Coldstream Park
116 B South River Road
Bedford, NH 03110

Tel: (603) 668-4353
Toll Free: (800) 639-2711
www.baldwinclarke.com

# ESOP OPPORTUNITIES WHITE PAPER

*This White Paper contains an overview of the Exit Planning Process. We have White Papers describing, in detail, many of its elements. Please contact the advisor who gave you this White Paper if you'd like additional information about a specific topic.*

An Employee Stock Ownership Plan (ESOP) is a tool business owners use to achieve many common Exit Objectives:

1) Provide partial or full liquidity for existing shareholders;
2) Leave the business gradually;
3) Provide employees with a stake in the future growth of the business; and
4) Keep the business in the community.

*Carmine Abruzzo was the 60-year-old owner of a company that employed just over 75 employees, many who had worked with Carmine since he started the company. Over the years, a number of professional buyers (usually representing private equity groups) had approached Carmine, expressing their interest in buying. Additionally, several of Carmine's customers had approached him about selling due to the company's expertise and performance.*

*Carmine 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 his family financially set for life, but also preserve the legacy of the company in the community. Carmine liked his community, he cared about his employees and, if he could manage it, wanted to see the company—and its employees—stay put. Finally, Carmine wanted to transition out of his company slowly because he believed that was the best way to ensure its ongoing success.*

*The first tentative offers by the private equity groups assured Carmine that he could reach his first goal: financial independence. But none of these buyers was willing to make any promises about keeping the plant in his community, much less keeping his employees on board. Nor were they focused on Carmine's other goal: a slow transition out of the company.*

*Like so many owners today, Carmine struggled with his exit decision. He didn't know who could help him. He hadn't mentioned his non-financial goal to any of the investment bankers he had interviewed, but suspected that none had much incentive to help him reach any but his financial goals.*



©2013 Business Enterprise Institute, Inc.
revised 04/13

Then Carmine read an article that presented an appealing alternative: He could cash out for fair value, his employees could own the company, and — the frosting on the cake — Carmine could pay no capital gains taxes on the sale. The article painted a picture far too good to be true, but he deemed it worth a phone call to his trusted advisors, including his CPA and attorney.

*ESOPs are qualified retirement plans, typically stock bonus plans, which must invest primarily in the stock of the sponsoring employer. The sponsoring employer is your business.*

This White Paper describes "the rest of the story," that an ESOP can be a most attractive buyer, particularly if owners: 1) wish to provide a benefit to their employees based on the performance of company stock; or 2) cannot find, or are not interested in finding, a third-party buyer.

## THE EMPLOYEE STOCK OWNERSHIP PLAN

ESOPs have received a lot of favorable press lately, including stories about business owners who cashed out at fair market value from their businesses, paid no capital gains tax on the sale of their stock and, in the process, transferred ownership of their companies, in part or whole, to their employees.

Business owners considering an exit via an ESOP should ask the following questions:

- What is an ESOP?
- How does an ESOP buyout work?
- What company characteristics make an ESOP successful?
  - What are the advantages *to an owner* of selling to an ESOP?
  - What are the disadvantages *to an owner* in selling to an ESOP?
  - What are the advantages *to the company* when establishing an ESOP?
  - What are the disadvantages *to the company* when establishing an ESOP? And,
  - What are the advantages to employees participating in the ESOP?

This White Paper explores the answers to these questions and will help you make a more informed decision about whether an ESOP might be an appropriate exit choice for you.

## WHAT IS AN ESOP?

ESOPs are qualified retirement plans, typically stock bonus plans, which must invest primarily in the stock of the sponsoring employer (the sponsoring employer is your business). ESOPs must adhere to legal requirements, which generally include:

- Full-time employees participating in the plan.


©2013 Business Enterprise Institute, Inc.
revised 04/13

- Shares allocated to participants typically in proportion to compensation.
- Full vesting of benefits not exceeding six years from date of participation. Upon termination of employment, the plan normally pays the participant the cash equivalent of his or her account balance. This distribution may be spread out over a period of five to 10 years depending on the reason for termination.
- The company's contributions to the plan are tax deductible. If the company is an S corporation, the company does not pay federal income tax, or in most cases, state income tax on income attributable to the shares held in the ESOP trust. Eventually, participants pay an income tax when they terminate employment and receive a distribution from the ESOP (unless rolled over into another retirement plan or Individual Retirement Account).
- The chief difference between an ESOP and other types of defined contribution plans such as profit sharing plans or 401k plans is that ESOPs must invest primarily in the stock of the company sponsoring the plan.
- An ESOP can receive contributions of stock or cash from the company, both of which are tax deductible to the corporation. If it receives cash, that cash can be used to purchase stock from the company shareholders, or to repay the ESOP loan.
- An ESOP is specifically allowed to borrow funds (a "Leveraged ESOP") to acquire stock from the stockholder of the company.

## HOW DOES AN ESOP BUYOUT WORK?

There are many ways to establish an ESOP. Simplified, a leveraged ESOP transaction involves the following steps:

1) The company's **Board of Directors** decides to establish an ESOP, often after conducting a feasibility study.
2) The Board of Directors appoints a **Trustee,** who then, while relying on the advice of an **independent appraiser,** establishes the Fair Market Value for the company's stock. After the sale of stock to the ESOP, the appraiser will value the stock at least annually.
3) **The ESOP** buys the stock from selling shareholder(s). This purchase can be funded in many ways, including the use of company cash, a bank loan, or seller notes. **The shareholder** transfers stock to the ESOP in return for cash and/or a promissory note.
4) **The company** (either "S" or "C" corporation) makes tax-deductible contributions to the ESOP.
5) **The ESOP** uses these contributions to make principal and interest payments on the debt incurred to purchase the shares**.**
6) **The employees** become beneficial owners of shares in the company, as eligible participants in the ESOP, which is now a shareholder of the company.


©2013 Business Enterprise Institute, Inc.
revised 04/13

## WHAT COMPANY CHARACTERISTICS MAKE AN ESOP SUCCESSFUL?

Successful ESOP companies generally have the following characteristics:

- Strong cash flow and profitability adequate to generate enough pretax or tax-free cash to buy the owner's shares, conduct its normal business and to sustain future growth;
- A management team capable of managing the company successfully after the owner has left;
- Low existing debt;
- Relatively large payroll base (usually but not always); and
- An owner willing to sell stock at fair market value.

Candidates with three or more of these characteristics should consider exploring ownership transition through an ESOP as a possible exit path.

## WHAT ARE THE ADVANTAGES *TO AN OWNER* OF SELLING TO AN ESOP?

### "Tax-Free" Rollover of Stock Sold to the ESOP

Shareholders of a closely-held C corporation may sell their stock to the ESOP and, under certain circumstances, pay no tax, provided the proceeds are reinvested in the securities of operating domestic, public or private corporations within 12 months after or three months before the sale to the ESOP (IRC 1042). In order to qualify, the stock sold cannot be "Section 83" stock, and it must be held for a three-year period prior to the sale to the ESOP.

### Liquidity and Cash to Owner

A leveraged ESOP buyout can put cash and/or cash flow (in the form of a seller note) in the owner's pocket. Owners with businesses worth three to ten million dollars often cannot attract all-cash buyers. These businesses may have strong cash flow, superior management teams, and bright futures. Yet, they are too small to attract the interest of financial, institutional or strategic buyers.

The tax benefits of a Leveraged ESOP buyout are such that the cash flow of the company can be captured before it is taxed and used to finance the purchase of stock. Banks will loan a strong company, with limited existing debt 2.5-3.5x EBIDTA for an ESOP term loan. If the owner desires to sell more shares than can be funded by a bank loan, the balance can be funded with mezzanine debt, and/or seller subordinated notes. The bank and seller loan scenario leaves the owner with cash and an income stream from seller notes, and positions employees as the new beneficial owners.

### Allows Owner to Sell Over Time

Carmine could sell 100 percent of his shares with bank financing and a seller note as discussed above. However, sellers frequently will sell a minority portion of shares at the outset and the balance at a future date. There is a great deal of flexibility to design an ESOP that will meet goals and objectives of the seller, company and employee benefit objectives.


©2013 Business Enterprise Institute, Inc.
revised 04/13

### Other Benefits

In selling stock to an ESOP liquidity is provided to the owner's estate. In addition, owners who are employees and who do not elect the IRC 1042 "Tax-Free" roll over may participate in the ESOP, and the corporation can generally provide those same shareholders as well as those who might be excluded from ESOP participation, with deferred compensation and other equity incentives (such as stock option, bonus purchase, phantom stock and stock appreciation rights). Some restrictions may apply for S corporations.

## WHAT ARE THE DISADVANTAGES *TO AN OWNER* OF SELLING TO AN ESOP?

### Collateral

Banks require collateral as a condition of making a loan to an ESOP. If the company does not have sufficient collateral, then this often includes, at least for a time, the departing owner's replacement securities purchased with the proceeds of the sale of his/her stock to the ESOP. This disadvantage was almost a deal breaker for Carmine as it is for many owners. To finance the remaining purchase price, Carmine would be required to pledge most of his sale proceeds as security.

### ESOP Affects Cash Flow

Allocating the bulk of the available cash flow of the company to ESOP contributions (in order to repay the financing costs of acquiring an owner's stock) can hinder the ability of a company to grow.

## WHAT ARE THE ADVANTAGES *TO THE COMPANY* WHEN ESTABLISHING AN ESOP?

### Tax-Deductible Loan Payments

Contributions used to make ESOP loan principal payments are tax deductible to the corporation.

### Tax-Free S Corporation Income

Income attributable to stock owned by an S corporation ESOP is not subject to federal tax. This benefit may not be available for smaller companies with approximately ten or fewer employees, due to IRC 409(p).

### Dividends may be tax deductible when paid through the ESOP

Dividends on C-corporation ESOP stock that are "passed through" the ESOP to participants or used to repay ESOP loans may be tax deductible to the corporation. These dividends are not counted in the normal contribution limit of 25 percent of payroll.

### Stimulate Company Productivity

In addition to the tax treatment advantages, an ESOP holds the potential for productivity gains in the company.

In the new book, *Shared Capitalism at Work: Employee Ownership, Profit and Gain*


©2013 Business Enterprise Institute, Inc.
revised 04/13

*Sharing, and Broad-Based Stock Options,* edited by Kruse, Freeman, and Blasi, the editors list some take-away findings on shared capitalism. The book identifies employee stock ownership plans (ESOPs) as a primary model of shared capitalism in the U.S. "Shared capitalism improves the performance of firms. It is associated with greater attachment, loyalty, and willingness to work hard; lower chance of turnover; worker reports that co-workers work hard and are involved in company issues; and worker suggestions for innovations. Shared capitalism is most effective when combined with employee involvement and decision-making and with other advanced personnel and labor policies." Numerous studies, including several by Rutgers University are available through the National Center for Employee Ownership (www.nceo.org) and The ESOP Association (www.esopassociation.org).

## WHAT ARE THE DISADVANTAGES *TO THE COMPANY* WHEN ESTABLISHING AN ESOP?

### Repurchase Requirements

When a participant terminates employment, the company (or the ESOP) must repurchase the departing employee's stock. This "repurchase obligation" can eventually become significant as employees retire and leave the company. To fund this liability the ESOP must receive additional cash contributions from the company or the company must buy back the stock from the departing participant. The good news is that companies can plan for this outflow of cash and there is a great deal of flexibility in the timing of payouts, within certain legal constraints.

### Cost

The cost to establish an ESOP is more often than not outweighed by tax savings. The cost to install a leveraged ESOP depends on many variables, including choice of a valuation firm, "quarterback," trustee, and law firm, financing structure, and other advisory services.

*The cost to establish an ESOP is more often than not outweighed by tax*

The fees for implementing a leveraged ESOP can vary significantly, however the typical cost to establish an ESOP and sell ownership of a $5M company will be about $100,000, while the tax savings on a $5M ESOP transaction could exceed 40 to 80 percent of the value of the sale, or in the $5M scenario, $2M to $4M of tax savings.

In addition to costs associated with establishing an ESOP, operating an ESOP requires annual administration by a Third Party Administrator ("TPA") which is similar to administrative services provided to 401(k) plans or Profit Sharing Plans. The IRS requires companies to hire an independent valuation firm to appraise—annually—the value of the company's stock. The valuation for this example would generally cost between $12,000 and


©2013 Business Enterprise Institute, Inc.

$20,000 and is used to establish the price of the company stock.

### Fiduciary Responsibilities

The Employee Retirement Income Security Act of 1974 (ERISA) governs the operations of an ESOP and outlines specific fiduciary responsibilities. Fiduciaries of an ESOP (generally any person or organization who exercises any authority or control over the operation of the plan and its assets) must be certain that the ESOP transaction is undertaken for the benefit of the participants and their beneficiaries. Furthermore, ESOP fiduciaries should hire independent legal and financial advisors to advise them on the structure and appropriateness of the purchase of stock from the owner. Owners can and should minimize their fiduciary risk by either letting other "insiders" serve as ESOP trustees, or by retaining an outside trustee, and must make certain that those trustees exercise independent judgment and seek advice from experienced advisors.

*Eighty-four percent of members report motivation and productivity increasing as a result of the ESOP.*

*--ESOP Association and the Employee Ownership Foundation Survey, August 2010.*

### Motivating Key Managers

ESOPs are a broad-based benefit plan, meaning that any employee who is eligible participates and shares are spread out among all employees. This can be a disincentive to key employees unless management incentive plans are put in place for their benefit.

As part of ESOP design, it is normally prudent to create an equity- or cash-incentive program for the management group, linked to repaying ESOP debt and growth of company share value. This provides key employees with equity or other financial compensation outside of the ESOP as a reward for their ongoing efforts.

## WHAT ARE THE ADVANTAGES *TO EMPLOYEES* OF PARTICIPATING IN AN ESOP?

### Employees Share in Growth

ESOP's offer significant benefits to employees as well. Not only do employees share in the equity growth of the company, they receive contributions from the ESOP that tend to be larger than those from profit sharing plans. In addition, their accounts accumulate free from taxation and are tax favored at distribution.

### Years of Extensive Research and Surveys Support the Success of ESOPs

In August 2010, The ESOP Association and the Employee Ownership Foundation released the results of a survey (conducted among the Association's 1,400 corporate members) that confirmed positive benchmarks for ESOPs. Among its finding was that 84 percent of members report motivation and productivity increasing as a result of the ESOP.


©2013 Business Enterprise Institute, Inc.
revised 04/13

Additionally, the 2010 General Social Survey, funded primarily by the National Science Foundation and conducted by the National Opinion Research Center at the University of Chicago, found that three percent of employees with employee stock ownership, which include the ESOP model and other forms of employee ownership, were laid off in 2009-2010 compared to a 12 percent rate for employees without employee stock ownership.

The data also indicated that 13 percent of the employees with employee stock ownership intended to leave their companies in the coming months whereas the rate was 24 percent for employees without employee stock ownership. This indicates significantly lower expected turnover for workers with employee stock ownership.

## WHAT ARE THE DISADVANTAGES *TO EMPLOYEES* OF PARTICIPATING IN AN ESOP?

There are no guarantees. The value of the benefit is based on the value of stock at the time the employee receives a distribution. The value of company stock can go up or down. However, as the research discussed above points out, companies owned by ESOPs have a track record of performing!

## CASE STUDY

Let's return to our fictional owner, Carmine Abruzzo for a moment. As they would with any suggested exit path, Carmine's advisors insisted that he:

- Set objectives;
- Determine a business value and make sure proceeds from the sale to the ESOP are sufficient to meet owner's financial objective;
- Protect and promote the value of the business through motivating and retaining key employees;
- Carefully plan and implement his Exit Plan;
- Consider business continuity issues that would arise should Carmine not survive until he sells the stock; and
- Protect his family in the event of his death.

An ESOP would certainly meet Carmine's Exit Objectives. Let's now look at the first four steps on his chosen Exit Planning path.

## STEP: FIX EXIT OBJECTIVES

Briefly, Carmine was willing to remain with the company for additional two or three years. When he left the business, he wanted cash sufficient to achieve financial security. He and his advisors determined that he needed to net $2 million (after taxes) from the sale of his interest to the ESOP. Lastly, Carmine had a strong, but not overwhelming, interest in transferring the business to his employees, (especially to his key employees) and in keeping the business in the community.

## STEP TWO: DETERMINE BUSINESS VALUE

As Carmine settled on his Exit Objectives he


©2013 Business Enterprise Institute, Inc.
revised 04/13

decided to look into setting up an ESOP. The company's board of directors appointed an ESOP committee that hired a firm experienced in ESOP valuations, to provide a preliminary range of value. Carmine wanted to know if the business could be sold for an amount of money sufficient to meet his financial security objectives ($2 million after-tax), and used a valuator skilled in ESOP valuations to get the best-possible estimate. A formal valuation would be part of the ESOP sale process. The appraiser thought that Carmine's company was worth approximately $2.5 million, a value in excess of Carmine's minimal financial needs (absent any taxation); provided management would continue with the company after the sale to the ESOP. The appraiser emphasized the importance of retaining the key management team.

## STEP THREE: KEEP EMPLOYEES ON BOARD

With his objectives set and preliminary idea of the value range in hand, Carmine and his advisors knew it was imperative to develop a key employee incentive plan to motivate his three key managers to remain with the company after his departure. The company's continued success depended upon a core group of key employees who had the experience to operate, manage and grow the company. Without continued success, the company would not be able to generate sufficient income to pay Carmine for his stock via the ESOP or to repay any bank loan used to finance the purchase of Carmine's stock.

It is important for owners to understand that key employees, for the most part, will work and act like owners when they participate in owner-like incentives. Generally all key employees want more ownership than they are eligible to receive as participants in the ESOP. They will insist upon additional stock or equivalent incentives.

The type of key employee incentive plan will depend to great extent on the owner's long-term objectives. For example, if the seller envisions a 100 percent S corporation ESOP, an incentive plan will generally need to be a synthetic equity program.

Key employee incentives then, must be part of the initial design of an owner's exit plan. Key employee incentive plans can either be stock-based or cash-based, promising an additional bonus if the company performs pursuant to an agreed upon standard. In Carmine's case the employees were most interested in actual stock ownership, however because he would eventually have a 100 percent S corporation ESOP, Carmine's advisors designed a phantom stock plan in which each of the three key employees would be able to receive five percent of the value of the outstanding stock of the company. The key employees' right to exercise their phantom stock options would be delayed until Carmine's stock has been purchased and all ESOP-related debt has been repaid.


©2013 Business Enterprise Institute, Inc.
revised 04/13

## STEP FOUR: DESIGN AND IMPLEMENT THE ESOP PURCHASE

Finally, after the Board hired an ESOP consulting firm to complete an ESOP Feasibility Study, Carmine made the decision to implement the ESOP.

First, an experienced ESOP attorney drafted the ESOP Plan and Trust documents, and the related stock purchase agreements. The proposed plan provided that all employees who worked 1000 hours or more would become participants after one year of service. The plan further required that each participant work five years before becoming fully vested.

The company's board of directors then appointed an independent trustee to purchase the shares on behalf of the ESOP trust. This provided a level of protection for both Carmine and the company.

The ESOP could have been funded with cash for a few years prior to Carmine's expected departure date, however he decided to sell all of his shares for $1M—cash (funded by a bank term loan) and $1.5M in a subordinated seller note that would pay interest only until the bank loan was repaid.

The bank required that Carmine pledge sale proceeds as collateral. Through determined negotiation, Carmine's advisors reduced the collateralization period and minimized the amount of pledged securities Carmine was required to pledge. In the end, Carmine pledged 50 percent of the sale proceeds to be release as the loan was repaid.

Carmine could have pursued a different ESOP strategy. He could have sold his stock to the ESOP using an installment note for the full purchase price. Alternatively, he could have elected to sell less than all of his stock to the ESOP, in an amount equal to the bank financing available to the company.

For example, Carmine could have sold 40 percent of his stock to the ESOP utilizing bank financing for the purchase.

Securing bank financing is the responsibility of the company. Banks will rarely loan directly to an ESOP. Instead, banks prefer to make loans to the company that then loans this cash to the ESOP.

Recall that one of the advantages of selling to an ESOP is that the owner is not taxed on the sale proceeds provided he or she is a qualified seller and acquires appropriate replacement securities. These securities are generally U.S. stocks or blue chip bonds or specifically designed long-term bonds called Floating Rate Notes ("FRNs"), and are a lender's first choice for collateral.

## CAUTION

No departing owners want the specter of future litigation looming over them. Owners can avoid this exposure by realizing that when creating an ESOP, the company's board of directors has created a buyer: a buyer who will want to make (and must make) independent and informed decisions. This buyer, the ESOP, will use its own set of advisors including an appraiser and an attorney.


©2013 Business Enterprise Institute, Inc.
revised 04/13

## CONCLUSION

Like all exit strategies, making an informed decision about whether an ESOP might be an appropriate exit choice for you takes time, attention and resources.

As you evaluate the many different ways of leaving your business in style, consider the ESOP as yet one more opportunity to achieve all of your Exit Objectives.

If you would like more information about ESOPs, and the process of evaluating whether your exit objectives can be realistically achieved with and ESOP, please contact me.

*We wish to thank Paige Ryan, Senior West Coast Representative and Ronald Gilbert, President, of ESOP Services, Inc. (www.esopservices.com ) for their contribution to this White Paper. Paige and Ron are both BEI members providing only ESOP-related consulting services.*

*If you would like more information about how we can facilitate an exit planning process tailored to meet your specific objectives, please give us a call.


©2013 Business Enterprise Institute, Inc.
revised 04/13