



Lowenstein Sandler's Executive Compensation and Employee Benefits Podcast: Just Compensation

Episode 54

By [Andrew E. Graw](#), [Taryn E. Cannataro](#), [Zachary Bocian](#)

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Zachary Bocian: Welcome to the latest episode of *Just Compensation*. I'm Zachary Bocian, an associate in Lowenstein Sandler's Executive Compensation, Employment, and Benefits group. I'm joined today by two of my colleagues, Andrew Graw, partner and chair of our group.

Andrew Graw: Hi, Zach.

Zachary Bocian: And Taryn Cannataro, counsel in our group.

Taryn Cannataro: Hi, Zach.

Zachary Bocian: Today's discussion focuses on employee stock ownership plans, ESOPs. We'll cover what ESOPs are and briefly discuss how they developed, why companies adopt them, some of the key benefits and drawbacks, and some of the legal and compliance pitfalls we regularly see in practice. As always, this is intended to be a high-level discussion and is not legal advice. We encourage you to consult with your counsel about how these concepts would apply to your specific facts and objectives.

So, to kick us off, Andy, what is an ESOP?

Andrew Graw: I'm glad you asked. At its core, an ESOP is a tax qualified retirement plan designed to invest primarily in the sponsoring employer's stock. It's like a 401K plan, but instead of investing in mutual funds, it only allows for investments in employer stock. And employees do not contribute as they would in a 401K plan. All of the contributions towards the plan are made by the employer.

What makes ESOPs unique is that, unlike 401K and other types of plans, they can actually purchase employer stock from the employer or from existing shareholders. Also, an ESOP can borrow money to purchase employer stock from the employer or other shareholders. These features enable shareholders of a company a unique opportunity to create a buyer out of thin air for some of all of their shares. And tax benefits that are designed to promote employee

ownership that we'll discuss further offer additional financial incentives that make an ESOP a very attractive buyer.

I would also say that any shareholder of a closely held business that is thinking of selling some or all of their shares should always consider an ESOP as another alternative in comparison to, say, a private equity investor, and we'll talk about that, too.

Zachary Bocian: Thanks, Andy. Taryn, can you give a quick overview of ESOP mechanics from a company perspective?

Taryn Cannataro: Absolutely. You can think of an ESOP like a company sponsored trust that's set up for employees. Each year, the company contributes either cash or shares into that trust. And like Andy said, employees don't buy in out of pocket, but instead they earn allocations of company stock in their ESOP accounts over time, similar to how a 401K would receive annual contributions, except with company stock as the primary investment.

You'll often hear the term leveraged ESOP and connection with a transaction, and that just means that the ESOP trust takes out a loan to buy a block of the company's stock, often a large block from one or more existing owners. The lender can be a financial institution, but it's often the company that sponsors the ESOP or the selling shareholders, or the combination of this. The shares that the ESOP buys with the loan are deposited in a suspense account under an ESOP, which you can think of like a holding bucket. As the loan is paid down each year using tax-deductible company contributions, and often dividends or distributions, the ESOP releases a portion of the shares in the suspense account and allocates it to the employees. Usually pro rata, based on the ration of each employee's compensation in relation to the aggregate compensation of the cover employees.

Zachary Bocian: Thanks, Taryn. Andy, what are some of the tax benefits you mentioned of ESOPs to sellers?

Andrew Graw: There are actually several tax benefits that make a sale to an ESOP very attractive. ESOPs have been a favorite son of the Internal Revenue Code for many years. And as a result, over the years, many tax benefits have developed to promote ESOPs. Among them are, for C corporation sellers, that is if you are an owner of a C corporation, when you sell stock to an ESOP, you're actually able to defer taxable income on the gain from that sale by reinvesting the proceeds from the sale in what are called qualified replacement securities or QRP. QRP includes shares that are readily tradable on a security exchange, like NYSE or NASDAQ. Think of that particular tax benefit, which is one of the best, that apply to ESOPs.

A selling shareholder of a closely held business can diversify all or a portion of their investment in that closely held company, and without paying any taxes, reinvest the proceeds in stock of Microsoft, Google, or any other company that's on a national securities exchange. There's also ways to do that so that a portfolio can be managed over time. This rollover opportunity applies as long as

the ESOP acquires or owns at the time of the transaction at least 30% of the company stock. So again, a selling shareholder who wants to take advantage of this particular road has to be for a C corporation and the ESOP has to acquire at least 30% of the selling shareholders shares or own at least 30% at the time that the sale takes place.

For S corporations, there's a separate rule. The QRP one does not apply, but because an ESOP is a tax-exempt trust, the earnings of the S corp run through to the ESOP tax-free. And therefore, an S corporation ESOP can accumulate earnings of the company tax-free and use that money to, among other things, accelerate pay down of the loan that it would have taken out in the first instance to acquire the shares. Which as we'll talk about, will allow the selling shareholder to ultimately get paid out faster.

Another tax benefit that Taryn alluded to is that because contributions to an ESOP are tax-deductible and those contributions used by the ESOP to pay down the debt that it took out to acquire the shares, effectively what's happening is that the company is paying down debt of the ESOP with tax-deductible principle and interest. So that's also a key tax advantage.

And then going back to C corporations again, dividends on shares held in an ESOP in some cases can be deductible to the company if they're either paid out to participants or used to repay the ESOP loan. And again, that can allow the ESOP to pay down its debt faster and often, depending on how the deal is structured, that can inure to the benefit of the selling shareholders as well.

Zachary Bocian: Taryn, what are some of the non-tax benefits?

Taryn Cannataro: There are a number of non-tax benefits in having an ESOP. Various surveys have shown that employee ownership in company stock increases productivity and helps attract and retain employees. An ESOP also provides tax deferred retirement benefits. So, it's an alternative to a company having a 401K plan or can be in addition to a company having a 401K plan.

Zachary Bocian: Thanks, Taryn. Andy, how do employees actually accumulate stock under an ESOP?

Andrew Graw: As Taryn indicated at the outset, shares acquired by an ESOP get allocated among employees each year as the ESOP loan is paid down. So, here's an example.

If an ESOP acquires, say 100,000 shares with a loan that has a 20-year term and it's paid off ratably, one-twentieth of the shares, or 5,000 shares, will be allocated to employees each year. And then there's a second step, whereby those 5,000 shares get allocated amongst participants. Each participant is allocated a pro rata portion of that 5,000 shares based on his or her compensation relative to the aggregate compensation of all participants.

There is a limit on compensation that can be taken into account. Because an ESOP is still a tax qualified plan, it's subject to tax qualification limits. One of

those limits is on how much compensation can be taken into account under a plan each year. For 2025, that limit was 350,000.

Zachary Bocian: What happens to those shares that are allocated to employees?

Andrew Graw: Those shares get credited to a participants' account under the ESOP. Those shares can be subject to a vesting schedule. And at retirement, or depending on the terms of the ESOP, when the individual terminates employment, they would be available for distribution to that participant. But in the interim period of time while they're working, those shares will be credited to their ESOP accounts.

Zachary Bocian: Taryn, what other mechanics apply?

Taryn Cannataro: Unless the company's publicly traded, when the participants receive a distribution from the ESOP, those shares are illiquid. So, in order to make sure that participants can actually receive cash for their distributed shares, companies are required to offer participants a put rate to sell their shares to the ESOP or to the employer when they receive a distribution. In addition, when participants reach a certain age and a certain service milestone, they must be given the opportunity to move a part of their ESOP account out of company stock and into other investments or cash.

Zachary Bocian: How is the value of the shares determined for put options and diversification rates?

Taryn Cannataro: All transactions involving company stock, whether it's the initial purchase of shares from selling shareholders or the repurchase of shares to satisfy the put rates and diversification rates, must be determined by an appraisal performed by an independent valuation firm. Stock valuation is also used for annual reporting purposes, such as providing participants with annual statements showing how many shares they hold and the appraised value. Thus, an ESOP appraisal must be performed every year even if there aren't any transactions in the shares.

Prudent companies plan ahead for this repurchase obligation, since those buybacks can be meaningful as the workforce retires. A repurchase liability forecast can help prepare an ESOP company to meet future obligations without straining its cashflow.

Zachary Bocian: Andy, what other ESOP features are worth highlighting here?

Andrew Graw: Well, although employees accumulate shares within their ESOP accounts, it's the ESOP trust itself rather than the employees that are the actual shareholder. A trustee manages the ESOP for the benefit of participants. Voting rights with respect to ESOP shares are controlled by the trustee. However, on certain significant corporate events like mergers or sales, participants have to be given the right to direct the trustee as to how to vote the shares that are allocated to their accounts. The trustee still gets to vote shares that have yet to be allocated.

So in other words, if the ESOP acquired shares with a loan and those shares are being held in a suspense or holding account and have yet to be allocated to participants when a transaction occurs, a vote on the transaction would be conducted where the trustee gets to vote the shares that are held in the suspense account, while employees get to direct the trustee as to the voting of the shares that are held in their own accounts, whether or not they're vested.

It is worth noting that the appointment of the company's board of directors is not a major corporate event requiring this sort of pass-through voting to participants of the ESOP. Though the trustee, in other words, gets to vote all of the shares of ESOP on who will be among the board of directors.

Zachary Bocian: And I think you mentioned this earlier, Andy. How does an ESOP transaction compare to a sale to a private equity investor?

Andrew Graw: Well, it's not going to be the same for every company, but an ESOP transaction can have significant advantages over a sale to a private equity buyer. We've covered some of the special ESOP tax benefits that make an ESOP an attractive alternative to a private sale, such as that tax deferred gain S corp tax savings that we talked about. It may also be difficult to attract a private equity investor. An ESOP can be established at any time when the selling shareholders or the company desire. It's essentially a manufactured buyer out of thin air.

Although an ESOP is represented by an independent trustee when it purchases shares from the selling shareholders and that trustee will perform due diligence on the company, in general a private investors' due diligence will be deeper than what we typically see in an ESOP transaction. The point is that selling shareholders can continue to be employed by the company after the sale to an ESOP and even maintain operational control, something sellers rarely get to do when they sell in private equity transactions.

In an ESOP transaction, the purchase price is established by an independent valuation firm, as opposed to through negotiation with a private investor. Although there is negotiation over the price with the trustee of the ESOP, because it's based on an independent valuation, the price will typically be within a range that is not unexpected to the selling shareholder. So that they can get a good feel at the outset before they even go through with the transaction of what the price range will be to make sure that they're satisfied with what they expect to get.

And another important factor is that unlike private equity transactions, ESOP transactions don't involve earnouts. So, the purchase price is what the purchase price is, but it's not going to be contingent on an earnout.

Zachary Bocian: Thanks, Andy. Taryn, anything else you would like to add here?

Taryn Cannataro: Yeah, Zach, I think there are a couple more practical items worth mentioning. First, ESOPs are tax qualified plans, just like a 401K plan or a pension plan is, and ESOPs must satisfy coverage, nondiscrimination and contribution limits set by the IRS. ESOPs can't be used to benefit only a handful of insiders.

Second, diversifying older or long tenured participants out of employer stock requires offering alternative investment options or distributions within prescribed windows. Also, if you're contemplating a transaction, ESOP rules on distributions of financed shares can affect timing. All of this has to be built into plan design at the outset, so it's important to consult with your compensation and benefits counsel early and often when designing and administering an ESOP.

Zachary Bocian:

Thank you both. Today we covered what ESOPs are and why they can be extremely advantageous to shareholders of closely held businesses. ESOPs can deliver significant tax and finance advantages while building an ownership culture, but they require careful structuring, modeling, and disciplined fiduciary oversight. This episode is intended to be a high-level discussion, and as always is not legal advice. Please consult your own tax and legal advisors for guidance tailored to your situation. If you enjoyed today's discussion, please subscribe, leave us a review, and share this episode with your colleagues. You can also reach out to us via email if you have any questions or ideas for future topics. We look forward to having you back for our next episode of *Just Compensation*.

Megan Monson:

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