HUSCH BLACKWELL

Are ESOPs 'It' for the Privately Held?

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Recently, the owners of a successful professional services firm told me they wanted to do an employee stock ownership plan (ESOP) because it is "in" and the "it" thing. I've been doing ESOPs since 1986, but never thought I'd be doing something that is "it"!

For business owners considering succession, an ESOP provides an alternative to selling the business to a third party or management. An ESOP is a qualified retirement plan that operates under many of the same rules that apply to a 401(k), except that employees don't contribute their own money and the plan invests in employer stock rather than mutual funds. The ESOP typically acquires stock by buying it from the company or the company owner(s).

Is an ESOP a Good Fit?

Many clients ask why ESOPs are so popular and have requested a litmus test to identify whether an ESOP might be right for them. Here are the criteria we have found to be relevant:

- Equity value is at least $3 million.
- The company has at least 20 employees, preferably 30 or more.
- The business owner is ready to sell but is willing to maintain some interest and level of governance in the company (slow transition).
- A management succession plan is in place.

ESOP ownership can prosper in any industry, and there is no upper limit on the size or value of company. We have worked on $1 billion ESOPs and many over $100 million.

An ESOP does not work as well if the seller wants both full fair market value (FMV) and 100 percent cash at close. These kinds of ESOP deals will necessitate some seller carryback (but there are advantages to that described below). Also, if a company is growing very fast and consuming large amounts of capital, an ESOP might slow growth because cash will be paid to the seller instead of being invested in the business.

What About Cost and Complexity?

I cringe when I hear that a company has ruled out an ESOP due to cost or complexity. An ESOP is like any other business decision: The costs are weighed against the benefits. If the company meets the criteria, the first-year tax benefits should outweigh the cost.

As for complexity, some companies are scared away after attending an ESOP seminar where well-meaning speakers have spouted a dizzying array of rules, complete with citations to regulations. Look at it this way: There are 39 pages of 401(k) regulations but only 16 pages of ESOP regulations. Employers don't understand all of the 401(k) rules; they hire expert companies to administer the complexities of their 401(k). The same is true for ESOPs.

Companies that meet the criteria but decide against an ESOP should do so because an ESOP is not the best way to achieve their succession objectives, not due to cost or complexity.

Why Are ESOPs 'It'?

- **Demographics.** About 2.5 million U.S. businesses have owners who are older than 55. Surveys and studies indicate that more than half of them will consider selling in the short- to mid-term. Most of them should consider an ESOP.

- **Value.** The owner can receive full FMV in a sale to an ESOP.

- **The government pays for a large part of the deal.** Almost every deal we do involves selling 100 percent of the company to an ESOP. The company either already is an S corporation for tax purposes or becomes one. The company issues the K-1 for its income to its 100 percent owner – the ESOP – which is a tax-exempt entity. So the income is permanently not taxed at the federal level and in most states. The growth in value of the stock is eventually taxed when an ESOP participant receives payment for his/her stock and fails to roll it over to an IRA. Further, the ESOP-related deductions for the final year of the seller's ownership can usually generate a tax saving for the seller, which is essentially additional purchase price paid by the government.

- **Seller notes can be a good investment.** Sellers typically receive a note for all or part of the purchase price. Most sellers find the note to be a desirable investment. The return on the note is usually superior to the public market for investment of their proceeds, and they are taking less than normal credit risk because their debtor has 100 percent of its pretax cash flow to pay debt rather than 55 percent. Our ESOP clients not only survived 2008 but prospered, in part due to large cash reserves that allowed them to take advantage of the buying opportunities the Great Recession created. For many of our long-term ESOP clients, their biggest problem is how to deploy the excess cash on their balance sheets.

- **Warrants are the special sauce.** Most ESOP deals are structured so that the company issues warrants to the seller as part of the transaction. (A warrant is a right to purchase stock from the company at a future date for a fixed exercise price.) The exercise price is often the post-sale value of the company (i.e., post-seller debt, so the company's equity value is near zero. The warrants appreciate not only with growth in enterprise value, but also with each debt repayment. The warrants can end up being worth about 50 percent of the amount of the sellers' original sales price after five to 10 years, so they represent a second bite at the apple.

- **ESOP transactions facilitate gifting to kids.** Warrants are worth very little at issuance and can be gifted for little or no gift tax. The recipients receive mostly capital gain treatment upon liquidation of the warrants because the warrants are themselves capital assets that are sold back to the corporation.

- **Control.** Although many of our clients value employee involvement, the sellers can maintain control over the company, at least while the seller notes are outstanding.

- **Culture/legacy.** Sale to an ESOP allows the seller to preserve the company's culture and legacy. This is often one of the greatest benefits of selling to an ESOP. The business is the owner's "baby." It contributes to the local economy and causes, and employs people who have helped build the company's value. Most owners realize that sale to a third party will ultimately result in the company transforming into something they don't recognize, and result in its profits being siphoned off to wherever the new owners reside. An ESOP avoids this fate, keeps the profits of the company in the community and rewards the employees for their hard work and loyalty.

- **Benefit to management.** Most owners want to disproportionately benefit management. Although an ESOP benefits all employees, every deal we do includes significant "stock appreciation rights" for the management team that are in addition to their ESOP benefits. These rights typically result in a big payday for management that is conditioned upon first repaying the seller notes.

Contact Us

To learn more about whether an ESOP might be a good fit for your company, contact Mark D. Welker of Husch Blackwell's Business Succession Planning team.