and ensure that the business continues as an independent entity rather than being absorbed by a larger competitor or restructured by private equity.

**Certainty and Confidentiality.** Unlike a traditional M&A process that might take 9—12 months (or more) with no guarantee of closing, ESOP transactions typically offer greater certainty. The process can be conducted confidentially without exposing sensitive business information to competitors or the broader market.

### Benefits to Employees

**Retirement Benefit.** Employees receive ownership stakes in the company without contributing any of their own money. This often represents an additional retirement benefit beyond any existing 401(k) or pension plans, with returns directly tied to company performance. Employee accounts grow tax-deferred, like traditional retirement accounts. When employees eventually receive distributions, they are eligible for tax-free rollover into IRAs or other qualified retirement plans.

When a distribution includes actual company stock, employees may want to evaluate the net unrealized appreciation (NUA) rules before rolling over. In certain circumstances, taking a stock distribution in-kind and paying tax only on the original cost basis can produce a lower overall tax liability than a full rollover.

**Job Security and Motivation.** ESOP companies often experience improved job retention because employees have a vested interest in the company's long-term success. The ESOP structure can motivate and reward employees, often providing credit for prior years of service. This alignment of interests creates a culture of shared responsibility and accountability.

**Transparency.** Unlike informal profit-sharing arrangements, ESOP participants receive annual account statements showing exactly how their benefit is growing. Each statement details the number of shares allocated to the employee, the current price per share (as determined by the independent annual valuation), and their vested percentage.

### Benefits to the Company

**Tax Advantages.** For C-corporations, the company effectively receives a tax deduction for the total value of stock sold to the ESOP. For S-corporations that are 100% ESOP-owned, the benefits are even more substantial, as these companies incur no federal income tax liability and, in most cases, no state income tax liability at the corporate level. This exemption can free up substantial cash flow for debt service, growth initiatives, or employee compensation.

**Enhanced Cash Flow and Strategic Flexibility.** The tax savings generated by ESOP ownership increase available cash flow, which can be deployed strategically for growth, innovation, acquisitions, or debt reduction. This improved financial flexibility can strengthen the company's competitive position.

**Acquisition Opportunities.** ESOP-owned companies can structure future acquisitions to allow sellers of acquired companies to also sell tax-free under IRC Section 1042. This creates a potential competitive advantage in deal negotiations and can make an ESOP-owned company an attractive acquirer.

**Culture, Retention, and Recruitment.** Employee ownership cultivates a distinctive company culture where workers think and act like owners. In tight labor markets, this ownership culture becomes a powerful tool for both retention and recruitment, helping companies attract and retain quality talent.

### Risks, Challenges, and Misconceptions

While ESOPs can offer significant advantages, they are not without meaningful trade-offs. A disciplined evaluation requires examining both sides of the ledger.

### Implementation and Ongoing Costs

ESOP transactions are complex and expensive. Initial implementation costs typically range from \$250,000 to \$750,000 or more, depending on company size and transaction complexity. These include fees for ESOP advisors, multiple legal counsels, independent valuation firms, lenders, accountants, and plan administrators. Ongoing annual expenses for valuations, trustee fees, plan administration, and regulatory compliance can further strain cash flow, particularly for smaller companies.

## Valuation Considerations

ESOP valuations must reflect fair market value, which typically falls short of what strategic buyers might pay. Strategic acquirers may pay a premium for synergies, market share, intellectual property, or other strategic benefits that an ESOP, buying the company as a going concern, generally cannot match. For owners hoping to maximize absolute sale price, this can be disappointing. However, when factoring in tax savings from Section 1042 treatment and the ability to retain upside through warrants, the economic comparison becomes more favorable than headline numbers suggest.

## Repurchase Obligations

As employees retire or otherwise leave the company, the ESOP must repurchase their shares at fair market value. This creates an ongoing cash requirement that can become significant as the first generation of ESOP participants reach retirement. The National Center for Employee Ownership (NCEO) has found that approximately 67% of ESOP terminations cite repurchase obligations as a primary rationale. Poor planning—such as excessively short internal loan terms or overly generous vesting for prior service—can quickly create unsustainable cash requirements.

## Regulatory Complexity and Corporate Resources

As a qualified retirement plan governed by ERISA, ESOPs face substantial regulatory oversight, bringing compliance requirements, reporting obligations, and fiduciary responsibilities that add complexity and potential legal risk. The ESOP trustee must act in the best interests of plan participants, which can sometimes create tensions with management or selling shareholders. Beyond direct costs, the initial transaction and ongoing administration demand significant management attention that can distract from core business operations.

## Common Misconceptions

**Misconception: “ESOPs are just like giving stock to employees.”** *Reality: Employees do not directly own stock or control company decisions. The ESOP trust holds shares on their behalf, providing economic benefits without fragmenting ownership or creating governance challenges.*

## “Fair Market Value”



ESOPs are required by law to pay no more than “adequate consideration” for company stock, which, in practice, means fair market value (FMV) as determined by an independent, qualified appraiser. FMV represents the price at which property would change hands between a willing buyer and a willing seller, neither being under compulsion to act, and both having reasonable knowledge of relevant facts.

Because the ESOP is purchasing the company as an ongoing entity—without the synergies, market share consolidation, or intellectual property leverage that a strategic buyer might capture—FMV typically falls below what is commonly referred to as “synergistic” or “strategic” value. This distinction is important for owners to understand when comparing ESOP economics to third-party sale outcomes.

**Misconception: “All employees become equal owners.”** *Reality: ESOP allocations typically reflect compensation levels and years of service, meaning higher-paid, longer-tenured employees generally accumulate larger account balances. Pure equality is neither automatic nor typical.*

**Misconception: “ESOPs automatically improve performance and culture.”** *Reality: While many ESOP companies experience cultural and performance benefits, these outcomes require intentional effort—integrating the ESOP into company culture, communicating effectively with employees about ownership, and creating accountability for performance.*

**Misconception: “Selling to an ESOP means immediate, full liquidity.”** *Reality: While debt can be utilized to increase cash proceeds at closing, many ESOP transactions include seller notes that get paid over time. The amount of cash available at closing depends on the company’s cash position, debt capacity, and transaction structure.*

## ESOP vs. The Field

Every exit strategy involves trade-offs. The decision to pursue an ESOP should be made in the context of available alternatives, weighing financial outcomes, personal objectives, and practical considerations.

### ESOP vs. Third-Party Sale

A third-party sale may deliver premium valuations reflecting synergies, market share, or intellectual property value. However, these transactions often involve loss of control, cultural disruption, extended and uncertain timelines, exposure of confidential information, and full taxation on proceeds. By contrast, an ESOP provides greater certainty of close, confidentiality, continued involvement, legacy preservation, and potentially better after-tax economics.

### ESOP vs. Management Buyout (MBO)

Management buyouts allow the business to pass directly to select key leaders, offering continuity and preserving institutional knowledge. However, MBOs face practical challenges that can limit their viability. Key management rarely have sufficient personal capital to fund the acquisition, often requiring the seller to finance a significant portion of the purchase price. The transaction also generally lacks the tax advantages available through other structures. An ESOP addresses the capital constraint by using the company's own cash flow and borrowing capacity to fund the acquisition, while spreading ownership broadly across the workforce rather than concentrating it in a small group.

### ESOP vs. Family Succession

Family succession preserves the business within the family lineage, but the complications are frequently underestimated — successor alignment, capability gaps, estate tax exposure, and equitable treatment of family members both inside and outside the business. For owners who lack an interested or capable successor, or who do not want to burden the next generation with debt, operational risk, or family conflict, the ESOP offers a proven and structurally clean alternative. The business remains independent, employees are protected, and the owner achieves liquidity without forcing an outcome the family may not be positioned to sustain. In many cases, it is itself an act of stewardship.

## ESOP vs. Dividend Recapitalization

Dividend recapitalizations can provide liquidity while retaining ownership, but they do not solve for an owner's exit and succession plan. ESOPs can achieve similar partial liquidity with greater flexibility, potentially more favorable tax treatment, and establish a roadmap for an eventual exit.

### The Dual-Track Process



Some owners pursue a dual-track process, evaluating both an ESOP and a third-party sale simultaneously. This approach can improve negotiating leverage, provide valuation context, and ensure that the owner has a genuine comparison of economic outcomes.

Running parallel processes does add cost and complexity, and there is a risk that a half-hearted ESOP exploration may not produce the best possible ESOP structure. Owners considering a dual-track should engage experienced ESOP-specific advisors to ensure that both paths receive rigorous attention.

## What Makes a Good ESOP Candidate?

Not every company is well-suited for an ESOP. Certain characteristics significantly increase the likelihood of a successful transaction and sustainable long-term ESOP ownership. The following factors represent the profile of an ideal candidate.

### Financial Characteristics

**Size and Scale.** While there is no absolute minimum, most ESOP advisors look for companies with at least \$2 million in annual EBITDA and enterprise values of \$10 million or more. Companies with annual payrolls of \$2 million or higher generally have sufficient scale to absorb ESOP costs without those expenses becoming disproportionately burdensome.

**Strong, Predictable Cash Flow.** Companies need consistent, predictable cash flow to support three major obligations: debt service on ESOP financing, annual ESOP contributions and administrative expenses, and eventual repurchase obligations. The business should demonstrate a history of steady or increasing sales and profits over the previous three to five years.

**Debt Capacity.** Since many ESOP transactions are at least partially debt-financed, the company must have additional borrowing capacity. Lenders will evaluate cash flow coverage, existing debt levels, asset base, and business stability.

**Growth Trajectory.** Steady, controlled growth creates rising share values that make employee ownership meaningful and helps ensure that repurchase obligations can be met over time. Companies in decline or facing uncertain futures face significant ESOP challenges.

**Tax-Paying Position.** The tax benefits of ESOP ownership are most valuable for profitable companies with tax liabilities to offset.

### Management and Succession

**Strong Management Team with Successors.** Perhaps no factor is more critical than having a capable management team in place to run the business after the principal owner steps back. Ideally, key leadership positions have identified successors ready to assume greater responsibility.

Attempting an ESOP without a succession plan creates substantial risk—if the owner is the business, and no one can fill their shoes, the ESOP structure does not solve the fundamental problem.

**Employee-Centric, Transparent Leadership.** Management should value employee contributions and embrace shared ownership. Leaders who operate secretly, share little financial information, or see employees as cost centers rather than assets typically struggle with the ESOP culture. Successful ESOPs require transparency and willingness to treat employees as partners.

**Management Incentives.** If management does not receive appropriate incentives outside the standard ESOP allocation, such as stock appreciation rights (SARs), supplemental bonuses, or enhanced allocations, they may lack sufficient motivation to drive company performance post-transaction.

### Workforce and Culture

**Demographics and Headcount.** Companies with diverse workforces across age groups create natural repurchase obligation cycles rather than a simultaneous retirement “bulge.” Companies with at least 25–50 employees generally find ESOPs more economically viable. Workforces heavily concentrated near retirement create significant near-term repurchase risk.

**Employee Stability and Engagement.** Low turnover and high engagement amplify ESOP benefits. However, ESOPs can also be strategically used in higher-turnover industries to “stitch employees into the company” and improve retention.

### Owner Objectives and Structural Considerations

**Realistic Expectations.** Owners who value legacy preservation, employee rewards, tax advantages, and transition flexibility over obtaining maximum sale price make ideal ESOP candidates.

**Willingness to Stay Involved.** Sellers willing to remain partially invested and involved during a three-to-six-year transition align well with ESOP structures.

**Appropriate Corporate Structure.** C-corporations, and S-corporations can sponsor ESOPs. Partnerships and professional corporations typically cannot.

## Circumstances That Align with ESOPs

Beyond the general advantages, certain specific situations can make ESOPs particularly compelling. The following scenarios illustrate circumstances where ESOP structures have proven especially effective.

### The Corporate Divorce

When business partners need to part ways, but one partner wants to remain, an ESOP can acquire the departing partner's shares. The departing partner achieves liquidity (with potential Section 1042 benefits), the remaining partner maintains control, the management team stays intact, and the company gains employee ownership benefits.

### Uncooperative M&A Environment

Owners who have been through an unsuccessful sale process or face a subdued dealmaking environment often find the certainty and seller-friendly structure of ESOPs an attractive alternative that removes the urgency of accepting an underwhelming third-party offer.

### Real Estate-Involved Businesses

Entrepreneurs who also own significant real estate, or who operate in industries where real estate is particularly integral to business operations, such as assisted living facilities, convenience stores, restaurants, or car dealerships, can roll those assets into the operating company before the ESOP transaction, increasing enterprise value and the amount eligible for Section 1042 tax deferral. The real estate can also serve as additional collateral to strengthen the bank financing package, potentially improving deal terms and reducing seller note exposure.

### Confidentiality-Sensitive Industries

In any traditional M&A process, sensitive business information flows to potential buyers who may be competitors, customers, or suppliers. For government contractors, companies holding valuable intellectual property, proprietary manufacturers, and others where confidentiality is genuinely business-critical, that exposure carries real risk regardless of whether a deal closes. An ESOP eliminates this risk entirely. The effective "buyer" is the company's own employee base, and the process can be conducted without marketing the business to the broader market.

## Retention-Challenged Industries

Professional services, staffing, architecture, engineering, and consulting firms often share a common problem: the key business assets walk out the door at the end of every day, and competitors know it. ESOPs can serve as a structural retention tool, giving key employees a meaningful, accumulating stake in the enterprise they help build. This "stitching in" effect can reduce turnover, improve recruiting, and increase the long-term value of the business, all while providing the current owner with a viable exit path.

## Community-Anchored Businesses

For owners deeply embedded in their communities, ESOPs typically preserve jobs, maintain community presence, and ensure that the business continues as an independent entity rather than being acquired and potentially relocated or absorbed.

### Industries Well-Suited to ESOPs



**Professional Services:** Architecture, engineering, consulting, and advertising firms often make excellent ESOP candidates due to their people-centric business models.

**Manufacturing and Distribution:** Companies with strong balance sheets, equipment assets, stable customer bases, and predictable cash flows frequently perform well as ESOP companies.

**Construction and Specialty Trades:** Project-based businesses with skilled workforces benefit in similar ways to professional services firms. Ownership stakes can be key in attracting and retaining tradespeople in competitive labor markets.

**Government Contracting:** Beyond confidentiality considerations, continuity of management and culture during an ownership transition can be a factor in maintaining security clearances and long-term contract relationships.

## Nuances of an ESOP Transaction

The basic mechanics of an ESOP transaction are relatively straightforward. The decisions that shape its long-term economics, including how it is financed, how the loan is structured, and how ownership transitions over time, require more careful consideration.

### Financing the Transaction

**Cash.** The company may use available cash to fund part or all of the purchase. This provides immediate liquidity to the seller but reduces the company’s capital.

**Debt.** Many ESOP transactions involve borrowing from banks or other non-bank lenders. The company takes the loan, lends the proceeds to the ESOP (creating an “internal loan”), and the ESOP uses them to buy the shares. As the company makes tax-deductible contributions to the ESOP, the ESOP repays the internal loan, and shares are released to employee accounts.

**Notes.** Sellers often accept promissory notes (also known as “seller financing”) for a portion of the purchase price, receiving payments over time (typically 5–10 years). This note provides partial immediate cash while deferring the balance.

## Internal Loan Mechanism

A key feature of ESOP financing is the internal loan structure. When a company borrows externally to fund an ESOP purchase, it typically lends those funds to the ESOP trust. Over time, the company makes tax-deductible contributions to the ESOP, which the ESOP uses to repay the internal loan. As payments are made, shares are released and allocated to employee accounts, based on compensation, years of service, or other formulas. Longer loan terms (10–15 years) spread allocations over more years, benefiting future employees and moderating repurchase obligations.

### Partial, Majority, or Full Transactions

**Partial Transaction.** The owner sells a minority stake (i.e., 1–49%) to the ESOP, retaining majority ownership. This provides liquidity and estate planning benefits while maintaining control, with the option to sell additional tranches over time.

**Majority Transaction.** The ESOP purchases more than 50%, making the ESOP the majority shareholder. The selling owner becomes a minority shareholder but typically retains significant board representation and influence.

**100% Transaction.** The ESOP purchases all shares and becomes the sole shareholder. This maximizes tax benefits (especially for S-corporations) and simplifies governance, but it requires the owner to fully transition control (once they have been fully paid out).

### C-Corporation vs. S-Corporation Considerations

**C-Corporation ESOPs.** Sellers can use Section 1042 to defer capital gains taxes by reinvesting in QRP. The company receives tax deductions for contributions to the ESOP, but it still pays corporate income taxes on profits.

**S-Corporation ESOPs.** Sellers cannot use Section 1042 (S-corps do not have the same capital gains treatment). However, the portion of the company owned by the ESOP pays no federal or state income taxes. A 100% ESOP-owned S-corporation is entirely tax-exempt at the corporate level, creating enormous cash flow advantages.

Many owners weigh these tradeoffs carefully, sometimes converting from C-corp to S-corp, or vice versa, before the ESOP transaction, to optimize tax outcomes.

## Warrants and Upside Participation

Warrants are a common feature of ESOP transactions that allow the selling shareholder to participate in future appreciation. Typically, the seller receives warrants representing the right to purchase a percentage of the company’s stock at a predetermined strike price at a future date.



Warrants are normally paired with seller financing. Lenders in leveraged ESOP transactions typically restrict the interest rate payable on subordinated seller notes, often well below what an investor would require for comparable risk. Warrants compensate for that constraint. The seller accepts a below-market yield on the note and recovers the difference through equity upside if the company grows post-transaction.

## The ESOP Process: Step by Step

Implementing an ESOP involves multiple phases, typically spanning 6–12 months from initial exploration to closing. Understanding this timeline helps set realistic expectations.

### Phase 1: Feasibility Study and Valuation



The process begins with a feasibility study to determine whether an ESOP makes strategic and financial sense. This analysis is conducted by the ESOP Advisor, or Investment Banker (IB), hired by the company to provide an enterprise value range, taking into consideration numerous financial metrics. The feasibility study also includes modeling to project debt service coverage, repurchase obligations, and long-term cash flow impacts.

### Phase 2: Structuring the Transaction



Key decisions include the percentage to be sold as well as mix of cash, bank debt, seller notes, and use of warrants. Governance structure, management incentives and ESOP provisions are all critical to the success of the plan and the need to balance competing interests.

### Phase 3: Financing Arrangements & Letter of Intent



The company and/or its ESOP Advisor approach lenders, typically banks with ESOP lending experience who evaluate financial performance, management strength, industry dynamics and existing debt levels. In an ESOP transaction, lenders typically rely solely on the strength of the company to repay the debt. Personal guarantees from former owners or management are rare.

Once the valuation and general deal terms are satisfactory, and financing has been “soft circled,” an offer (i.e., letter of intent or term sheet) is drafted to be presented to the ESOP trustee. The offer outlines the proposed purchase price, financing structure, and other key transaction terms.

### Phase 4: ESOP Trustee Selection & Due Diligence



The company and its ESOP Advisor interview potential trustees, choose and document their choice to represent the employees. The trustee then hires both an attorney and an independent valuation firm to assess the offer. There will be negotiations back and forth between the seller’s and the buyer’s (ESOP) advisors.

Both the ESOP trustee and lenders conduct thorough due diligence, including financial statement review and quality of earnings analysis, customer and supplier concentration assessment, legal and regulatory compliance review, and management depth evaluation. The trustee has a fiduciary duty to ensure the transaction is fair to ESOP participants. This phase typically takes 60–90 days.

### Phase 5: Documentation and Closing



Transaction documents—including the stock purchase agreement, ESOP plan document, trust agreement, loan agreements, warrant agreements, and fairness opinion—are prepared and negotiated. At closing, funds and stock transfer, and the ESOP becomes an official shareholder.

### Phase 6: Post-Close Implementation



The real work of operating as an ESOP company begins: employee communication and education, cultural integration, plan administration, annual valuations, governance evolution, and repurchase obligation management. Success in this phase determines the ESOP’s long-term sustainability.

## Key Professionals Involved in ESOPs

ESOP transactions require a team of specialized professionals to execute the arm's length transaction. Business owners should seek advisors with substantial ESOP-specific track records rather than general practitioners who occasionally handle ESOP transactions.

Role	Represents	Key Function
<b>ESOP Advisor / Investment Banker</b>	Company / Seller	Typically, the “quarterback” of the ESOP transaction. Conducts feasibility study, coordinates workstreams and other deal professionals, assists with structuring, helps secure financing, and project-manages the overall process.
<b>Corporate Legal Counsel</b>	Company / Seller	Drafts transaction documents, advises on tax implications, ensures regulatory compliance, and protects seller interests. ESOP law is highly specialized.
<b>Bank / Lender</b>	Company / Seller	Provides debt financing, evaluates credit quality, structures loan terms. Not all banks have ESOP expertise—identifying experienced lenders is critical.
<b>Accountant / CPA</b>	Company / Seller	Provides financial statements, assists with tax planning (Section 1042, C-corp/S-corp conversion), ensures tax compliance.
<b>QRP Specialist (if applicable)</b>	Seller	Designs and implements QRP investment strategy, ensuring compliance with Section 1042 requirements.
<b>ESOP Trustee</b>	Employees (ESOP)	Fiduciary acting on behalf of employees. Reviews and negotiates transaction, commissions valuation, issues fairness opinion. Independence is critical.
<b>Trustee Legal Counsel</b>	Employees (ESOP)	Advises trustee on fiduciary duties, reviews documents from employees’ perspectives, ensures Department of Labor compliance.
<b>Independent Valuation Firm</b>	Employees (ESOP)	Provides independent valuation determining purchase price using recognized methodologies. Must reflect fair market value.
<b>Trust Plan Administrator (TPA)</b>	Ongoing / Shared	Handles day-to-day plan operations: recordkeeping, compliance testing, distributions, and participant communications.

## Characteristics of Successful vs. Challenged ESOPs

The difference between a thriving ESOP company and a struggling one is rarely the ESOP structure itself. It is the combination of company fundamentals, transaction design, and post-close execution. The following characteristics tend to distinguish success from challenge.

Green Lights	Red Flags
Strong, stable cash flow supporting debt service, contributions, and repurchase obligations.	Declining performance resulting in falling share values, frustrated employees, and strained covenants.
Capable, committed management with clear succession planning and leadership depth.	Weak or absent succession plan with leadership gaps when the founder departs.
Realistic transaction design with 10- to 15-year internal loan terms and thoughtful repurchase modeling.	Over-leveraged structure leaving insufficient cash for operations, growth, and obligations.
Active ownership culture with regular communication, financial transparency, and employee education.	Passive ownership culture where the ESOP exists on paper, but employees feel no connection.
Proactive repurchase planning with dedicated reserves or sinking funds.	Neglected repurchase obligations accumulating into a cash crisis.
Experienced ESOP-specialized professional advisors providing ongoing guidance.	Misaligned expectations between seller, management, and employees about what the ESOP would deliver.

ESOPs are not self-executing. They require the same quality of leadership, financial management, and strategic thinking that make any business successful—combined with the additional discipline of managing the unique obligations and opportunities of employee ownership.

## Is an ESOP Right For You?

An ESOP can be a compelling, tax-efficient exit strategy when aligned with the right business profile and owner objectives. It is not a universal solution, nor a shortcut to liquidity. Rather, it is a complex capital markets strategy that rewards long-term thinking, disciplined execution, and genuine commitment to the principles of employee ownership.

For business owners who value legacy, continuity, employee engagement, and tax efficiency—and who have businesses with strong cash flow, capable management, and realistic expectations—an ESOP deserves strong consideration alongside other exit alternatives. The combination of liquidity for the seller, retirement wealth for employees, and tax advantages for the company creates a value proposition that few other exit strategies can match when the circumstances are right.

The most important step any business owner can take is to engage experienced, objective ESOP advisors early in the exploration process. A thorough feasibility study will provide the analytical foundation needed to make an informed decision—one that balances financial optimization with the personal, professional, and legacy goals that define a truly successful exit.

The right exit is not the one that maximizes any single variable. It is the one that best serves the full picture of what matters most to you, your employees, and your business.



### Questions for Your ESOP Advisor

When evaluating potential ESOP advisors, consider asking:

- How many ESOP transactions have you completed in the past five years?
- Do you work exclusively on ESOPs, or what percentage are they of your practice?
- Can you provide references from business owners who have completed ESOP transactions?
- How do you handle situations where the feasibility study shows an ESOP is not the right fit?
- What is your fee structure, and how is it aligned with my interests?

## ESOP Decision Checklist

The following checklist is designed as a practical self-assessment tool. It is not exhaustive, and checking every box is not a prerequisite for a successful ESOP. However, the more items you can affirm, the stronger the case for pursuing an ESOP exploration.

### Financial Readiness

- Annual EBITDA of \$2MM+
- Enterprise value of \$10MM+
- Consistent cash flow over 3–5 years
- Sufficient debt capacity for ESOP financing
- Currently in a tax-paying position
- Steady or increasing growth trajectory

### Management and Succession

- Strong management team in place
- Key successor(s) named and prepared
- Management embraces transparency
- Willingness to implement SARs or other incentives

### Workforce and Culture

- 25+ employees with diverse demographics
- Reasonable employee turnover rates
- Engaged, motivated workforce
- No significant adversarial labor issues

### Owner Objectives

- Open to fair market value pricing
- Willing to transition over 3–6 years
- Values legacy and employee rewards
- Comfortable with seller note component
- Interested in tax mitigation strategies

### Structural

- C-corp, S-corp, or LLC taxed as a corporation
- Clean balance sheet without excess leverage
- No major pending litigation
- Annual payroll of \$2MM+ to support costs

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