

ESOPs: The Swiss Army Knife of Liquidity Strategies

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The flexibility that is inherent in transactions with employee stock ownership plans (ESOPs) simultaneously presents tremendous benefits and challenges in structuring transactions. Evaluating all of the options allows the seller, the sponsor company, and the employees to determine which options work best for them.

INTRODUCTION

Employee stock ownership plans (ESOPs) offer business owners a flexible option for liquidity, business succession and incentivizing employees. ESOPs are so flexible that one of the greater challenges in evaluating this option for owners of privately held companies is working through all of the different options to ensure the sellers take advantage of all of the benefits available to them and their company. With all the tools it offers business owners, an ESOP is the Swiss Army Knife of liquidity strategies.

Business owners are initially attracted to ESOPs because they offer a tax advantaged strategy to sell all or a portion of their businesses while providing the benefit of ownership to company employees. Similarly, most consumers are attracted to a Swiss Army Knife for the knife—or perhaps the scissors.

However, as we unfold the multipurpose tools that are ESOPs, we find additional benefits that minimize personal tax and shareholder liability, enhance estate planning options, incentivize employees, and provide significant flexibility in the structuring of the transaction.

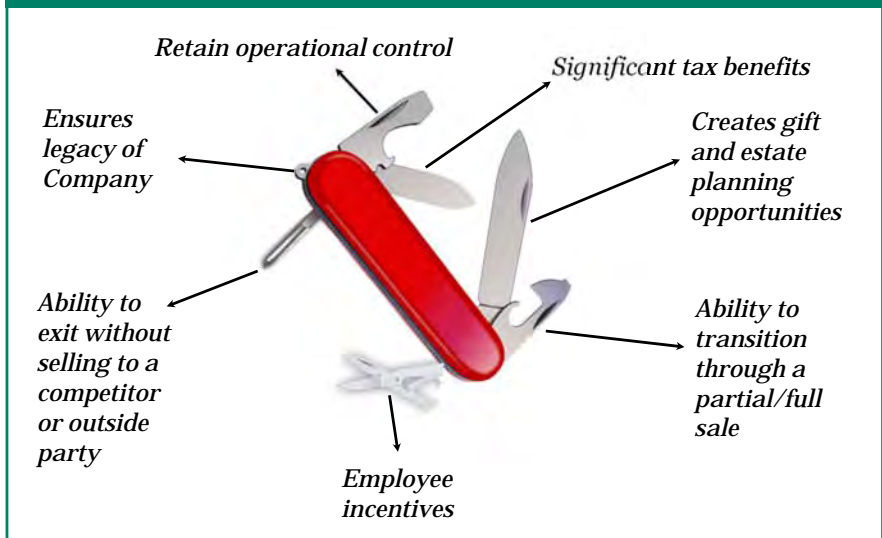
The primary reasons owners sell to ESOPs are as follows:

- Tax advantages
- Desire for liquidity
- Preserve company legacy
- Reward employees

BENEFITS IN THE SALE

Within the inherent conflict between buyer and seller, negotiations often result in some terms

Exhibit 1
The Swiss Army Knife of Liquidity Strategies



benefiting the buyer and some benefitting the seller. One of these terms that has ripple effects throughout the transaction is the buyer's desire to buy assets and the seller's desire to sell stock.

An ESOP trust is compelled to buy stock due to its basic structure, so the seller benefits without having to go through the standard give and take of a negotiation.

INCREASED NET PROCEEDS

Buyers prefer to buy assets for a number of reasons that primarily revolve around reducing risk and increasing return. As is often the case, when one party benefits, it is at the cost of another. As the buyer benefits through the ability to shield taxes and reduce liability, the seller bears that burden of risk and increased taxes.

When the buyer is compelled to purchase stock, as an ESOP trust is, the seller is in a naturally advantageous position. An asset sale can result in the seller paying a blend of ordinary income tax and capital gains taxes on the proceeds received in the sale. A stock sale, however, is taxed at capital gains rates.

The ESOP trust is also exempt from income tax liability, so it also has no interest in making a Section 338(h)(10) election which would have nearly the same tax impact to the seller as an asset sale. Financially, the seller takes home significantly more proceeds solely due to the stock sale.

Additionally, the ESOP trust provides the ability for the selling shareholders to defer all of their capital gains liability through Section 1042.

As shown in Exhibit 2, the result can be as much as 42 percent more net proceeds to the seller just by selling to an ESOP trust.

FLEXIBLE DEAL STRUCTURE

Flexibility is a key benefit in any liquidity strategy and a sale to an ESOP trust is the most flexible of all.

Many buyers require that they purchase a controlling interest in a company while an ESOP is open to purchasing interests ranging from a minority stake to 100 percent of the stock.

The ESOP is also flexible regarding the financing structure that is best for the company as long as it falls within market rates. As soon as you think the ESOP structure doesn't have additional flexibility, you discover another tool at your disposal.

The burden that falls on an ESOP trustee and other advisers to the ESOP trust in a transaction is to ensure that the ESOP trust pays no more than fair market value for the block of stock purchased and that the general terms and conditions of the transaction are "fair."

Contrast this with a strategic or financial buyer whose primary goal in structuring a transaction is to negotiate the most advantageous price and terms for themselves. While the ESOP trust is zealously represented in a transaction, the burden of "fair" that drives the ESOP advisers does not translate into price, terms, and conditions that are unfair to the seller.

Much like the spoon in the Swiss Army Knife, these benefits of ESOP transactions are often overlooked in the initial ESOP overview.

Some other benefits in deal structure in ESOP transactions are as follows:

- Flexible financing options, within market rates
- Flexible deal structure
- Ability to sell shares without involving a competitor
- Operational control remains with current management
- Seller minimizes personal liability in sale
- Seller receives preferential, personal tax treatment

Exhibit 2
Comparative Analysis of Net Sale Proceeds

	Asset Sale	Stock Sale	Stock Sale with Section 1042 Election
Gross sale proceeds	\$100.0	\$100.0	\$100.0
Estimated income tax [a]	(30.0)	(23.9)	0
Net sale proceeds	\$70.0	\$76.1	\$100.0

Note:

[a] Income tax calculation is for illustration only. Income taxes due are estimated at 30 percent on asset sales and 23.9 percent for stock sales. The estimate does not include any basis calculation or state income tax.

ADDITIONAL BENEFITS POST-TRANSACTION

After the sale to the ESOP is closed, the seller and the company may realize additional benefits that the transaction has provided above and beyond the benefits available during the transaction. One of the effects of a leveraged ESOP is an immediate decline in the post-transaction stock value due to the impact of adding leverage to the company.

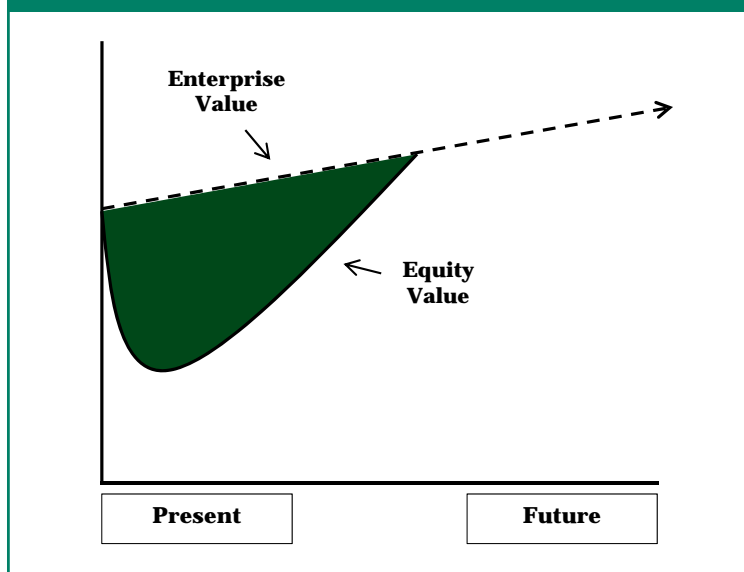
However, this temporary drop in stock price can facilitate gifting stock at this lower price, which may allow the shareholder to transfer more shares while staying within the gift tax limitations. This temporary drop in price may also be an advantageous time to look at selling stock to key managers or implementing a stock-based incentive plan to ensure employees are motivated to continue to drive stock price. An example of this is presented in Exhibit 3.

GIFTING

The sale to an ESOP trust presents an advantageous way to institute a gifting plan. A large number of closely held businesses are capitalized mostly by equity. These businesses carry very little long-term debt on their books.

Typically, the sale of company stock to an ESOP involves the company taking on additional leverage to finance the transaction. The additional debt depresses the equity value of the company, making it an excellent tool to gift shares to future generations.

Exhibit 3
Post-Closing Value Trajectory



Due to federal limitations on the amount of value that an individual can gift tax-free to future generations, business owners are often gifting minority stakes of their closely held business to their heirs on an annual basis. The value of the gift can be further depressed through the use of discounts, which are applied to minority positions.

Applying reasonable assumptions of the amount of debt a company would incur as part of an ESOP transaction as well as the discounts that should be applied to a minority stake, allow the shareholder to make gifts at a value that is substantially below the initial, pre-ESOP, market value of the stock. With gift exemptions at an all-time high, the depressed post-ESOP share value becomes even more powerful.

FLEXIBLE PLANNING

If there is a seller financed component to an ESOP transaction, there are numerous tools with which to plan estates, using cash, notes, stock and often warrants. This provides maximum flexibility in estate planning. If a gifting program is not a strategy of interest to a business owner, an ESOP transaction provides other benefits from an estate planning standpoint.

One of the requirements that the Department of Labor has for companies owned by an ESOP is that they undergo an annual appraisal to determine the market value of the company. The established equity price makes it less likely that the Internal Revenue Service will attempt to have its own independent appraiser assign a value to the shareholder's company, which can lead to unforeseen estate taxes.

Finally, the established ESOP trust also serves as a ready buyer for the stock of the shareholder. This prevents the situation where the surviving spouse or other heirs are forced to sell the business at a distressed price.

ESOPs provide numerous estate planning opportunities during various stages. While ESOP transactions are becoming a more widely known liquidity strategy for business owners, the ancillary benefits are significant and often overlooked.

EMPLOYEE IMPACT

Finally, the impact on employees may be the most overlooked reason for initiating a sale to an ESOP. There are numerous studies showing that employees are more productive and happier when working for ESOP-owned companies.

This employee impact often translates to more profitable and successful companies' post-transaction. While this may not have been the reason why the business owners sold to an ESOP, it can often be the biggest unexpected benefit.

The evidence shows that ESOP-owned companies have several characteristics that increase employee productivity and result in a more successful company. Studies have shown that ESOP-owned companies and their employee-owners benefit from the following:



- Enhanced revenue growth as compared to non ESOP-owned companies¹
- Increase corporate longevity by preserving a corporation's independence, thereby reducing layoffs²
- Tax benefits to both business owners and the businesses themselves
- Increasing employee productivity and job satisfaction³
- Better job stability and longer tenured employees⁴
- Higher contribution levels to employee's retirement plans⁵

THE BOTTLE OPENER

Sometimes secondary benefits become the most valuable. While most business owners initially evaluate an ESOP strategy for the tax benefits that affect the seller and the company, there are ancillary benefits that enhance the benefits to both the seller and the company.

Much like the bottle opener on a Swiss Army Knife, a seller may not enter into the ESOP transaction fully appreciating the extent of all of the benefits relating to an ESOP—but they are very happy to have them.

Notes:

1. Steven F. Freeman, "Effects of ESOP Adoption and Employee Ownership: Thirty Years of Research and Experience" (Organizational Dynamics Working Papers, University of Pennsylvania, 2007).
2. Rhokeun Park, Douglas Kruse, and James Sesil, "Does Employee Ownership Enhance Firm Survival?" *Employee Participation, Firm Performance and Survival, Advances in the Economic Analysis of Participatory and Labor-Managed Firms* 8 (2004).
3. Freeman.
4. Ibid. Also, Phillip Swagel and Robert Carroll, "Resilience and Retirement Security: Performance of S-ESOP Firms in the Recession" (Georgetown University, McDonough School of Business, March 10, 2010). Also, Alex Brill, "An Analysis of the Benefits of S ESOPs Provide the US Economy and Workforce" (Washington, DC: Matrix Global Advisors, July 26, 2012).
5. Brill.

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