



Exit Planning Information & Education for America's Business Owners

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Weatherby & Associates, PC
Counselors at Law
Helping Families Preserve and Protect Assets and Values

Issue 11

ESOPs: Exit Opportunity for Business Owners

*Aesop is famous for his stories that teach important lessons but are fictional and often fantastic. Our topic today, **ESOPs** (Employee Stock Ownership Plans) is similar. Fictional and often fantastic claims are made about what **ESOPs** can and cannot do. **ESOPs** can help business owners to achieve a number of important Exit Planning goals-namely, selling a business tax-free to employees for full market value. But as with a fable, readers must take care to separate the important lesson from the fiction. What can or should you believe about **ESOPs**? Read on.*

Business owners use **ESOPs** (Employee Stock Ownership Plans) as a tool to achieve three common Exit Objectives:

- I To leave the business soon;
- I To leave the business with cash adequate for financial stability; and
- I To leave the business to employees

What is an ESOP?

An **ESOP** is a qualified retirement plan, typically a profit sharing plan, that must invest primarily in the stock of the sponsoring employer. It is subject to a number of legal requirements.

Armed with that basic information, let's look at how an **ESOP** helped one fictitious owner to achieve his Exit Objectives.

Steve Victoria was the sole owner of VECEI, a 35-person firm with annual revenues of \$5 million and cash flow of \$500,000.

After exploring a sale to a third party, Steve's business broker suggested that a cash sale was unlikely. A sale to employees was also problematic given their inability to obtain meaningful financing.

*Until Steve came across an article about **ESOPs**, he thought that his only exit option was to gradually diminish his involvement in the hope that VECEI could*

continue to distribute earnings to him. The article outlined a far different exit option. It said that Steve could cash out for fair value, his employees could own his company and, best of all, Steve would pay no taxes on the sale.

Steve wasted no time contacting his advisors to see if an **ESOP** could work for him. His first question was: What companies are suited to an **ESOP**?

ESOPs do not work well for every company. To be successful, a company should have:

- I Strong cash flow;
- I A good management team that can carry on after an owner's departure;
- I Little or no permanent debt;
- I A relatively large payroll base;
- I An alignment between shareholder and employee interests; and
- I Adequate capitalization to sustain future growth.

ESOP Advantages

The biggest advantage in the minds of many owners is the fact that the funding of a purchase by an **ESOP** is accomplished via pre-tax instead of post-tax dollars. Running a close second is that if, after an **ESOP** purchases the owner's C corporation stock, the **ESOP** holds at least 30 percent of the corporation's outstanding stock, the shareholder's proceeds are tax-free so long as they are invested in U.S. stocks and bonds.¹

Finally, national surveys indicate that a company's productivity improves after an **ESOP** is instituted.²

ESOP Disadvantages

For every silver lining there is a cloud and **ESOPs** are no exception.

- I First, using (or establishing) an **ESOP** as your exit vehicle is expensive. Expect to pay between \$25,000 and \$100,000 depending on the complexity of your situation.
- I Second, ERISA, the body of law that governs **ESOPs**, imposes significant responsibilities on its fiduciaries so that the interests of the participants and beneficiaries are represented and achieved. In fact, the sale of an owner's stock to an **ESOP** must be an arm's length transaction between the owner and an independently-directed and administered **ESOP**. If an owner makes any decision for the **ESOP** regarding the purchase or financing of his stock, he exposes himself to lawsuits claiming a breach of fiduciary obligation to the **ESOP** and its participants.
- I Third, because an **ESOP** is required to repurchase stock from terminating employees, companies must make significant cash contributions to cover this liability — cash that would otherwise be used to grow the company.
- I From the employee's perspective, **ESOPs** are not always welcomed with enthusiasm. Key management groups are given total ownership responsibility but must share the reward with other employees.
- I And last, but not least is the lending bank's requirement that the **ESOP** have equity in the transaction before it will loan the **ESOP** the funds necessary to purchase the owner's stock. To create this equity, the company must pre-fund the **ESOP** with cash that otherwise would have been bonused to the owner.

Having weighed the pros and cons of **ESOPs**, Steve decided, with the help of his advisors, to pursue this exit strategy.

First, he had to set his objectives. Steve decided that he was willing to remain

with VEI for two to three years and he wanted \$2 million (after-taxes) from the sale.

Second, Steve hired an investment banker as his valuation expert to perform a preliminary valuation, the purpose of which was to determine if Steve's financial objective (\$2 million after-tax) could be met.

Third, Steve had to develop a key employee incentive plan that would keep the key employees on board before and after Steve's departure.

Fourth, Steve's attorney drafted the **ESOP** document to comply with the many ERISA requirements regarding vesting, participation, and fiduciary duties. Attorneys also drafted the necessary documents to ensure the continuity of the company (should Steve die before the **ESOP** transaction could take place) and to provide for Steve's family (in the event of his death). The **ESOP** was then funded with cash contributions for three years, after which it was able to obtain bank financing sufficient to pay Steve the entire purchase price.

The final result? After 3 years, Steve sold his interest to the **ESOP** for \$2.5 million. The bank required that he pledge half as collateral, to be released as the loan was paid down. Because Steve acquired blue chip stock and bonds, he was able to avoid the capital gains tax on the sale of his stock to the **ESOP**.

*Subsequent issues of **The Exit Planning Review**TM discuss all aspects of Exit Planning. The provider of this Newsletter ([Hank Weatherby](#)) offer you unbiased information about what you may need to know — *How To Run Your Business So You Can Leave It In Style*TM.*

¹Internal Revenue Code, Section 1042.

²The National Center for Employee Ownership, [^Top](#)

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