

Ten Fables About Selling Your Company to an ESOP

BY ROGERS SMITH

As a business owner, the thought of selling your company probably produces a number of emotional responses: fear, excitement, nervousness, exhilaration, confusion. Likewise, introducing an exit vehicle which is conceptually new to most small business owners, such as an Employee Stock Ownership Plan (ESOP), can be downright frightening. Therefore, I feel the best way to introduce discussion about ESOPs is by outlining what ESOPs are not.

There are many misconceptions about ESOPs being fielded today, both in the press, and by professionals from various fields. More importantly, we as business owners sometimes shun ideas that are new to us; or we build our own points of view from sometimes-imperfect information. For this reason, I will attempt to dispel ten misconceptions or fables about selling your company to an ESOP.

ESOP Fable #1: *It would be easier just to sell my company to a third party.*

Business owners will often have the following belief: “When the time comes to retire, I will simply sell my company to an interested buyer.” Unfortunately, it’s not that easy. Finding a qualified buyer for a privately-held business can be a daunting task. In fact, the entire business brokerage industry devotes most of its energies to simply finding qualified buyers for business sellers. A qualified buyer is one that can afford to acquire the business, and is ready and willing to pay a fair price. Finding such a buyer generally involves advertising the business for sale, interviewing potential candidates, weeding out the unqualified prospects, and negotiating a selling price and other terms.

Even if you have been approached in the past by parties expressing interests in buying your company, getting an actual commitment to purchase can often be

discouraging. Likewise, a little research often reveals that many of those “interested parties” are simply the result of over-zealous business brokers seeking new clients, rather than genuine qualified buyers interested specifically in acquiring your company.

Herein lies one of the key benefits of selling your company to an Employee Stock Ownership Plan. There is no need to find a qualified buyer, or to otherwise put your company on the market. The ESOP actually makes a market for your stock. The ESOP will pay fair market value for your stock, in cash. And consummating the sale can take considerably less time than a typical third-party sale, often in less than 120 days. Moreover, an ESOP provides a systematic approach to selling your company, one that adds form and structure to a normally disjointed process.

ESOP Fable #2: *ESOPs are only applicable to very large corporations.*

There is a commonly held notion that the benefits offered by Employee Stock Ownership Plans are available only to the largest of corporations. In reality, most ESOPs are found in companies with fewer than 100 employees. Of course, the larger ESOPs from companies such as Publix Supermarkets, United Airlines and W.L. Gore of Gore-Tex get the headlines; but ESOPs can be found in companies with as few as ten employees.

ESOP Fable #3: *If I sell to an ESOP, I will lose control of the company.*

One of the major concerns a business owner can have is a perceived loss of control after selling an interest in his or her company to an ESOP, particularly if only a partial interest is sold. However, in most ESOP sales, the selling owner will elect to be the Trustee of the ESOP. The ESOP Trustee is empowered to vote all of the shares of stock owned by the plan. This means if you sell your shares to an ESOP, you can maintain full control of the company, for as long as you choose.

Only in certain circumstances, such as the liquidation of the business, do employees actually vote their shares of stock. Thus, a major headache of theoretically having to consult employees and have them vote on every corporate decision is effectively removed, leaving the issues instead to the Trustee.

ESOP Fable #4: *My employees cannot afford to buy my company.*

One sentiment we encounter often in the field can be paraphrased as, “How can my employees even consider buying my company...most live paycheck to paycheck.” The answer is simply, the employees do not have to pay for the company. The employees do not contribute personal funds, or even provide credit for the transaction. Funding is provided by specialty lending institutions whose focus is solely on funding ESOP buyouts.

Over time, ownership is passed from the ESOP to the employees in the form of a contribution, in exchange for their dedication and loyalty to the company. The longer the employee remains with the company, the larger will be his or her ownership stake. The ESOP is, in essence, a retirement plan, funded by stock in the company.

Therefore, the motivational aspects of these plans can be extremely powerful for the employees. In fact, most ESOP companies experience lower employee turnover after implementing the plans; and according to several national studies, ESOP companies tend to be 8-12% more profitable than their non-ESOP counterparts.

ESOP Fable #5: *An ESOP won't pay me what my company is worth.*

Most business owners have ideas of what their companies are worth. And many feel by selling to the employees through an ESOP, they will not realize full value for their shares. The truth is if you sell your company to an ESOP, you will be paid full fair market value. The determination of just what is fair market value will be made by

an independent valuation analyst. This removes the need to endlessly negotiate the sale price of the shares being sold.

The business valuation profession uses sophisticated yet standardized techniques to determine the fair market value of a business interest. Independence of the valuation analyst is required, which effectively removes any biases in favor of either the buyer or the seller. Therefore, you can be confident you will receive a fair price for your company when selling to an Employee Stock Ownership Plan.

Moreover, by selling your company to an ESOP, you will have the opportunity to fully defer all taxes on the sales proceeds. This means not only will you receive full value for your company, but you will also enjoy powerful tax advantages as a result of selling to an ESOP, which otherwise would not have been available through selling to a third party.

ESOP Fable #6: *ESOPs are new and untested.*

When first introduced to the concepts of employee ownership and ESOPs, business owners are often skeptical of the idea, considering such transactions as new and untested. Yet, ESOPs have been around for more than 25 years. The statutory framework for today's ESOP was developed by Congress in 1974 to broaden the ownership of capital, and to provide employees with a stake in the ownership of their employers. To induce companies to create ESOPs, Congress developed powerful tax incentives for both existing owners and their companies.

In 1974 there were less than 200 ESOPs. Today there are more than 11,500 ESOPs in place, covering more than 10 million employees, and controlling over \$400 billion in company stock, or roughly 8% of all U.S. stocks. By comparison, 401K plans control roughly half this amount, or \$200 billion in company stock.

ESOP Fable #7: *Lenders won't be interested in financing my buyout.*

One concern of business owners we frequently encounter is whether a lender would be interested in financing the buyout of their businesses. The answer is yes, if you have the right lender. As a general rule, conventional business lenders will not be interested in financing an ESOP buyout. This can be attributed to their lack of ESOP knowledge, and to a general distaste for wandering outside of their core business practices.

Specialty lenders, on the other hand, are quite interested in financing ESOP buyouts. In fact, some specialty lenders focus their practices entirely on ESOPs and employee buyouts. And the loan terms for ESOP loans can be considerably more favorable than those of conventional loans. This is due, in part, to ESOP loans generally having lower default rates than those of any other type of commercial loan.

Further, your company will have the ability to deduct from taxes not only the interest paid on the buyout loan, but also the principal payments. This lowers the company's effective borrowing costs by roughly 30%. As a result, the ESOP can be in a better position to buy your shares when compared to a third party acquirer, who will not have access to such favorable tax treatment.

ESOP Fable #8: *I am concerned with the thought of employees selling their stock to someone else.*

An obvious fear to business owners considering selling an interest in their companies is whether employee/shareholders can simply sell their shares to anyone on the street. This concern is addressed by specific restrictions placed on the shares in employees' stock accounts. Most plan documents give the company a specific right of first refusal on all stock contributed to employees.

What this means is your employees, upon distribution, must offer to sell their shares back to the company. This

is the mechanism through which the employees receive their retirement funds; and it keeps shares from falling into the hands of unrelated companies or individuals. Further, all shares are distributed with a back-up liquidity measure called a put option. This put option allows the retiring employee to sell (or put) his or her shares back to the company at fair market value. Both the stock restriction and the put option ensure liquidity for the employee, and trade protection for the company.

ESOP Fable #9: *I will not be able to sell a part of my company, while leaving the other part to my children.*

Often business owners would like to leave their businesses to their children; but must also fund their own retirement years. A logical solution would be to sell a partial interest in the company, and leave the rest to the children. However, selling a partial interest in a privately-held company can be nearly impossible, unless the seller will agree to a steep discount in price.

ESOPs, on the other hand, will allow you to sell an interest in your company to its employees, at fair market value, and donate or sell the remaining interest to your children. Under this scenario, your children can remain in control of the company, while you receive a lump sum distribution for the interest sold to the ESOP.

ESOP Fable #10: *An ESOP will remedy all of my company's problems.*

While the Employee Stock Ownership Plan is a powerful financing vehicle, it is not a panacea. If your company has fundamental financial, organizational, or operational problems, an ESOP may not be the most effective remedy. ESOPs work best in health companies or in companies demonstrating potential for future success.

Likewise, installing an ESOP in a healthy company does not ensure improved performance. In order to realize the greatest performance improvement from an ESOP,

the employees must be educated about the benefits offered; and this education process must be reinforced regularly. Otherwise, skeptical employees will consider the plan as just another management scheme.

The Employee Stock Ownership Plan has become one of the most powerful vehicles of corporate finance available to owners of privately-held businesses. Accordingly, its success can be measured by the rapid growth in the number of plans established, from less than 200 in 1974, to more than 11,500 today. By dispelling some of the most commonly held ESOP misconceptions, and by studying the opportunities offered by such plans, company owners will find the ESOP offers some significant advantages over selling a business to the general public.

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