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Creating Buyers: The ESOP as Exit Strategy

Interest in creating employee stock-ownership plans seems to be ticking up among business owners worried that capital-gains tax rates soon may rise. They may want to sell now while the rates stay at 15%.

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These are tough times for selling a privately owned business. Valuations are low as the economy struggles to emerge from its recession, and even where buyers and sellers can agree on price, it can be difficult to secure bank financing to complete a deal. That's pushing some business owners to create their own buyers — in the form of employee stock-ownership plans that also serve the purpose of providing employees with retirement benefits.

ESOPs are employee benefit plans subject to regulation under ERISA, the Employee Retirement Income Security Act of 1974. But they're also an efficient exit strategy for owners of privately held companies, whose ranks are expected to swell now that Baby Boomers are beginning to retire. In a typical ESOP deal, the company creating the ESOP borrows the money to fund the transaction and then pays it back over time. It contributes shares to the ESOP trust annually and allocates them to employees, usually in proportion to their compensation but sometimes incorporating a years-of-service criteria, too.

Denver Wholesale Florist Co. in Denver, Colorado, which recently created an ESOP, is a prototypical example. The company began as a marketing organization for carnation growers in Colorado 100 years ago and at one point had about 100 shareholders. As carnation growing migrated to South America in the 1960s and 1970s, the company transformed itself into a flower wholesaler. It now has 15 locations across the country.

"We don't have carnation growers in Colorado anymore, and by 2007 a lot of our owners were in their 70s and weren't actively involved in the company anymore," says David Lisowski, president of DWF. "At that point, a decision had to be made about how to provide [cash] for them."

The company entertained the idea of selling to a third party or liquidating, but soon settled on a sale to the employees as the preferred option. Among other things, securing financing wasn't a problem. Over its century of operation, the company had amassed plenty of real estate that was fully depreciated, and it was able to use that as collateral for a bank loan to finance the \$8.5 million transaction. The deal closed in August 2008.

Because DWF was structured as a C corporation, the deal also included some tax incentives for the selling shareholders. Under federal tax law, owners of C corporations who sell to an ESOP can defer capital-gains taxes on their profits if they roll the proceeds into marketable securities within 12 months of the transaction, provided the ESOP acquires at least 30% of the company's shares. "There is no tax liability until those replacement securities are sold," observes James Daniel, an attorney with law firm Womble Carlyle Sandridge & Rice in Charlotte, North Carolina. Hold those securities until death, he adds, and they will then pass to the former owner's heirs with a step up in basis, so that no tax is ever paid on the original capital gains.

Owners of companies that can't get financing to buy out the entire company have other options for completing a deal. They can sell a minority stake, for example, with plans to sell more at a later date, or they can hold a note from the company for a portion of the sale price.

The company itself can gain some tax advantages by switching to employee ownership. If it is structured as an S corporation, it will be exempt from paying corporate income taxes on any shares held by the ESOP. Many companies that create ESOPs while they are C corporations later convert to S status after the transaction is completed, which is the route DWF followed.

J. Michael Keeling, president of the ESOP Assn., an industry trade group, estimates that there about 10,000 ESOPs in the United States today. He says about 1,500 or so new ones are created each year, but that a like number are terminated, usually through a sale to a third party.

Now, though, interest in creating ESOPs seems to be ticking up, says Elyse Bluth, managing director and head of the

ESOP practice at Duff & Phelps, an independent financial-advisory and investment-banking firm in Chicago. That interest is gaining urgency, she adds, among business owners worried that tax rates on capital gains may go up in the year ahead; they want to sell now while the rates remain at 15%.

For CFOs overseeing the creation of an ESOP, critical issues to consider include the company's ability to shoulder the associated debt burden, assuming it borrows to do the deal, and the cost of buying back the shares of vested ESOP participants who leave the company or want to diversify their holdings. Under federal law, employees who are 55 and have at least 10 years in an ESOP must be given the option to diversify up to 25% of their account out of company stock, and 50% by age 60. Otherwise, they receive the vested portion of their account upon termination, either in a lump sum or via installment payments.

"Employee buyouts are a key issue in terms of cash flow and cash requirements," says Dave Lesse, CFO of DWF. "Anyone contemplating the establishment of an ESOP must weigh these costs, as well as the debt-servicing requirements, against future growth opportunities."

CFOs also will want to make sure the sale to the ESOP is fairly priced. The law requires that the company be valued by an independent, third-party expert. "If the Internal Revenue Service and the Department of Labor find out you sold it for too much," says Keeling, "you're in big trouble with them — and they do bring lawsuits. ESOPs are pretty well regulated. You can count on being audited by the [Department of Labor] and/or the [Internal Revenue Service] within five or six years of creating one."

Finally, CFOs should be prepared to communicate more regularly and in more detail to employees about the financial health of the company once the transaction goes through, since those employees now will be shareholders of the organization, too. "We've always been pretty open with information," notes DWF's Lisowski, "but now we're trying to do quarterly newsletters to update them on the highlights of what's going on with the company."

ESOPs aren't right for every company. They are more complicated to set up than a simple 401(k) plan, although that's partly because they're often created to satisfy two objectives: to provide retirement benefits for employees and to enable the sale of the company. There's also the issue — bright-lined by the implosion of Enron earlier this decade — of steering employees into holding company stock. That's not a diversified investment, and it has come under criticism in Congress and by financial advisers as being risky for plan participants.

There are mitigating factors, though. First, at many companies ESOPs exist alongside another retirement plan, not in place of it. Second, ESOPs are not obliged by law to hold only company stock; many hold other, more-liquid assets, too, especially those that must regularly buy out departing employees. Finally, Keeling notes, about half of all Americans have no retirement savings plan at all. "It may be good to be diversified," he says, "but being diversified into zero doesn't help at all."

The key to creating a sound ESOP that works well for selling shareholders, employees, and the company itself, Keeling and other experts agree, is to plan carefully for its creation and operation, relying on legal and accounting advisers with expertise in the field. To be sure, ESOP companies sometimes find themselves wrestling with the cost of paying back the loan that funded the plan's creation or with the cost of redeeming shares for departing employees; there are usually a variety of ways to surmount those hurdles.

"What I most often see defined as failure," he says, "is people not being happy with what has happened, so that there is no improvement either in the performance of the company or in the job satisfaction or the attitudes of the employees. And all of that is traceable to insufficient planning and expectations."

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