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ESOP Growth Presents Market Opportunity for Retail Agents

Employee Stock Ownership Plans (ESOPs) can be found in every business sector and have become increasingly popular as part of company perpetuation strategies. However, creating an ESOP carries risks that need to be managed and insured – for both the former company owners and the new employee ownership group. As such, there is opportunity for retail agents to grow a book of business in this space by increasing their knowledge and aligning with partners who have access to the markets and products they need to succeed.

CONTACT

To learn more about how Amwins can help you place coverage for your clients, reach out to your local Amwins broker.

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ESOP history, trends and risks

ESOPs aid in perpetuation of private and family-owned companies and are normally used as part of a holistic compensation plan. As a qualified deferred compensation retirement plan, an ESOP gives employees ownership, in the form of shares, in the company where they work. Having employee ownership can also improve culture and recruiting and has been shown to encourage employee productivity.

Although the concept of employee ownership can be traced back to the early days of the U.S., the first official ESOP was created in 1956. Following the passage of Employee Retirement Income Security Act of 1974 (ERISA), which set guidelines for employee benefit plans and helped facilitate the modern ESOP structure, the popularity of these plans began to climb. The Economic Recovery Act of 1981, Small Business Job Protection Act of 1996 and general transition to a service-based economy propelled ESOP growth in the following years.

After seeing a slight decline in the 2010s, the number of ESOPs has been steadily increasing in recent years. According to data from the **National Center for Employee Ownership**, 2021 (the latest year available) had an increase in ESOPs that was entirely driven by sale activity at private companies. This trend is expected to continue as the U.S. workforce and company ownership age.

Despite their benefits, ESOPs are not without risk, the majority of which revolve around company valuation or sale/loan terms, with ESOP trustees and former business owners potentially held liable for any problems. Over the past decade, there have been **settlements or judgments of $385.5 million** involving ESOPs.

There are regulatory risks as well. ESOPs are prohibited from paying more than “adequate consideration” for company shares and, between 2007 and 2017, the Department of Labor’s Employee Benefits Security Administration (EBSA) found ERISA violations—primarily valuation and loan term issues—in **more than 1,000 cases**.

The EBSA has also placed investigative emphasis on ESOPs and, since 2005, has maintained an ESOP National Enforcement Project to investigate ERISA violations in connection with ESOPs. Investigations and enforcement may also come from the Internal Revenue Service and the Pension Benefit Guaranty Corporation.

Risk management

Retail agents are in a key position to help clients and prospects manage risk around ESOP formation and transition by recommending best practices to follow and what insurance to put in place.

An ESOP Trustee is required by law to obtain an independent valuation for ESOP purposes. It is tempting for privately held companies to look to members of the C-suite to serve as Trustees due to their familiarity with the business. However, this familiarity makes it difficult for those individuals to make objective assessments. ESOP investigations frequently focus on potential conflicts of interest when the person(s) transacting with the plan also have fiduciary responsibilities to the ESOP.

An independent ESOP valuation firm has the specialized knowledge and experience required to assess the financial data of the company, including multiple years of financial statements and cash flow projections, as well as other complex financial data. Additionally, the valuation firm considers customer concentration, geographic concentration, terms of contracts and leases and management depth, among others.

An outside firm also brings objectivity and independence to the process that internal staff cannot. In-depth interviews with the management team are essential to glean the "story behind the numbers," establish credibility around projections and generate transparency that may otherwise be lacking in closely held firms. In addition to value, a valuation firm also considers the transaction as a whole – analyzing interest rates, synthetic equity and overall deal structure.

While many appraisers can complete ESOP work, there are complex rules and regulations related to ESOPs that specialists are well versed in, while bringing a demonstrated commitment to ethics and professional standards.

Insurance coverage

Both the existing company and acquiring ESOP need comprehensive liability insurance protection. The two cornerstone coverages are Fiduciary Liability (FL) and Directors & Officers (D&O).

Fiduciary liability insurance protects plan fiduciaries against claims made by employees or the Department of Labor alleging mismanagement, including improper management of plan assets, misrepresentation or failure to provide required information to participants, or failure to follow the teams of the plan. It will also typically cover the cost of legal defense in addition to settlements and judgments. Keep in mind that, according to ERISA and as confirmed by court decisions, an ESOP plan itself cannot indemnify fiduciaries. Therefore, without fiduciary liability insurance, fiduciaries may find their personal assets at risk for losses or damage resulting from a claim.

Directors & Officers (D&O) insurance protects the personal assets of directors, board members and other managing members if they are personally sued for mismanagement. The role of directors can become complicated in an ESOP transaction as they may bear fiduciary responsibilities to both existing/former shareholders as well as ESOP participants, and particularly if they appoint/monitor the ESOP committee.

Other coverages to recommend include, but are not limited to:

Employment Practices Liability (EPL). As company ownership/culture changes, employment-related claims may be made by dissatisfied employees.

Crime. With change comes new/increased opportunity for theft, including employee theft.

Cyber. Change in ownership requires systems/access changes, creating potential control vulnerabilities during the transition.

Potential coverage gaps to address include:

Coordination of coverages. Both fiduciary liability and D&O are claims-made forms and coverage needs to be coordinated between the ESOP and former owner(s) policies. This can be a complicated scenario involving Prior Acts Coverage, Extended Reporting Period endorsements and/or Waiver of Change in Control ("Full Continuity") clauses.

ESOP coverage language. Existing fiduciary liability and D&O policies must be carefully evaluated to see how newly formed ESOPs are addressed. Some cover newly formed ESOPs and their trustees, while others specifically exclude them. There are many differences between company forms to be aware of.

Partner with an expert

Liability coverage for ESOPs is complex, the market is specialized and underwriting scrutiny is high. In addition to a new business application, expect to provide, at a minimum, a detailed and company-specific ESOP supplemental application, multiple year-end financial statements and thorough documentation of how the ESOP valuation (share price) was derived. Also expect to allow underwriters ample time to do a deep dive into this information and focus on share price volatility, overall financial condition, reputation, ownership structure and more.

In a complex and specialized market, retail agents are well-served to partner with an expert in the space. Amwins has broad expertise, established underwriter relationships and access to specialized resources to help you succeed.

Insight provided by:

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