

Employee Stock Ownership Plan

A Conversation with Irvin Brum and The Editor

Business owners, while weaving dreams of retirement, may not have an evident successor. Their children have moved to distant states or pursued other careers. For closely held companies the dilemma may be especially acute when only one of several principals wants to exit. There is only one realistic strategy which allows Owner A to retire, while Owners B and C stay in control, without selling the company outright—that is the Employee Stock Ownership Plan (ESOP).

Nested within the Employee Retirement Income Security Act of 1974 (ERISA), the ESOP is a vehicle for the business owner to cash out his share of the company in a staged and tax-advantaged manner, and for the wage earner to participate in the American Dream by acquiring an ownership stake, gain assets for a secure retirement, and promote continuity of the firm. Its creators in the US Congress wisely imbued the law and subsequent IRS code changes with rich and flexible tax incentives that served to powerfully motivate business owners to embrace the model.

Today more than 11,000 such plans exist in the US, covering approximately 13 million employees. Publix Supermarkets, with 150,000 employees, has one. Avis once had an ESOP and during that period ran the iconic TV commercial extolling its employee-owners' "We Try Harder" mentality. Davis & Warshow and Personal Touch are two metro-NY companies that recently became ESOPs.

The CORRIDOR explored the ESOP with Irvin Brum, who regularly counsels clients in the formation of ESOPs and other exit strategies.

ESOP benefits must be offered to all employees who work 1,000 or more hours, except for unionized employees. Brum characterizes it as a highly flexible tool available for successful companies whose owners are seeking liquidity and investment diversification without necessarily selling their entire ownership of the company. At the same time ESOPs also provide an extra layer of compensation, which serves to attract, retain and motivate top-flight employees.

For an interested client, Brum starts by sizing up the ESOP model's suitability, does some "back of the envelope calculations," and may recommend a feasibility study, before pursuing one of several pathways for the ESOP structure. In Brum's view, a viable candidate is a company with revenue of \$10 million or higher, or possibly a bit less if its profit margin is robust, a strong balance sheet with manageable debt, and reliable cash flow.

If there is a green-light, two sets of attorneys paid for by the company, with one representing the employees, set up the governing Trust. "The Trust becomes a friendly, cooperative partner as the new owner," Brum explains. "The process is not adversarial, yet it is a real negotiation." An appraiser determines the company's value. An outside trustee acts as fiduciary to protect employees' interests. In subsequent years an internal fiduciary, such as the CFO, may substitute.

When the fit is right, the ESOP strategy serves to protect companies from the pitfalls it would encounter if it were instead to shop for a strategic buyer or joint venture partner, Brum points out. Similarly, it avoids having to give up control to outside private equity investors.

The company makes annual contributions to the trust which then allocates benefits to employee accounts in proportion to compensation. Unlike the 401(k), it is a pure benefit, with no employee cost-sharing. Employees who leave the firm typically sell back their shares to the company or the ESOP.

Most ESOPs, Brum notes, are "leveraged" to maximize the tax advantages. If one owner is exiting, the company might take a standard bank loan and directly or indirectly lend the proceeds to the trust, which then pays the departing owner. Exiting owners can also provide financing in the form of notes that are subordinate to the bank but carry a higher interest rate. The company makes annual contributions to the trust sufficient to repay the loans. By cycling the loans through the trust, not only the interest on the loan, but also its principal becomes fully tax deductible to the company. "The leveraged ESOP is unique in that Uncle Sam ends up underwriting much of the company's payments to the trust which funds employees' retirements and buys out the owner," Brum explains.

Another tax advantage, available to C-corporations, allows business owners to defer and potentially avoid paying taxes on the sale of their stock to the ESOP. This benefit is so valuable that business owners often convert their S-corps to C-corporate status right before implementing an ESOP. After the loans used to fund the buyout of the owner's shares are paid back, these companies will usually revert to their S-corporate status. As S-corporations, the portion of the company that is owned by the ESOP will be income tax-free. If the entire company is owned by the ESOP, no income taxes will be paid, giving the company a huge competitive advantage.

One more instance where the ESOP works its magic is when a company is pursuing a strategic acquisition. As the acquirer, the ESOP firm can confer all its tax advantages on its target, which sweetens the deal for both sides by allowing the acquirer to outbid other suitors on an after tax basis while actually paying less to buy the target.

"While ESOPs are not suitable for every company, under the right circumstances ESOPs can prove to be a homerun. Any business owner contemplating a sale of his or her company should absolutely consider the ESOP as a liquidity alternative," Brum says.

Brum wishes to dispel certain myths: ESOPs do not give employees decision-making power over company policies, nor do employees get to view "the company books." Employees receive only an annual statement showing the number and fair market value of the shares in their account. Nonetheless, it is to the owners' benefit to form committees to educate employees about their ESOP. Then, beyond the minimum legal requirements, it is solely at the principals' discretion whether or not to share business information with employee-owners or to confer further voting rights.

With capital gains tax rates up, Brum foresees ESOPs becoming more popular. With baby-boomer retirements soon to crest, the flexible ESOP may be worth a closer look.

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