



ESOP Opportunities White Paper

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

- 1.) To leave the business soon;
- 2.) To leave the business with cash adequate for financial security; and
- 3.) To leave the business to employees.

Let's look at the case of Steve Victoria, sole owner of Victoria Engineering and Consulting, Inc. (VECI).

VECI was a 35-person firm with annual revenues of \$5 million and annual cash flow of \$500,000. Steve explored the sale of his company to an outside third party, but, after his business broker's investigation, it appeared that a cash sale was unlikely.

Steve's second choice — to sell VECI to his employees — was problematic because he knew they lacked the ability (and, perhaps, the willingness) to obtain meaningful financing. Steve was unwilling to leave VECI in the hands of his employees — no matter how capable of running it they might be — without the majority of the company's value converted to cash and stowed safely in his pockets. There seemed to be no way out. He was stuck

in his business.

Steve's only exit appeared to be to diminish his involvement gradually in the hope that VECI could continue to distribute earnings to him.

Then Steve read an article in an airline travel magazine that presented an appealing alternative: He could cash out for fair value, his employees could own VECI, and — the frosting on the cake — he would pay no 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 crusty old law firm. This White Paper describes "the rest of the story."

Employee Stock Ownership Plan

ESOPs have received a lot of favorable press lately. It is almost as if an ESOP is the modern-day equivalent of a diet pill that lets folks eat all they want and still lose weight.

ESOPs are touted as allowing business owners to cash out at fair market value from their businesses, pay no taxes on the sale and, in the process, transfer their companies to their employees. To separate truth from fiction - or reality from hype - business owners need to ask the following questions:

- What is an ESOP?
- How does an ESOP buyout work?
- What company characteristics are needed to make an ESOP work well?
- What are the disadvantages to an owner in selling to an ESOP?
- What are the advantages to an owner of selling to an ESOP?

This White Paper explores each question and will help you make sense of the hype and of the confusing technical requirements surrounding ESOPs.

WHAT IS AN ESOP?

ESOPs are qualified retirement plans, typically profit sharing plans, which must invest primarily in the stock of the sponsoring employer (in your case, the sponsoring employer is your business). As such, ESOPs must follow all requirements of governing law, including:

- All full-time employees eventually participate in the plan.
- Each participant is allocated a share of the plan assets in proportion to compensation.
- Full vesting of benefits cannot exceed six years from date of participation. Upon termination of employment, the plan must give the participant the right to receive his or her account balance in cash over five years.
- Contributions to the plan by the company are tax deductible and the plan does not pay income tax on income it earns. Eventually, participants pay an income tax when they terminate employment and

receive a cash distribution from the ESOP (unless rolled over into an IRA).

- The chief difference between an ESOP and a regular profit sharing plan 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. If it receives cash, that cash can be used to purchase stock from the owner of the company.
- An ESOP may borrow funds (a “Leveraged ESOP”) to acquire stock from the owner of the company.

HOW DOES AN ESOP BUYOUT WORK?

As the chart below illustrates, in its simplest form, an ESOP buyout transaction contains the following parties:

- 1.) The company that contributes cash to its ESOP.
- 2.) The ESOP that uses the tax deductible contributions to acquire the owner’s stock.
- 3.) The owner who transfers his stock to the ESOP in return for cash. If this transaction meets certain qualifications, the cash that the owner receives is not taxed to him. In this scenario available cash flow of the company is contributed on a tax-deductible basis to an ESOP which pays that cash to an owner who may be able to receive payment without paying any taxes provided certain requirements are met.

- 4.) A bank. Since most owners want as much cash up front as possible when they sell their stock, a financing source is usually required which will loan money to the ESOP that in turn uses the loan proceeds to acquire the owner's stock.
- 5.) The loan is repaid from the company's future contributions to the ESOP or dividend payments from the stock owned by the ESOP.

At this point, the employees/participants have become, at least indirectly, the new owners of the company. Their interests will need to be protected throughout the transaction.

WHAT COMPANY CHARACTERISTICS ARE NEEDED TO MAKE ESOPS WORK WELL?

ESOPs are not for every business. To be successful a company should have the following characteristics:

- Strong cash flow;
- Good management team to carry on after the owner has left;
- Little or no permanent debt;
- Relatively large payroll base (but not always);
- Alignment of shareholder and employee interests; and
- Adequate capitalization to sustain future company growth.

If your business lacks any of these characteristics, especially the first three, it is unlikely that an ESOP is the best path for you.

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

Cost

ESOPs are costly to establish and relatively costly to maintain over the years; in many respects the sale of stock to an ESOP is more complex and almost as expensive as a sale to an outside third party. The fees for a Leveraged ESOP buyout of an owner range, from \$25,000 to \$100,000. In addition, to establish an ESOP, at least one arms-length, third party appraisal is needed (at a cost of \$10,000 to \$20,000, or more). An annual update to the appraisal is also required at a cost of several thousand dollars.

Fiduciary Responsibilities

The fiduciary responsibility requirements of the Employee Retirement Income Security Act of 1974 (ERISA) are significant. The fiduciaries of an ESOP (which typically include the company, the trustee and the individual members of a committee appointed to administer the ESOP) 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 letting others serve as ESOP trustees and by making certain that those trustees exercise independent judgment and seek advice from experienced advisors.

Repurchase Requirements

When a participant terminates employment, the company (or the ESOP) must repurchase the departing employee's stock over a five-year period. This "repurchase liability" will eventually be 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 directly from the departing participant.

Pre-Funding

Pre-funding of an ESOP by the company is normally required. A bank is not going to lend 100 percent of the purchase price of an owner's stock. With a strong balance sheet, banks might lend 60 to 70 percent of the purchase price. Consequently, companies often pre-fund the ESOP by making contributions during the one to three years before the intended stock transaction. This pre-funding serves as the ESOP's "equity" in the purchase making the bank or financial institution far more likely to lend the balance of the purchase price.

Keep in mind that pre-funding the ESOP uses monies that otherwise could have been bonused directly to the owner.

Employee Skepticism

It surprises some owners to learn that key employees often view the ESOP as a disincentive. These key employees must run the company and assume the responsibility of

ownership without reaping 100 percent of the reward. As part of the ESOP buyout design, it is normally prudent to create an equity or cash incentive program for the management group. Doing so allows them to acquire equity or other financial reward outside of the ESOP as a reward for their efforts on a go-forward basis.

Collateral

A financial institution usually requires collateral as a condition of making a loan to the ESOP. Usually, this collateral includes, at least for a time, the departing owner's replacement securities he has purchased with the proceeds of the sale of his stock to the ESOP.

ESOP uses available Cash Flow

Finally, 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 the company to grow.

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

Tax Treatment

The payment of both principal and interest to fund a purchase by the ESOP can be accomplished with pretax rather than after-tax dollars. Remember, the company makes tax-deductible contributions to the ESOP or, in the case of a "C" corporation, dividends paid on stock owned by the ESOP to repay the loan are considered tax deductible.

If the ESOP purchases stock from the shareholder of a C corporation, and after the sale the ESOP owns at least 30 percent of the outstanding stock of the corporation, the selling shareholder will not be taxed on the proceeds as long as they are invested (generally speaking) in U.S. stocks and bonds (not mutual funds).

Of course, when those replacement securities are sold, a capital gain is generated, the size of which is determined by the owner's basis in the stock sold to the ESOP. To avoid this tax treatment, owners can hold on to those replacement securities until death when, the securities receive a step-up in basis and can be sold free from any capital gain.

Few owners, however, aggressively pursue this capital gains tax-saving opportunity. Instead, they invest the proceeds from the sale of stock to the ESOP in high-quality floating rate bonds. As long as these bonds are not sold, no capital gains tax is incurred. The owner can use these bonds as collateral to obtain a loan from any number of brokerage houses or other financial institutions. The interest rate for the loan will be less than one hundred basis points greater than the interest paid by the bonds. The proceeds from this loan can then be invested in a variety of stocks and bonds, or simply spent — all without any tax consequence.

When the reinvested asset is sold, a capital gain is generated but only on the difference between the sale price and the purchase price. Combining the deferral of gain on the sale of stock to an ESOP with the purchase of

long-term bonds used as collateral can mean that the business owner permanently avoids capital gains tax on the sale of his stock to the company's ESOP.

Stimulate Company Productivity

In addition to the tax treatment advantages, an ESOP holds the potential for productivity gains in the company. According to an article in **Nation's Business** (Volume 85, 1997), "In a survey of 1,150 ESOP companies in 1995...68 percent of the respondents said their financial figures improved the year after they instituted an ESOP and 60 percent said productivity improved."

Cash to Owner

A leveraged ESOP buyout puts cash in the owner's pocket. Other than a sale for cash to an outside third party, the ESOP is the best way to maximize the amount of cash at closing. Owners with businesses worth three to ten million dollars often cannot attract cash buyers. These businesses have strong cash flow, a superior management team, and a bright future. 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 the owner's stock. A combination of ESOP pre-funding and borrowing from a bank (or other financial institution) puts the owner in much the same

position as if he had sold to a third party for cash — except it allows employees to be the new owners.

VECI CASE STUDY

Let's return to Steve Victoria and VECI to see how Steve and his advisors dealt with the many issues surrounding the creation of an ESOP. Like any other Exit Planning path, Steve's advisors insisted:

- That he set objectives;
- That he determine a business value;
- That the value of the business be promoted and preserved through motivating and keeping key employees;
- That the contemplated Exit Plan, in this case an ESOP, be well-planned and implemented;
- That business continuity be considered should Steve not survive until he sells the stock; and
- That Steve's family be protected in the event of Steve's death.

Now that we understand how an ESOP met Steve's objectives, we will review the first four steps on his Exit Planning path.

STEP ONE: FIXING EXIT OBJECTIVES

Briefly, Steve was willing to remain with the company for an 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, Steve had a

strong, but not overwhelming, interest in transferring the business to his employees, especially to his key employees.

STEP TWO: DETERMINING BUSINESS VALUE

As Steve was determining his Exit Objectives he also hired a valuation expert, experienced in ESOP valuation, to obtain a preliminary company value. Steve did not request a formal valuation at this time. Instead, he was interested only in knowing if the business could be sold for an amount of money sufficient to meet his financial security objectives (\$2 million after-tax). He knew that a formal valuation would come later as part of the ESOP sale process. The appraiser thought that VECI was worth approximately \$2.5 million, a value in excess of Steve's minimal financial needs (absent any taxation); provided management would continue with the company after the sale to the ESOP. The appraiser would have significantly discounted the value of the company in the absence of preexisting key employee incentive plans.

STEP THREE: KEEPING EMPLOYEES ON BOARD

With his objectives set and valuation in hand, Steve 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 Steve's departure. Why? Once Steve left, VECI's continued success depended upon a core group of key employees who had the experience to operate, manage and grow the

company. Continued success was vital. Without it, the company would not be able to generate sufficient income to pay Steve for his stock via the ESOP or to repay any bank loan used to finance the purchase of Steve's stock. Also, as we've seen, Steve's appraiser confirmed that the value of VEI could not be supported unless Steve provided for the continuity of management after the sale to the ESOP and Steve's departure. Without the core group active and motivated, the company's value would have to be adjusted downward.

It is important for owners to understand that key employees, for the most part, are unwilling to work and act like owners unless they are owners to a "significant" degree. Every company and every group of key employees define *significant* slightly differently but generally all key employees want to have more ownership than they are eligible to receive as participants in the ESOP. They will insist upon additional stock or equivalent incentives.

Meeting this demand is problematic because their ownership and the price they pay for it must be similar to the ownership and price of stock sold to the ESOP. If not, the ESOP participants can rightfully object to the favorable deal the key employees receive.

Key employee incentives then, must be part of the initial design of the owner's exit plan. These key employee incentive plans can either be stock-based or cash-based — the promise of an additional bonus if the company performs pursuant to an agreed upon standard. In Steve's case the employees

were most interested in actual stock ownership.

Consequently, the company devised a stock option plan in which each of the three key employees would be able to receive 10 percent of the outstanding stock of the company as well as cash bonuses to pay for the exercise of the stock option plan. The key employees' right to exercise their stock options is delayed until Steve's stock had been purchased and paid for by the ESOP.

STEP FOUR: THE DESIGN AND IMPLEMENTATION OF THE ESOP PURCHASE

First, VEI's attorneys reviewed an ESOP prepared by an experienced third party administration firm that specialized in ESOPs. It provided that all employees who worked 1000 hours or more became participants after one year of service. The plan further required that each participant work five years before becoming fully vested in a share of the plan assets. The co-trustees of the ESOP would be one of the key employees and a local bank familiar with the administration and fiduciary responsibilities of ESOP trustees. Steve's advisors stressed the importance of protecting himself by using independent trustees. The ESOP was to be funded with cash for three years before Steve's expected departure date.

By creating the ESOP before the expected sale date, VEI could make annual contributions to the ESOP on a tax-deductible basis. This enabled the company to contribute almost \$750,000 to the ESOP in the three

years prior to the sale. This pre-funding, in turn, provided the ESOP with sufficient cash to pay almost 40 percent of the purchase price of Steve's stock. It was anticipated that a bank would lend the ESOP the balance of the purchase price.

Steve could have pursued a different strategy using the ESOP. He could have sold the stock using an installment note to the ESOP and initiated his exit immediately, although bank financing would, in all likelihood, be unavailable. Alternatively, he could have elected to sell less than all of his stock to the ESOP improving the possibility of bank financing.

For example, Steve might have been able to sell 30 to 40 percent of his stock and the ESOP may have been able to obtain bank financing for the purchase.

Steve opted for a complete exit after three years during which the ESOP was pre-funded with dollars which could otherwise have been bonused to him.

The responsibility to obtain bank financing ultimately rested with a committee appointed by the ESOP trustees. It was their responsibility to obtain and to analyze loan proposals before selecting the most appropriate lender for the ESOP.

Although Steve did not serve on the ESOP committee, he was — much to his chagrin — involved in the financing. As a condition of financing for the remaining purchase price, every bank insisted that Steve pledge his sale proceeds as security.

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 acquires appropriate replacement securities. These publicly-traded, liquid securities are generally blue chip bonds or stocks and are a lender's first choice for collateral. Through determined negotiation, Steve's advisors reduced the collateralization period and minimized the amount of securities Steve was required to pledge. In the end, Steve pledged 50 percent of the sale proceeds to be released as the loan was repaid.

CAUTION

Finally, a word of caution to owners who are considering using an ESOP as part of their exit strategies. The sale of an owner's stock to an ESOP involves more than simply making sure the owner's Exit Objectives are met. A sale of stock to an ESOP must be an arm's-length transaction between the selling owner and an independently directed and administered ESOP.

If an owner makes decisions for the ESOP regarding the purchase or financing of his stock, he exposes himself to allegations and lawsuits claiming a breach of fiduciary obligation or duty to the ESOP and its participants. No departing owner wants the specter of future litigation looming over him. Owners can avoid this exposure by realizing that when creating an ESOP, they have created a separate buyer; a buyer who will want to make (and must make) independent and informed decisions. This buyer will use its own set of advisors including an appraiser, a

financial advisor, a transaction attorney and perhaps a CPA — the same advisors owners use to make an informed decision to sell to an ESOP.

CONCLUSION

The decision to sell your stock using a Leveraged ESOP is neither easy nor inexpensive. Yet, it is no more difficult or expensive than selling your business to an outside third party.

If that third party cannot be located, or is

unacceptable to you, or if you wish to provide a benefit to your employees in the form of indirect ownership in your company, an ESOP can be a most attractive buyer. 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.



CAPITAL PLANNING ADVISORS

601 University Avenue Suite 175
Sacramento, CA 95825
P: 916-286-7650

100 Pringle Avenue, Suite 540
Walnut Creek, CA 94596
P: 925-524-2800

1410 Rocky Ridge Drive, Ste. 340
Roseville, CA 95661
P: 916-286-7650

Fax: (916) 290-0926
youradvisors@capitalplanningadvisors.com
www.capitalplanningadvisors.com

Capital Planning Advisors LLC is a Registered Investment Adviser. Advisory services are only offered to clients or prospective clients where Capital Planning Advisors LLC and its representatives are properly licensed or exempt from licensure. Past performance is no guarantee of future returns. Investing involves risk and possible loss of principal capital. No advice may be rendered by Capital Planning Advisors LLC unless a client service agreement is in place. Securities offered through Avisen Securities, Inc. Member FINRA/SIPC