Len Hornung

Successful Exit, LLC

(608) 828-9800

www.successfulexit.biz

ESOP

WHITE PAPER

The purpose of this white paper is to provide enough information to help you to determine whether an ESOP could be an appropriate exit path for you based on your goals and resources, and therefore deserves further investigation.

Simply stated, an employee stock ownership plan (ESOP) is a qualified retirement plan that must invest primarily in your company's stock. An ESOP enables:

- Owners to receive fair market value for their ownership
- Employees to receive and purchase the companies they work for via an ESOP Trust on a tax-advantaged basis.

As with most tax-advantaged exit strategies, an ESOP comes with both complications and costs.

Let's begin by looking at why one owner chose to use an ESOP to meet his exit goals.

New Town, Michigan was about to lose one of its hometown companies. And no one had a clue. Richard Butler was the 60-year old owner of a company where 75 mostly long-time employees worked. Over the years, several professional buyers, usually representing private equity groups, had approached Richard expressing interest. A few of his much larger customers had also approached Richard about selling to them. Richard was well aware that he couldn't work forever, but he just couldn't see how he could orchestrate an exit that would not only leave him (and his family) financially set for life, but also preserve the legacy of the company in the community. Richard liked New Town, he liked his employees, and if he could manage it, he wanted to see the company—and its employees—stay put. Richard also wanted to transition out of his company slowly, because his management team was good, but it needed more seasoning before it could succeed without him. The initial exploratory offers from private equity groups assured Richard that he could reach his first goal: financial independence. But none of these buyers were willing to commit to keeping the plant in New Town, much less keep Richard's employees on board.

Like so many owners, Richard not only struggled to choose an exit path that would meet all his goals, he also didn't know who could help him. He didn't ask the investment bankers who sought to help him sell his business. He suspected that while they would be motivated to help him reach his financial goal, they would have little incentive to help him reach any of his values-based goals (i.e., a gradual transition and keeping the business in New Town).

He didn't ask his CPA, because when he'd asked her years earlier what she thought of an ESOP as a possible exit path, her response was typical, "ESOPs are too expensive to operate, too complicated, and have too many pitfalls. I've never seen one that worked well." [1]

Eventually, Richard decided to call an advisor he'd heard speak about ESOPs as a possible exit path for owners with goals similar to his. After meeting with that advisor—one with an expertise in exit planning—and learning more about ESOPs, Richard ultimately chose an ESOP as his exit path.

ON RICHARD'S TERMS

*B*efore choosing an ESOP, Richard first looked at his exit path options. Since neither his children nor his management team were interested in owning the business, his options were: 1) sell to an outside third party or 2) sell to an ESOP. He then evaluated how well each transaction would achieve his goals.

He discovered that he could achieve financial security via either of these paths because his company had the most important value drivers in place:

- A top management team
- Proven systems and processes for all aspects of the business
- A broad and diversified customer base
- Sustainable and growing cash flow and revenue

In short, Richard's business was not dependent on him.

Having narrowed his options, Richard and his advisor looked at two additional factors:

1. Could Richard's management team operate well in an employee-ownership culture?
2. Which path would give Richard control over how quickly he could step away from day-to-day operations and ultimately, entirely?

Richard's management team had proven themselves to be collaborative in decision making and objective when appointing team leaders, so they could do well in an ESOP-owned company.

Richard had no fixed departure date in mind, but he did want to begin extracting himself from the day-to-day operations of the company. If Richard sold to an outside third party, he understood that stepping back and stepping away would be issues for negotiation.

At Richard's request, his exit planning advisor set up a meeting with an ESOP consultant. Richard left that meeting enthusiastic about an ESOP as a possible exit path. He engaged the ESOP consultant to complete a feasibility study that would:

- Answer questions about valuation, financing options, plan and transaction design
- Provide Richard and his advisors with the information needed to determine whether an ESOP would be appropriate

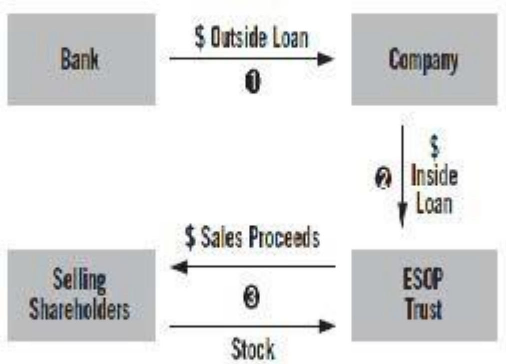
After reviewing the consultant's feasibility study, Richard chose the ESOP over a third-party sale, even though proceeds from a sale to a third party might exceed those from an ESOP. Richard, like most owners, believed that close counts even if every penny doesn't. Meaning: once he achieved financial security, more money was not as critical as achieving other goals.

Of course, before Richard made his final decision, he and his advisors reviewed how ESOPs work, their benefits, challenges, and design features. The balance of this white paper covers the same elements.

HOW ESOPS WORK

ESOP Structure

Let's look first at the structure of an ESOP sale. [2]



Kelly Finnell, a prominent ESOP Feasibility Consultant, provided this diagram and explanation for each step.

In Step 1, the Company obtains a loan (or "Outside Loan"), often from a bank. Due to technicalities in the lending laws, banks almost never loan money directly to an ESOP. Instead, banks loan money to the company establishing the ESOP.

In Step 2, the Company lends money (the "Inside Loan") to the ESOP. Generally, the Company loans the same amount it borrowed from the bank in Step 1, although the Company could lend the ESOP more or less. The terms (repayment period, interest rate, etc.) of the Inside Loan often mirror the terms of the Outside Loan, but in certain situations there may be reasons for the terms to differ.

In Step 3, the ESOP Trust (ESOT) uses the cash it received via the Inside Loan to purchase Company stock from the selling shareholder(s). The stock that is purchased will be held initially in the ESOTs "Suspense Account."

ESOP Main Characteristics

- An ESOP is a qualified defined contribution retirement plan and as such is regulated and subject to oversight by the IRS and U.S.Department of Labor (DOL).
- The company can deduct its contributions to the ESOP as it would with any other qualified plan, including contributions used to repay the loan principal.
- There is no income tax assessed on the income earned by the assets (the original owner's stock) that the ESOT owns until that stock is distributed to plan participants, usually when they retire.
- There is a capital gains tax deferral to owners who sell their C-corporation stock to an ESOT provided several requirements are met. [3]
- If your company is an S corporation, to the extent that an ESOT owns its stock, the company's otherwise taxable income is no longer taxed because the ESOT does not pay income taxes.
- A board of directors-appointed trustee, not employees or plan participants, largely controls the stock owned by an ESOT. Employees generally only vote their ESOP shares on matters that, under state law, require a super-majority vote. Typically, these matters include: the approval or disapproval of any corporate merger or consolidation, recapitalization,

reclassification, liquidation, dissolution, sale of substantially all of the assets of the company or similar transactions.

ESOP BENEFITS

Let's look at the benefits of an ESOP to owners.

Meets Financial Objectives

Careful planning often allows owners to ultimately receive as much after-tax cash as they would from third-party buyers.

Keeps the Company in Community

Because owners can continue to effectively control their businesses even after the buyout businesses can remain in their communities.

Allows Owners to Leave Gradually

If they choose, owners and former owners can remain as CEO and:

- Continue to lead their companies
- Prepare their management teams to succeed upon their departure
- Reap the benefit of increasing share value by selling stock over time

Gives Owners the Option to Stay After the Sale

The trustee of the ESOT, not employees, elects the board of directors who in turn has the power to hire or fire the President and CEO. Often the owner selects the initial trustee. Loren Rodgers, Executive Director of NCEO.org, notes here, "Selecting the trustee is ultimately the responsibility of the board, possibly delegated to a committee. When he or she owns all of the shares, the original owner controls the board, and even afterward he or she typically has profound influence over the board."

Gives Valued Employees the Opportunity for Extraordinary Retirement Benefits

Many owners wish to reward long-term employees who have contributed greatly to the success of their companies, so they choose an ESOP.

ESOP CHALLENGES

Owners must also weigh the challenges ESOPs present before choosing an ESOP as the optimal exit path.

Considerable Setup and Operational Costs

- For businesses with fewer than 20 employees and a value of less than $3 million to $5 million, an ESOP may not be cost effective, even with the tax savings.
- According to Loren Rodgers, the costs of setting up an ESOP can be as low as $50,000 to $100,000 and run as high as $350,000. "In my experience," says Finnell, "costs generally range from $200,000 to $350,000 depending on the size and complexity of the transaction. Both Rodgers and Finnell agree that cost depends on business value, complexity, the

number of advisors involved, whether investment banking services are needed, and the hourly fees of advisors involved. Interestingly, the fees for setting up an ESOP are often less than the fees charged by an investment banker, attorney and accountant in a sale of a comparably sized company to a third party. “The primary determinant of cost,” adds Finnell, “is the value of the stock that will be sold to the ESOP. If pressed for a rule of thumb, I’d say that, to produce an attractive cost-benefit ratio, an owner must sell at least $3 million worth of stock to an ESOP.”

- In addition to setup and design fees, every party in the ESOP transaction (owner, company, and ESOP Trustee) may have its own professional, and usually expensive, representation. Each is responsible for its own fees, but the source of the money used for payment is the company.
- There are also annual professional fees for third-party administration, valuation, and trustees, but fees are significantly lower than the cost of the initial transaction.

Regulatory Scrutiny

“Companies have been establishing ESOPs for more than 40 years,” says Rodgers. “Over that time the Department of Labor and the IRS have issued many guidelines and regulations, and the courts have rules on acceptable and unacceptable practices.”

Operational Complexity

“Administering an ESOP is extremely complex,” observes Rodgers, “and involves extensive record keeping, employee reporting, government filings, and compliance testing. Fortunately, a healthy market exists for third-party administrators (TPAs) for ESOPs, and those TPAs have carefully designed (relatively inexpensive) tools to handle the administrative complexity.”

Fiduciary Risk

Again, we turn to Loren Rodgers, “The trustees of ESOTs and anyone else who acts as a plan fiduciary (such as an ESOP administrative committee) are subject to the ‘prudent expert’ standard. This is a high standard, and anyone who serves as a plan fiduciary needs to both understand his or her exposure and be prepared to meet those standards. Fiduciaries need to be trained, receive sufficient information, and should also carry fiduciary liability insurance. Companies that do not want an insider to shoulder this fiduciary burden may choose to hire a professional trustee (either an individual or institution) to serve as the plan’s trustee.

Employee Ownership Culture Not a Fit with Successor Management

We’ve found on more than one occasion that broaching the idea of an ESOP to members of a management team meets push-back along the lines of, “If we are going to be responsible for the ongoing success of the business after you (the owner) exit, we’d rather just buy the company from you.” Depending on the structure and design of a management buy-out, this might be a perfectly acceptable exit path for owners like Richard.

Repurchase Obligation

Under an ESOP, the participating employees accumulate stock in their accounts within the ESOT and when they leave the company, the company repurchases their vested shares. The company need not begin payments immediately nor make the payment as a lump sum.

Due Diligence

An ESOP is like any other third-party buyer in terms of due diligence. If a company has undisclosed or environmental liabilities, the ESOP Trustee will demand that the seller make representations and warranties that survive the closing and shift some of the risk to the seller.

Personal Guarantee

If an ESOP uses bank financing to purchase stock from an owner, banks may require the seller (owner) to personally guarantee the bank debt or use their personal assets as *collateral for the bank loan. Kelly Finnell and other ESOP experts report that sophisticated lenders usually don't require the replacement securities to be used as collateral because they view ESOP loans as low risk.*

Loren Rodgers notes that, "Of course, some lenders do often require SOMETHING as collateral, though it depends on the size of the transaction, the stability of the company, the size of the loan, the existing banking relationship, etc."

Owner Involvement

If you choose a bank-financed ESOP because you want to exit into the sunset as quickly as possible, make sure the bank is comfortable with your successor management team. Our experience is that banks may not loan to ESOPs unless the original owner stays involved with the company after the sale. The reason should be no surprise: Banks view original owners as largely responsible for the historical success of a company. "That's true for the most part," observes Rodgers. "But banks may not require a commitment from owners to stay if they developed—before they sold to an ESOP—management teams that allow the company to function successfully without the owner."

CONCLUSION

This white paper is a high-level overview of a complex exit path. Rather than provide an exhaustive technical discussion of every detail, our goal is to describe some of the most important ESOP elements so, with our help (or that of your current advisors knowledgeable about this and other exit paths), you have enough information to consider whether, in light of your goals, an ESOP is worth exploring. If you'd like to learn more about the workings, benefits and challenges of this exit path, or talk about whether an ESOP is appropriate in your situation, give us a call.

Content in this White Paper is for general information only and is not intended to provide specific advice or recommendation to any individual. Additionally, it is not to serve as a substitute for individualized tax and/or legal advice. If you have a concern regarding *your specific situation, please discuss it with a qualified tax or legal advisor or contact us today.*

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[1] Because ESOPs require a working knowledge of several complex specialty areas (ERISA rules and fiduciary, banking, securities, tax, and M&A law) many advisors cannot discuss (or are not comfortable discussing) ESOPs.

[2] Finnell, Kelly O., The ESOP Coach, 2010, page 2.

[3] The main requirement is that the ESOT owns at least 30 percent of the company's outstanding stock following the sale. With planning and meeting additional requirements, this tax deferral can be permanent. In other words, if you sell your stock to an ESOT for $6,000,000, you can invest those proceeds in stocks and bonds (meeting the definition of "qualified replacement property") and defer paying capital gains taxes until you sell that replacement property. If you own those securities at death, the capital gains tax is permanently avoided (but dying is not the most pleasant way to save taxes).

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