Structuring ESOPs

The following figure illustrates the steps involved in establishing an ESOP. The ESOP borrows from financial institutions (step 1), and the employer sponsoring the ESOP guarantees the loan (step 2). The ESOP uses the borrowed funds to purchase stock from the sponsoring employer, and the stock is used to provide collateral for the loan (step 3). The employer then makes periodic cash contributions to the ESOP (step 4). The interest and principal on the loan are repaid by cash contributions to the ESOP from the sponsoring firm (step 5). Because of its contingent liability (loan guarantee), the sponsoring firm transfers ownership of the stock to the ESOP only as portions of the loan principal are repaid (step 6).