ESOPs in the Craft Brewing Industry

By Timothy L. Stewart

Full Sail Brewing Co. has been an employee-owned company since 1999.

Where Succession Planning and Employee Engagement Intersect

With the increasing popularity of craft beers and the corresponding success of many craft breweries in recent years, one question will become more and more pervasive in the industry: "What is the succession plan for our brewery?"

Clearly, most craft brewery owners are not inclined to sell their businesses to just anyone. Many detest the idea of selling to a larger entity that might absorb and dilute the products and brands on which the owners have dedicated so much time, money, and effort (*see* blood, sweat, and tears). Along those same lines, a brewery's culture and its employees are so critically important to the owner that the idea of turning the business over to an outsider is a non-starter.

With those and many other factors in play, this article will examine the pros and cons of using an employee stock ownership plan (ESOP) as the succession planning vehicle for craft breweries. With craft brewers such as New Belgium Brewery, Deschutes Brewery, and Full Sail Brewing having chosen that option, there is strong evidence that it can work well in the craft brewing industry.

What is an ESOP?

An ESOP is a tax-qualified retirement plan, similar to a 401(k)/profit sharing plan. However, unlike a 401(k)/profit sharing plan, an ESOP must invest primarily in the stock of the employer. It is entirely up to the employer to decide whether or not to create an ESOP, just like it is up to the employer to offer any particular employee benefit. Some of the same designs and features of 401(k)/profit sharing plans (vesting schedules, waiting periods, etc.) can also be utilized in an ESOP.

Deschutes Brewery launched its ESOP in 2013 for the company's 25th anniversary.

The ESOP, then, is a willing "buyer" of any amount of employer stock that the owner is willing to sell, from 1 percent to 100 percent and everything in between. And, unlike a management buyout, all employees who work at least 1,000 hours per year must be allowed to participate and receive allocations of the employer stock.

Most ESOPs use the following structure: the employer establishes the ESOP to receive contributions of employer stock (from the business owners [the "Sellers"]) over a period of years. The value of these stock contributions is fully deductible to the company, just like a matching or profit sharing contribution would be. In exchange for their stock, the Sellers receive some combination of cash and a promissory note. Cash at the closing would have to be provided by an outside loan. However, since banks tightened their lending criteria in 2008, more and more ESOP transactions are financed 100 percent by the Sellers without bank financing. That is, the Sellers act as the lender and will receive interest in addition to the principal value of their stock. The payments to the Seller are made by the company from future profits, and the stock gets gradually allocated to the ESOP participants as the loan is paid off.

The stock price is generally set by an independent, third-party valuation expert. In many transactions, the Sellers also receive stock warrants and/or stock appreciation rights to provide continued incentive for the Sellers to grow the business following the sale.

Advantages of ESOPs

One of the advantages that the ESOP structure provides to the Seller is flexibility. By setting up the ESOP, the Seller has created (from thin air) a "willing buyer" of as much (or as little) stock as the Seller is willing to sell. Often, Sellers would prefer to divest themselves of stock over a period of years, rather than all at once. While this is uncommon in traditional "third party" transactions, it is *very* common in ESOP transactions, even where the Seller prefers to maintain a majority of the stock. Finally, the Seller can

sometimes participate in the ESOP as well (*see* "having your cake and eating it too"), provided that the Seller remains employed following the transaction.

Other primary advantages of ESOPs, from the Seller's and the Company's perspective, are those provided through the Internal Revenue Code. That is, there are several tax advantages to using an ESOP as a succession plan. In the C Corporation context, the Seller can take the proceeds of the sale and roll them over into "qualified replacement property" (U.S. securities, generally) and defer all capital gains taxes on the sale. The Seller would then recognize the capital gains as the amounts are liquidated from the U.S. securities. Or, to the extent that the amounts are not liquidated before the Seller's death, his/her beneficiaries would inherit them tax-free!

For entities that are S Corporations, the tax advantages can be truly game-changing. Unlike C Corporations, S Corporations do not, themselves, have revenue or compensation that can be taxed. Rather, the profits in S Corporations flow through, for tax purposes, to the shareholder(s) of the entity. So, for S Corporations with ESOPs that own all or part of their shares, the profits of the Corporation flow through to the ESOP to the extent of the ownership. However, ESOPs are, as qualified retirement plans, tax-exempt entities. That means that the profits attributable to the ESOP are exempt from federal income tax (and, in many states, state income tax). By way of example, imagine an S Corporation brewery that establishes an ESOP and sells 100 percent of its stock to the ESOP. That brewery will no longer pay federal income taxes on its profits! This is good news both for the bottom line of the company and its employees, but also for the Seller, as the company has more money to pay back the Seller for the stock. Furthermore, after the debt is repaid, the company can use the tax savings for other business purposes, including payment of other debt or dividends to employees.

ESOPs and Craft Brewery Culture

According to Irene Firmat, CEO/founder of Full Sail Brewing, and Peter Skrbek, CFO of Deschutes Brewery, one reason why ESOPs are such a good fit for them is that the craft brewing culture and employee ownership go together like hops and barley. That is, one of the main reasons that a *brewery* succeeds is that its employees are fully engaged in the company and its vision. Likewise, the most successful ESOP companies have employees who think like owners. That is, simply, they care more about the success of the company. In the craft brewing industry, you already have a group of people who look upon their industry as more than just a job. There is a great sense of pride in most successful craft breweries that starts with the founders and continues all the way through the organization. If you add employee ownership (i.e.,

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New Belgium became a 100-percent employee-owned company in 2013.

Photo © Full Sail Brewing Co., Dechutes Brewery, and New Belgium Brewing Co.

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In 2013, New Belgium Brewing announced that the company's ESOP had purchased the balance of company shares, making it 100-percent employee owned. NBB had been a partial ESOP since 2000 with a controlling interest (59 percent) held by co-founder Kim Jordan and her family.

"There are few times in life where you get to make choices that will have multi-generational impact—this is one of those times. We have an opportunity to write the next chapter of this incredible story and we're really excited about that," Jordan said in a press release. "We have always had a high involvement ownership culture and this allows us to take that to the next logical level. It will provide an elegant succession framework that keeps the executive team intact ensuring our vision stays true going forward."

Deschutes launched its ESOP in 2013 in conjunction with the 25th anniversary of the brewery. Full Sail has been an employee-owned company since 1999. Firmat noted in an interview that, if Full Sail were to do it all over again, management would communicate more with employees regarding what the Company *needed from them* to be successful and less about the employees' *entitlement* to employer stock.

"Some people think being an 'owner' means smoking cigars and putting your feet up on your desk. That's obviously not it," said Firmat.

In other words, it's important to make employees understand what it means to be *business partners* with the company.

Concerns with ESOPs

Firmat does believe that an ESOP is not necessarily the right choice for every brewery. She points to the fact that in an ESOP transaction, it is the *company* that bears the responsibility to pay back the Seller and/or the Lender in exchange for the stock of the company being distributed to employees through an ESOP. This additional debt puts an even greater pressure on the company to be profitable. That notwithstanding, the transaction should be structured to allow some flexibility for the company to be able to pay its debt obligations even if there is a lull in the business. In addition and as discussed previously, a company that is profitable before an ESOP transaction may be even more profitable afterward, particularly if the company is an S Corporation and no longer pays federal (and often state) income taxes on profits to the extent of their ownership.

The other issue pointed to by skeptics is the fiduciary liability that comes along with any ESOP transaction. That is, because an ESOP is a qualified retirement plan subject to ERISA (Employee Retirement Income Security Act), the ESOP trustee carries a fiduciary obligation to act in the best interests of the ESOP participants. Where this most often comes to a head is where a company struggles following an ESOP transaction, and the company is unable to keep up on its debt obligations to the Seller. Both the Department of Labor and the participants themselves maintain a right to sue the fiduciaries of the ESOP for a fiduciary breach if they believe that the price paid for the company's stock was too high.

This type of fiduciary liability, however, exists with any qualified retirement plan. And yet, that liability rarely prevents employers from establishing 401(k) plans and profit sharing plans. Furthermore, the risk can be mitigated through fiduciary liability insurance and by hiring an independent fiduciary to negotiate on behalf of the ESOP.

ESOP Fables

As acknowledged previously, there are some risks associated with ESOPs, just as there are risks associated with any business succession plan. Yet there are many common beliefs about ESOPs that simply are not true. ESOP practitioners commonly refer to these as "ESOP fables." Some are as follows:

- "My employees do not have the money to buy me out." *Actually*, this is not a concern for ESOPs, but rather for traditional management buyouts. With ESOPs (as outlined above) the owner's stock is contributed to the ESOP (just like a profit sharing contribution), and the owner takes back a promissory note or a lender loans the company the necessary funds to pay the owner. The future profits of the company are then used to pay off the debt.
- "ESOPs are just for big companies." *Actually*, an ESOP could be a viable alternative for employers with as few as 12 to 15 employees.
- "ESOPs are too expensive to establish." *Actually*, the costs of establishing and maintaining an ESOP pale in comparison to the commissions paid to business brokers/investment banks that are often used to find an interested third-party buyer. In addition, the ongoing costs are normally more than offset by the tax savings discussed above.
- "I will have to divulge all of the company's financial data to employees." *Actually*, the only data that must be disclosed to employees is the value of their stock. However, ESOP companies like Full Sail Brewing *voluntarily* make much more financial data available to employees to encourage employee engagement.
- "I will lose the ability to control my company." *Actually*, day-to-day decisions and operations will continue to be made by the officers of the company. Only *major* corporate matters require "pass through" voting to ESOP participants. Most "shareholder-level" decisions are made by the named trustee/fiduciary.
- "As a retirement plan, an ESOP does not allow enough diversification of investments." *Actually*, ESOPs are required to allow long-term employees a window to exchange up to 50 percent of their employer stock for cash, and to provide sufficient investment choices for the employee to invest that cash (or allow the employee to roll the cash out of the plan and into an IRA). Further, most employers that sponsor ESOPs also sponsor 401(k) plans to allow employees to further diversify.

Certainly, no succession plan is guaranteed success. However, the ESOP option, though often overlooked, could be the "outside the box" solution for your brewery's succession plan.

As an employee benefits attorney and shareholder in the firm of DeWitt Ross & Stevens, S.C., Tim Stewart has handled all legal aspects of Employee Stock Ownership Plans (ESOPs), from inception to termination and everything in between. Stewart works with ESOPs of small businesses with fewer than 25 participants and very large corporation ESOPs with thousands of participants. Because all ESOPs are governed by federal law (ERISA), Stewart works with ESOP companies in the firm's home states of Wisconsin and Minnesota, throughout the Midwest in Iowa, Illinois, Indiana, and Michigan, and on the coasts in states such as New York and California.