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ESOPs and Restaurant Businesses

By Dennis Monroe

While many businesses have taken advantage of Employee Stock Ownership Plans (ESOPs) for employee incentives and buyouts, there are very few to be implemented in the restaurant industry. They have been deemed difficult to implement, and administer because of the high-level of employee turnover and part-time workers.

However, ESOPs can be a great tool for ownership transition, altruistic goals and tax savings. In the case of an ownership transition, one key advantage is the tax-efficient structure, where the rules are favorable for borrowed funds. Debt can be from a bank or provided by the selling owner. In its simplest form, the principal loan payments made under the leveraged ESOP are deductible as contributions to the ESOP. Also, if you are a flow-through entity such as an S Corporation, you can shelter income because the trust that owns the employee interest is tax-exempt. Further if the company is a C Corporation and the shareholder sells 30% of more of their stock to the ESOP the proceeds can be rolled over tax free to the stock of domestic corporations.

Let's look at some examples of ESOPs and what conclusions we can draw from each of them:

The first one is a Minneapolis-based company called Hell's Kitchen, owned by Cynthia Gerdes and Steve Meyer. They structured the ESOP through a 100% buyout by an ESOP trust. The owners are selling their interest, and taking back a promissory note, on what we would call an installment sale. The note will be paid off over eight to 10 years. The structure has some distinct tax advantages for the company, employees and the trust. As it relates to Cynthia and Steve, they pay capital gains tax (lower rate) on the gain at the time they receive a principal payment under the installment note. They did not get the tax free rollover because the company is an S Corporation .

What's unique about their ESOP is how they've treated the employees. First, to be a participant in the ESOP, you have to be an employee for one year and be over age 21. The nice thing is that an employee, for purposes of participating in an ESOP, only has to have 700 hours worked in a given year, and that includes a lot of pseudo part-time employees. Hell's Kitchen has 143 employees, and at least 100 of those will be able to participate in the ESOP. Further, the key to this ESOP is the management team, which has been trained and is more than capable of running Hell's Kitchen. The management team will stay in place, play a central role in making this ESOP work and be incentivized to operate a successful business through ESOP ownership.

Example two is Parasole Restaurants, a large multi-concept restaurant operator and founder of Bucca di Beppo and Oceanaire. Parasole implemented an ESOP in the Bucca concept. Unfortunately, when this concept planned to go public, the ESOP had to be bought out. The good news is a number of employees were able to do things like pay off home mortgages, which made a big difference in their lives.

Example three is Grand Central Oyster Bar in New York. They set up a 100% ESOP about 12 years ago, which apparently has been a huge success and is still owned and operated successfully under an ESOP structure.

For my fourth example, I turn to an industry that's analogous to the restaurant business, namely hair salons. I was fortunate to be involved more than 20 years ago with the implementation of an ESOP for Cole's Salon for You. They have five salons, and the ESOP has been a huge success in terms of employee retention, morale and wealth-building for employees. As far as I know, this is the only hair salon company in the country that has implemented an ESOP.

When considering the use of an ESOP as a strategy, keep in mind that while an ESOP offers a number of both tax and financing advantages, implementing it is a very complicated and a somewhat expensive process. You are required to have initial stock valuations, as well as annual valuations, audited statements, ESOP benefit administration and a fair amount of ongoing legal and accounting support. It's particularly tricky for restaurants to maintain an ESOP due to employee turnover. On the upside, once restaurant ESOPs are successfully implemented, the employee turnover tends to improve and the pressures of wages and upside labor cost are somewhat mitigated.

One of the real stumbling blocks for ESOP implementation in the restaurant business is franchising. Most franchise documents are not set up to allow for an ESOP. I have heard anecdotally that a couple of franchisees have attempted to create ESOPs, but those attempts have been rejected by the franchisor. The primary reason is the franchisor wants to have somebody who is ultimately personally liable under the franchise agreement so they can enforce non-competes and other rights upon franchise termination. They don't want to have a multi-ownership group (i.e. the ESOP trust). This is also the reason many franchisors don't like their franchisees to go public. I do think that given what's happening in the labor market and the financing world, we're going to see franchisors reconsidering their resistance to the ESOP.

Two of the above examples I gave were 100% ESOPs. There's no reason that you have to do a 100% ESOP. Cole's and Parasole's were both far less than 100%. In that case, you could still have the original founders in control and be able to utilize the ESOP for the benefit of employees and the growth of the enterprise.

In general, while not easy to implement and not cheap, an ESOP should be explored for helping with employee retention, exit planning, tax savings, liquidity and growth.

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