ESOPs: The Good, The Bad, and The Ugly

Submitted by Ronald J. Adams©, CPA, CVA, ABV, CBA, BCA, CFF, CGMA, 02/24/2017

In the previous article, *Business Transition Options* we discussed some of the basics of employee stock ownership plans (ESOP). ESOPs are qualified retirement plans that must invest primarily in the stock of the owner's company. They are creatures of federal law and thus are regulated by several federal agencies. Finally, ESOPs are the bailiwick of specialists. As Exit Planners, we are our owner-clients' most impartial source of guidance in determining whether a sale to an ESOP meets their goals.

Today, we turn to the advantages and disadvantages of business owners selling the stock of their companies to ESOPs.

Advantages

Financial Security

Owners may attain financial security through a partial or complete sale of their ownership interest. Further, they can stay in effective control until they are paid in full. If they wish, owners can enjoy effective control even after they have been fully paid.

Time

Whether it is important to an owner to exit quickly or slowly, a sale to an ESOP can be designed to accommodate an owner's desired exit time frame. Owners can leave their businesses gradually. Normally, they can remain as president or CEO even after selling all ownership to the ESOP Trust.

Tax Consequences

If a company is an S corporation, future business income at the corporate level is not taxed if an ESOP owns the company. This frees up the company's available capital to invest, acquire other companies, and/or increase cash flow.

If a company is a C corporation, payments to the owner (from the ESOP) for the owner's stock may be entirely tax-deferred.

Regardless of entity type, contributions from the company to the ESOP used to purchase the owner's stock are tax-deductible.

If an owner's desired successor is his or her employees and the owner wants the company to fund the employees' purchase, there are significant tax advantages to using an ESOP rather than a management buyout.

An Owner's Values-Based Goals

Benefit Employees. An ESOP provides all employees with a stake in the future growth of the business. They become the new owners of the company indirectly.

Benefit Key Employees. Included in nearly every ESOP design are incentive plans (usually stock appreciation right [SAR] plans) for key employees.

Culture and Legacy. Transferring a company to an ESOP that is then managed by its owner or long-tenured management team can ensure the continuation of the business' culture and legacy.

Community. ESOP ownership ensures that the business remains in a community of the owner's choosing.

Successor Choice

The successor in business operations is a company's existing management team. Owners know their capabilities well, and their successors in ownership are, indirectly at least, the very people who have helped the owner to build the company, its culture, and values.

Disadvantages

Financial Security

Debt. It may be necessary for owners to accept a promissory note for part of the purchase price. Also, owners may be required to personally guarantee the bank financing that is used to acquire their stock. Further, once an owner exits, management may not prove capable of continuing to produce the necessary cash flow to pay off its debt to the owner.

Price. When compared to a sale to a third-party strategic buyer, owners who sell to an ESOP may leave money on the table.

Cost. The costs to establish and operate an ESOP can be significant.

Time

Whether owners leave slowly (by selling gradually and remaining involved) or quickly (by cashing out and leaving), they can be exposed to risk, since the company's future cash flow will be used to repay any bank loan to the ESOP. Thus, if owners (a) are no longer involved in the business or do not control the future of the company and (b) have pledged sale proceeds as security for the bank loan or have not received all of the purchase price at closing, they risk losing the unpaid portion of their sale proceeds.

There may be a long-term risk to the viability of the business, even after owners are paid off in full, under the following conditions:

1. The stock sale was financed and there are loan repayments to make.
2. ESOPs are obligated to purchase stock from the ESOP accounts of departing employees.

Finally, the level of due diligence in a sale to an ESOP is similar to that of a sale to a third party. If a company has undisclosed liabilities, environmental liabilities, or an over-concentration of too few customers, the buyer (whether third party or ESOP)

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will lower its purchase offer and demand warranties and representations (between trustee and seller) to mitigate its risk.

Tax Consequences

In return for favorable tax treatment, the IRS and Department of Labor subject ESOPs to a high level of scrutiny and regulation. That's the price owners pay for the significant tax benefits the IRS provides to ESOPs.

An Owner's Values-Based Goals

There are no disadvantages related to an owner's values-based goals, assuming that management maintains the company's culture, location, legacy, and so on.

Successor

A capable and motivated management team that remains with the company after ownership is transferred to an ESOP is critical. If your client's management team will not operate well in an employee-ownership culture, an ESOP will likely not be a viable Exit Path.

Planning: The Great Mitigator

One of the many advantages of Exit Planning *well in advance of an owner's exit*, regardless of Exit Path, is that many of the disadvantages of that Path can be mitigated or overcome. This is true with sales to ESOPs. To assess how the advantages and disadvantages listed here make an ESOP an Exit Path you might recommend, it may be helpful to compare these to the advantages and disadvantages of other Exit Paths.

In our next article, we'll explore various ESOP design considerations. For more information on ESOPs please feel free to contact us directly at (774) 719-2236 or e-mail us at: **adams.r@foxboro-consulting.com**.

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