

## CHAPTER ONE

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# Historical Background of ESOPs

ESOPs can become the industrial equivalent to the Homestead Act, which was instrumental in giving this nation an identity as homeowners. Industrial wealth has been concentrated in the hands of a small percentage of the population. As this is being written, it is estimated that nearly 10 million employees of American corporations are covered under ESOPs and are experiencing the pride of owning equity in the company to which they are devoting their working careers.

The modern ESOP parallels the theory first put forth by a prominent German economist, Johann Henrich Von Thunen, during the early days of the industrial revolution. Von Thunen put an ESOP of sorts into being when he set aside a share of his farm's profits for his employees. He invested the profits in machinery that would enhance earnings. A portion of the profits was then put in each worker's name. Earnings that were invested in other than capital equipment spun off interest, which was allocated and distributed to the employees as a second income. The principal itself expanded and was distributed to the employee at retirement.

Von Thunen's concept was the antithesis of that set forth by his contemporary, Karl Marx, who felt that all capital should be owned by the government. Von Thunen wanted to spread the wealth among the people rather than let a handful of politicians control the productive capital. This would merely serve to substitute the politicians for the few nonpoliticians who at that time owned the vast portion of the capital.

In 1920, contributions to defined-benefit pension plans were given favored tax treatment by Congress. Legislation was passed in 1921 marking the birth of profit-sharing and stock bonus plans. The Tax Revision Act of 1942 served as the catalyst to induce industry to install these various tax-sheltered retirement plans.

Revenue Ruling 46, enacted in 1953, permitted any qualified retirement plan to borrow money for the purpose of purchasing stock. One year later, the nation's first leveraged ESOP was instituted. This was the well-known Peninsula Newspaper, Inc. ESOP. The company's owner wished to retire and transfer ownership to the employees. This was accomplished by means of a bank loan to the ESOP, in which all employees participated. The experiment was eminently successful, and today the paper is thriving and owned by its employees.

In 1973, the Regional Rail Reorganization Act became law, introducing legislation permitting ESOPs as a vehicle to enable corporations to finance their capital requirements.

The Employee Retirement Income Security Act of 1974 (ERISA) detailed the workings of the ESOP concept and added a certain precision to its implementation—coupled with some confusion.

The Trade Act of 1974 then added incentives for communities feeling the impact of trade competition from abroad. It structured a \$500 million fund to be loaned in such situations, granting special favor to those companies having ESOPs.

The Tax Reduction Act of 1975 added impetus to the ESOP movement. In addition to increasing the investment tax credit (ITC) from 7 percent to 10 percent, it increased the ITC to 11 percent if the extra 1 percent was contributed to a tax credit ESOP or Tax Reduction Act ESOP (TRASOP).

The Tax Reform Act of 1976 extended TRASOP through 1980 and allowed corporations to claim an additional ITC of one-half percent if employees contributed that amount to the TRASOP. The conference report contained within this Act, along with Section 803(B) of the Act, stated that ESOPs are not to be treated as conventional retirement plans. They are to be treated as instruments of corporate finance.

The final Regulations, promulgated on September 2, 1977, recognized the function of the ESOP as a financing device that can benefit employees as well as the corporation and its stockholders. The Regulations reiterated congressional intent that the ESOP be treated as a valuable financial vehicle to create capital and to disseminate equity among the employees.

The Revenue Act of 1978, enacted on November 9, 1978, extended the TRASOP. The Regional Rail Reorganization Act Amendments of 1978 mandated that 15 percent of Conrail be owned by an ESOP. Funds were infused for this purpose. The U.S. Railway Association Authorization of 1979 created a mega-million-dollar loan account for the Delaware and Hudson Railroad, provided an ESOP was created for the railroad.

The Rock Island Transition and Employee Assistance Act authorized funds for the acquisition, lease, or rehabilitation of the Rock Island Railroad or the Milwaukee Railroad in conjunction with an ESOP.

The Final and Temporary IRS Regulations on Requirements for Electing 11 Percent Investment Tax Credit TRASOPs were issued on January 19, 1979. These regulations, along with the Technical Corrections Act of 1979, further clarified and liberalized the tax-credit ESOP.

The Chrysler Corporation Loan Guarantee Act became effective in 1980 guaranteeing the loan, provided that Chrysler contribute \$162.5 million (about 15 percent of the loan) of newly issued stock to an ESOP over a four-year period. This provision placed nearly a quarter of the corporate ownership in the employees' hands.

At the end of 1980, the Miscellaneous Revenue Act of 1980 became law. One of the more important aspects of the law was the extension of stock bonus plans (essentially nonleveraged ESOPs) of the right to make cash distributions to participants, subject to the participant's right to demand stock. This legislation, the first of the 1980s, led to new bills by congressional proponents of ESOPs. It became apparent that the Reagan administration was off and running in the direction of ESOPs as a means of capital formation for private enterprise.

In that same year, the Small Business Development Act was passed. Companies, 51 percent of whose stock was owned by at least 51 percent of the employees, would be granted preferential loan guarantee treatment.

The Economic Recovery Tax Act of 1981 was positive for ESOPs. It provided for a payroll-based tax-credit ESOP called the Payroll ESOP (PAYSOP) to replace the capital-related investment tax-credit TRASOP effective after 1982.

The 1981 Act also increased the allowable deductible contribution from 15 percent of covered payroll to 25 percent if used to repay principal of ESOP loans after 1981. Contributions for servicing interest could be made without limit. Greater employer flexibility was assured by the addition of what amounts to a call on a participant's stock under certain circumstances.

The Deficit Reduction Act of 1984 was a bonanza for ESOPs. It provided for a tax-free rollover, which lets stockholders sell stock to an ESOP without incurring capital gains tax so long as the proceeds of the sale are reinvested in domestic stocks or bonds within one year and the ESOP owns 30 percent or more of the company. The Act made dividends payable to ESOPs tax deductible if used to repay debt for the acquisition of stock of the sponsoring company or if passed through to the plan participants. It also excluded from tax 50 percent of the interest income received by banks or insurance companies for ESOP loans (Code Section 133).

While legislation has become more stringent for other forms of qualified plans, it has been increasingly benign for ESOPs.

The Tax Reform Act of 1986 added even more new incentives for corporations to establish ESOPs. Although it terminated PAYSOPs, it created new benefits. For example, the act made dividends deductible if used to service debt for the purpose of acquiring stock for the ESOP. It provided for a limited estate tax deduction on the sale of closely held stock to an ESOP with a phaseout provision effective after December 31, 1990. Numerous other beneficial provisions that are covered in this book were also part of the 1986 Act.

The Revenue Reconciliation Act of 1989 (RRA'89) modified the requirements of a tax-deferred sale of securities to an ESOP. The act also imposed new more stringent rules on the 50 percent interest exclusion on loans made by certain institutions

to an ESOP. RRA'89 also repealed the provision that had permitted limited exclusion from estate tax of stock sold or transferred to an ESOP.

The Small Business Job Protection Act of 1996 (SBJPA'96) repealed Code Section 133, the 50 percent interest rate exclusion for lenders effective on loans made after August 20, 1996. Because of the restrictions, Section 133 loans were seldom used for private corporations but were used primarily in conjunction with large public company ESOPs.

The Taxpayer Relief Act of 1997 (TRA'97) made it possible and practical for Subchapter S corporations to have ESOPs. The rules governing S corporations are quite different from those of C corporations and will be discussed in Chapter 12 of this book.

The Economic Growth and Tax Relief Reconciliation Act of 2001 broadly improved ESOPs and other defined contribution plans.

The tax reduction that took place in 2001 made major changes in the amounts that could be contributed to ESOPs alone or in combination with other tax qualified plans.

## CHAPTER TWO

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# The Magic of ESOPs

### 2.1 WHY ESOPS ARE AN INSTRUMENT OF SUCCESSION PLANNING

What if there were a way that would let the owner of a private company:

- Sell stock of the company, pay no tax on the proceeds, and still keep control?
- Increase the company's working capital and cash flow with no cash expenditure and no additional productive effort?
- Buy out minority or majority stockholders with pretax dollars?
- Cut the cost of borrowing loan principal nearly in half by deducting principal payments as well as interest?
- Recover taxes paid in prior years with no cash expenditure?
- Possibly transform the assets of the corporation's profit sharing plan into working capital?
- Make acquisitions with pretax dollars and tax free to the seller?
- Make life insurance premiums tax deductible?
- Provide the employees with equity at no cash outlay on their part or the owner's part?
- Deduct the payment of dividends from taxes?

- Increase productivity, profitability, and company value with no cash outlay?
- Improve employee benefits dramatically with no cash outlay?
- And what if employees or executives with little or no cash could buy a division, a subsidiary, or a corporation with other people's money (OPM), with the government paying nearly half the cost of the loan principal and the business paying the rest?
- Allow the corporation to operate in a totally tax-free environment.

Too good to be true? An ESOP makes it all happen and does so with the sanction and encouragement of the United States Congress. ESOPs and employee stock ownership trusts (ESOTs), which are interchangeable, are tax-qualified plans and trusts, respectively, which are created by corporations for the benefit of their employees. Because of the unique nature of these plans, they benefit both the corporation and stockholders. This is why they are so ideally suited as the ultimate instrument of succession planning.

Unlike typical pension and profit-sharing plans, an ESOP is mandated to invest its assets primarily in stock of the employer. It is a seeker of stock and can obtain it from the corporation in the form of newly issued stock or treasury stock contributions. The company gets a tax deduction based on the value of the stock or cash it contributes. Another source of stock is from stockholders who are willing to sell some or all of their holdings.

## **2.2 HOW AN ESOP CAN CREATE A MARKET FOR A STOCKHOLDER'S STOCK**

In lieu of contributing stock to the ESOP, a corporation can make deductible contributions of cash. The cash can be used to acquire stock of shareholders who wish to divest themselves of some or all of their stockholdings. It is difficult for holders of private company stock to sell their stock. A sale of part of one's stock to the corporation is treated like a dividend for tax purposes. A sale to others generally means giving up control. Finding a buyer for minority shares of a private non-dividend-paying company is like searching for the Holy Grail. A majority owner or a minority stockholder can sell stock to an ESOP and defer taxes or possibly eliminate them.

This is a great way for an owner to transform paper into cash and diversify his or her estate while at the same time pass the company down to heirs or a second-line management team. By so doing, the owner can enjoy the spendability of his or her equity, assure perpetuation of the company, cash out minority stockholders, and still control the assets that are not in the ESOP. As we will see, this will enable the owner to continue to effectively control the corporation.

## **2.3 HOW A CORPORATION CAN CUT THE COST OF BORROWING NEARLY IN HALF**

Neither pensions nor profit-sharing plans can borrow, but ESOPs are permitted to do so if the proceeds of the loan are used to purchase employer stock. Tax-deductible corporate cash contributions to the ESOP are employed by the plan trustee to buy stock from the corporation or from stockholders. The deductibility of the amount needed to service principal payments in addition to interest reduces the cost for repaying the loan by the taxes saved. This should accelerate the debt amortization and save ongoing interest payments as well. One dollar of cash flow can, therefore, go nearly twice as far in retiring debt principal.

## **2.4 ESOPs—WHAT THEY REALLY ARE**

An ESOP is a defined-contribution plan that is a stock bonus plan or a combination of a stock bonus plan and money-purchase pension plan designed to invest primarily in qualifying employer securities. ESOPs must meet the requirements of Code Section 4975(e)(7). ESOPs were enacted into law by the Employee Retirement Income Security Act of 1975 (ERISA). All qualified employee retirement plans are governed by this federal law.

In a company whose stock is not readily traded, qualifying employer securities denotes common stock of the employer corporation that has voting power and dividend rights equal to or greater than that of any stock in the company that has the greatest voting power and dividend rates. Noncallable preferred stock, whether voting or nonvoting, that may be converted to such common stock is also a form of qualifying employer security so long as the conversion price is a reasonable one. ESOPs of public companies may, of course, invest in the tradeable securities of that company.

With a defined-contribution plan, the company can vary its tax-deductible contribution and make no commitment to the employee as to a precise retirement benefit. This is in contrast to a money-purchase plan in which the plan's formula determines the contribution. A defined-benefit pension plan promises a specific benefit and adjusts contributions in an amount needed to achieve the benefit promised.

Stock bonus plans, profit-sharing plans, thrift plans, and money-purchase plans fall into the general category of defined-contribution plans. An ESOP must invest primarily in qualifying employer securities, which it can obtain from the corporation or from stockholders who are willing to sell their stock. The corporation can make tax-deductible contributions of authorized but unissued stock, treasury stock, or cash to the ESOP.

## 2.5 ESOP—THE IDEAL FINANCIAL MACHINE

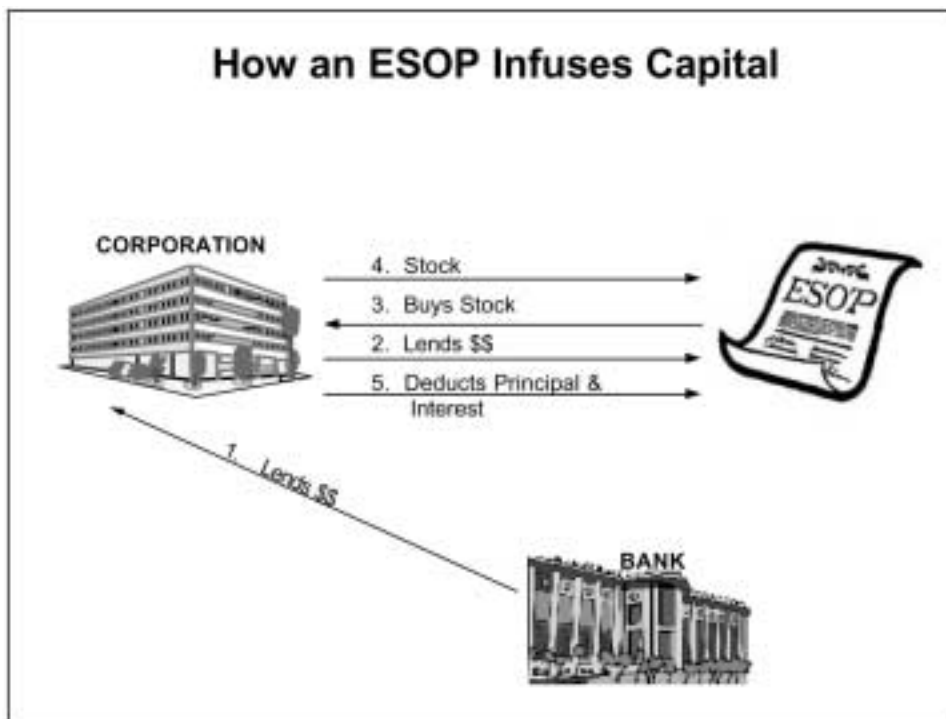
One of the most unusual attributes of ESOPs is their ability to create a corporate environment that is at one time beneficial to the sponsoring corporation, the stockholders, the employees, and the economy.

### (a) For the Corporation

ESOP benefits to the sponsoring corporation include these profitable benefits:

- Increased capital (see Exhibit 2.1)
- Increased productivity
- Increased net profit
- Improved market share
- Increased stock value
- Improved public relations

Exhibit 2.1



- Increased expansion
- Faster debt reduction because of ability to deduct contributions and dividends for repaying principal
- Improved employee morale
- Greater employee involvement toward the common goal
- A vehicle for succession planning
- An ideal recruiting tool
- Reduced turnover
- Reduced unemployment insurance premiums
- A vehicle for the orderly transition of management and employees
- An alternate to selling the company to outsiders
- An efficient, low-cost employee benefit program that can replace other costly plans
- A means to reward loyalty with equity without creating additional stockholders

### **(b) For the Stockholders**

ESOP benefits to the stockholders include:

- Increased share value
- Tax-deferred or tax-free exit from a private corporation
- Others share the responsibility and stress load
- A vehicle for succession planning
- A means to step down gradually per the owner's own timetable
- What is good for the corporation is good for the stockholders
- Continued voting control in a private corporation
- Facilitates charitable gifts

### **(c) For the Employees**

ESOP benefits to the employees include:

- Lower likelihood the company will be sold to outsiders
- Greater financial security for retirement

- Greater involvement and pride in their vocation through a sense of ownership
- Greater ability to affect their own wealth
- Ability to feel like owners
- Potential for current FICA-free dividends
- Fairness determined by independent valuation or, for public companies, the market pricing

### **(d) For the Economy**

ESOP benefits to the economy include:

- Greater corporate profits mean more taxes
- Greater corporate growth creates more employment of those who will become taxpayers
- Reduced turnover reduces unemployment insurance compensation and welfare payments
- At retirement, less reliance on the Social Security and welfare systems
- No need for an expensive government agency to dole out retirement payments
- Retirees will spend their retirement income, thereby funding the economic chain, each segment of which will pay local, state, and federal taxes

## **2.6 ADVANTAGES—GENERALLY**

Can one imagine a more perfect financial machine for a company? No machine is perfect, but the ESOP provides the means for company owners to determine the extent to which the vehicle will be used to achieve their corporate and personal objectives.

The ESOP makes it much easier to achieve corporate growth and increased profitability while repaying loyalty to the employees and an incentive for them to create greater wealth for themselves and for the stockholders.

## **2.7 CONGRESSIONAL BACKING**

Congressional leaders have recognized the benefits ESOPs can bring to the economy by increasing the tax base. They have passed many pieces of legislation over

the years to make ESOPs even more advantageous to the parties to the transaction, namely, the corporation, the stockholders, the employees, and the U.S. government.

## **2.8 ESOP—A MISUNDERSTOOD PROGRAM**

The use of ESOPs should be expanded even further by the government because of the obvious stimulus to the economy. Moreover, if a profitable, growing corporation has an adequate payroll and does not have an ESOP, there is a strong likelihood that the owners do not have an adequate understanding of the advantages of ESOPs and may even harbor some misperceptions about them.

ESOPs are truly a win–win instrument of corporate finance. It is important that more information be disseminated about the true nature of ESOPs.

## **2.9 COST TO IMPLEMENT AND ADMINISTER ESOPS**

The cost of implementation should generally be substantially less than the first year's tax savings. The primary costs are out of the way after the first year. The ongoing administration, although more complex to administer, costs about the same as other qualified plans. ESOPs should be implemented and administered by ESOP specialists who do this as a primary activity. ESOPs are not for all companies. With a few exceptions, they should not be implemented in companies that are not generally making a profit or that do not have the immediate realistic potential of doing so.

Although ESOPs have been used successfully to divest unprofitable divisions from public companies, such as in the well-known case of Weirton Steel, it is generally inadvisable to consider the ESOP a viable solution in companies that are not profitable. The author will take the liberty of quoting himself by saying: “An ESOP will not make a bad company good but will make a good company better.”



## CHAPTER THREE

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# The Environment for ESOPs

More than 20 legislative acts have led to the present lofty status of ESOPs. The Tax Reform Act of 1986 created additional momentum that has further entrenched the ESOP as an instrument of corporate finance. The environment in Washington was one wherein the legislator's primary goal was to tackle the huge deficit and curtail tax shelters. Yet, on balance, the ESOP benefits were liberalized for corporations and the employees. The 1986 Act made ESOP financing more practical than ever before. It came on the heels of the Deficit Reduction Act of 1984, which was a hard act to follow.

ESOPs have become a movement unlike any this country has seen for many decades. A steamroller effect has become evident among an ever-increasing number of our legislators who hope to broaden the ownership of capital among the millions of employees who help create it.

The 1984 legislation, spearheaded by Senator Russell E. Long, was cosponsored by 47 other senators. A similar bill encouraging ESOPs had been cosponsored by 24 members of the House of Representatives. Interestingly enough, the sponsorship was bipartisan.

The 1984 and 1986 Acts are so broad in scope as to widen and resurface the path laid down by the Employee Retirement Income Security Act (ERISA) in 1974. ERISA stated congressional intent—to broaden the base of capitalism—when it formalized the interchangeable acronyms, ESOP and ESOT.

### 3.1 THE ESOP CONCEPT

The ESOP is quite simple in its concept. It merely involves a tax-qualified plan under which an employer may make tax-deductible contributions of cash or employer

stock to a trust. The trust assets are allocated among the employee participants, who will receive distributions of cash or stock upon their termination, death, or retirement. Hopefully, the trust assets will have risen in value prior to that time. Distributions of stock for which there is no public market are generally readily redeemable into cash.

Unlike other tax-qualified plans, the ESOP can borrow cash from any source, including the corporation or stockholders, in order to *buy* stock from the corporation or from stockholders for the benefit of the employee participants. Because the ESOP is a tax-qualified trust, cash contributed to it by the corporation to service the loan is tax deductible. Both principal and interest can be paid with deductible dollars, thereby permitting the loan to be discharged at a large discount.

Alternatively, the corporation can make tax deductible contributions of stock to an ESOP, thereby saving taxes with no disbursement of cash. Tax savings increase the size, value, and earning capacity of the company. The effect is to create new capital that employees can own without reducing the wealth of the business owners.

### 3.2 SLOW EARLY DAYS OF ESOPs

ESOPs got off to a slow start because relatively few employers were willing to put their companies on the line with a program that seemed too good to be true. A no-action, wait-and-see approach seemed appropriate.

For other entrepreneur-founders of private companies, putting stock in the hands of employees did not come naturally. From the employees' standpoints, cash in hand was better than idle paper that paid no dividends. From the IRS's viewpoint during that early period, there was suspicion that tax savings without a cash expenditure spelled S-C-A-M. The Department of Labor, very protective of its employee flock, also cast a wary eye on a plan whereby employees might possibly become the beneficiaries of overvalued employer securities in exchange for their expended labor.

In retrospect, all of these parties could have afforded to be much more optimistic. Indeed, the history of ESOPs in use has demonstrated that an overwhelming percentage of ESOPs have been highly successful in benefiting employee, employer, and the U.S. Treasury. In only an insignificant number of instances has there been a willful misuse of the ESOP concept to the detriment of employees. ESOPs have worked out so well for such a large variety of corporations and their employees that the government has enacted a stream of favorable legislation to encourage more widespread adoption of ESOPs.

Credibility is no longer a factor among companies who are considering the possibility of adopting an ESOP. It is estimated that ESOPs have saved hundreds of thousands of jobs since ERISA and have created thousands of new jobs because of the capital they have brought to ESOP companies.

By broadening capital ownership, ESOPs give more than mere lip service to the term *capitalism*. ESOPs can become the greatest boon to capitalism since the country adopted the philosophy as its mode of economic development.

### 3.3 REAL SOCIAL SECURITY THROUGH ESOPs

The Social Security solution for creating retirement security has always been easy, if unimaginative: Simply fund Social Security currently, and have employers and employees ante up more cash as needed. This is all well and good, but as businesses contribute ever-increasing amounts of their earnings into the Social Security fund, it reduces working capital and cash flow. This inhibits the company's ability to expand and create more jobs. Productivity is curtailed.

To the extent that employees own capital through stock ownership, they will become less dependent on Social Security. A reduction of the number of those on the Social Security rolls would decrease the amount of capital needed to fund the program. Corporate earnings that employers save by not contributing to the public system would be put to better use in their own companies. This would increase the value of the stock owned by the ESOP participants. Employees would have more disposable income to invest for their future security if their Social Security taxes were reduced or eliminated.

ESOPs have proven to be the most cost-efficient means of placing capital into the hands of employees. This is due to the fact that the capital they receive does not come from existing stockholders, but is derived from capital that would not have existed were it not for the ESOP. Millions of ESOP company employees are now capitalists who would not have been so characterized just a few years earlier. Many additional millions of employees will join their ranks as ESOPs proliferate.

### 3.4 ESOPs AND MOTIVATION

Numerous studies have shown that improved productivity is a by-product of stock ownership among employees. According to a study by the Survey Research Center at the University of Michigan, companies, the majority of whose stock is substantially owned by their employees, are one-and-one-half times more profitable than comparable companies that are owned conventionally. A National Employee Ownership Council study completed in 1986 demonstrated a correlation between the amount of equity owned by an employee in his or her employer firm and productivity improvement. The study found that ESOP companies outperformed their competitors to a greater extent in the post-ESOP period than they did in the pre-ESOP period. The more participative companies showed the greatest gain where stock ownership was also involved.

It has also been determined that the greater the amount of equity the employees owned, the greater the corporate profitability. MBA candidates at the UCLA Graduate School of Management have also correlated improved employee motivation with stock ownership by the employees.

A report by Michael Conte of the University of Baltimore and Joseph Blasi and Douglas Kruse of Rutgers determined that public corporations, 10 percent or more

of whose stock is owned by employees, outperformed the various stock indexes. Other studies were quite consistent with these studies.

Equity ownership should be differentiated from management. Employees are more interested in equity accumulation in their ESOP account balances than they are in having a minority vote in the stock of the company. The greater their equity, the greater their motivation to achieve higher levels of productivity.

### **3.5 THE USE OF ESOPs TO SAVE JOBS**

ESOPs have been used with increasing frequency to fund leveraged buyouts (LBOs) of companies by their employees. This occurs typically when the founder wishes to retire and becomes interested in looking for outside buyers. A number of leveraged ESOPs occur as a result of a corporation's decision to relocate to a better labor or economic environment. Employees in such situations would face mass localized unemployment. Management buyouts of corporate subsidiaries with the help of ESOPs have also become fairly commonplace.

State and local governmental agencies often encourage and help finance employee takeovers because of the potential harm a corporate relocation could create. Unions have joined the ESOP movement in order to maintain jobs among their membership. They have, upon occasion, encouraged employees to invest earnings into the business rather than into higher wages in order to assure the long-range well-being of their members.

In a number of employee buyouts, unions have gone along with wage reductions to help finance the corporate acquisition. The unions and the employees have an incentive to make the company succeed, since they will be getting a slice of the equity pie. Employees of ESOP companies will become capitalists in the truest sense.

ESOPs are being implemented overwhelmingly in healthy, growing corporations, companies with good management and a bright future. This is the most efficient means of putting stock into the hands of many employees. ESOPs require no contribution from the employee. Tax savings and increased productivity repay the company and its principal owners for contributing stock to the employee trust. ESOPs are proving their worth to corporations, major stockholders, employees, and the community at large. Their flexibility and value as instruments of corporate finance have given ESOPs a permanent status.

From the government's standpoint, tax revenue increases with corporate productivity. As ESOPs help companies become more profitable, the companies invest in capital equipment, expand, and hire more people. The corporations pay more taxes, as do their subcontractors and suppliers.

Employees must work in order to provide revenue for the government. Distributions of their account balances are taxed to the employees at termination of employment. These distributions provide a magnificent means of circulating cash throughout the economy with an eventual gain to the government.

## CHAPTER FOUR

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# Exit Alternatives for Owners of Private Corporations

### 4.1 THE PREAMBLE TO OWNERSHIP TRANSITION

Founders of corporations go through various stages of growth—if they are fortunate. At the earliest stage, survival is the order of the day. In many instances, survival is at the forefront of the founders' thought processes throughout a major part of their business careers.

As founders increase their businesses' volume, profitability, and fair market value, they continue to build until such time as their inner clocks suggest that they slow down, which usually tends to trigger introspection and recurring thoughts of ways by which they can translate their achievements into a spendable form and smell the roses.

A large percentage of founders in their late 50s, 60s, and 70s have never prepared for retirement, either mentally or financially. Some at those ages who are prepared to retire financially have not prepared themselves psychologically to walk away from the business and into the realm of retirement.

What can they do in retirement that even comes close to the mental challenge and the variety of categories of events the chief executive officer (CEO) experiences that keeps the blood racing through his or her arteries? Most company owners who retire are less experienced at that new area of endeavor and ill-prepared for its challenges than they were when they dared to found their businesses.

Is one who is in his late 70s and in good health unable to cope with the hurly-burly of the daily business routine? Don't bet on it. When I was in my early 30s, I played a good game of four-wall handball. A frequent opponent of mine was an octogenarian who whipped the daylights out of me, using masterful strategy and conserving his energy by staying in one small area of the court while I was all over the place.

Like good wine, founders become seasoned with age. They are able to take problems in stride without missing a beat. Like my handball opponent, they learn how to expend less energy while accomplishing more through their vast storehouse of experience.

Many such owners do not dare contemplate total retirement and even become petrified at the possibility that they may have to play golf several times a week or function within one or two other categories of activities of which they might soon tire—then what? The chronology syndrome nonetheless prevails, and the founder realizes that the clock is ticking and it is timely to start becoming more liquid. Perhaps he or she knows of no way to sell the company stock and still continue to control and manage it. There are alternatives that the owner of the company should consider.

## 4.2 SELLING THE COMPANY TO AN OUTSIDE BUYER

Within a short time after selling the company to an outside buyer, or perhaps overnight, the former owner is often virtually banished from the business that had occupied his or her waking hours for a whole working career. This can be traumatic. Some sales are made on a workout formula, making a significant portion of the sale price dependent upon future profits. This type of sale can be particularly stressful to the selling shareholder, who is no longer in charge of the company's destiny.

Owners who sell to outside buyers often experience pangs of remorse due to their having placed the security of their loyal employees in the hands of strangers who owe no allegiance to those long-time employees. Those who were the most loyal are likely to be among the first to be discharged, because they tend to be among the most highly compensated. The founder often takes this route because it is often the only one with which he or she is familiar.

For companies that survive until their founders are ready to become *more* liquid, the destiny of the company is, most commonly, a sale to outside buyers. This is usually a path of least resistance.

Founders who have groomed children or other managers as their successors are to be commended for reducing the need to sell the company to outsiders. If the heirs are able to structure and finance the buyout in a manner that satisfies the founder's needs, such a succession plan might succeed.

If the buyer provides the total amount of financing and purchases 100 percent of the outstanding stock without requiring a four- or five-year workout nor the seller's taking back paper, the transaction, though quite rare, can be quick and relatively painless.

The disadvantages of selling to an outsider buyer include:

- The founder gives up his or her “toy” in life, the company, as well as the challenges and the brain stimulation—“if you don't use it, you lose it”
- Probable dislocations among the most valued and loyal employees

- Tax on the gain
- Loss of future salary and “perks”
- The trauma of losing power suddenly and facing a more sedentary lifestyle
- Possibly depriving a capable child or a manager of the opportunity to run the company.

### 4.3 THE INITIAL PUBLIC OFFERING ALTERNATIVE

Entrepreneurs typically relish the knowledge that whatever mistakes they make in the business are their own—as are the rewards. Is it any wonder then that they might be reluctant to make shares of their companies available for ownership by others who are not even remotely knowledgeable about the hands-on operation of their corporations?

If the business goes public, that is precisely what occurs. The financial results and operations are scrutinized by market makers who issue public reports, which include a prognosis of what the future holds for this once intensively private company. The company “comes out of the closet,” financially speaking. In addition, the company must deal with “Big Brother,” the Securities and Exchange Commission (SEC), whose presence looms large over the company’s landscape. The SEC offers no accolades, only the potential for public criticism. Above and beyond that aspect are the costs of proper disclosure starting with the prospectus, the lawyers, the certified public accountants (CPAs), the investment bankers, and the most costly commodity of all, time away from profitable pursuits.

Entrepreneurs who go the route of an initial public offering (IPO) must be prepared to suffer the cost of diverting their attention, as well as that of other executives and staff members, from the companies’ operations. The pressure to perform for others, the unnamed faces who invested in the companies’ stock, can be excruciating and unceasing.

In the vast majority of IPOs, the number of new stockholders at the early stages is usually not great—unless we are talking about the Microsofts and Genetechs of the world, companies with unusual market appeal.

A *thin market* is one that has a small volume of stock sales in the public sector due to little demand, resulting from a dearth of interest in the company. A sale of a fairly sizable block of stock can depress the market, thereby reducing the per-share price at a time when the founder might want to diversify his or her holdings.

A sale by the founder is done through a secondary offering that requires a prospectus and becomes public information. The public, possibly skeptical about the fact that insiders want to sell, often beat the would-be seller to the punch by selling first, causing the price to decline.

As noted above, some IPOs are wildly successful. These are the ones that everyone knows about because of their tremendous visibility. Other IPOs might start out

with a good public trading response, only to become flaccid shortly thereafter—or the market might remain strong permanently.

If the market starts out as a thin one, it tends to remain so for a few years—or indefinitely. In this instance, frustrated founders sometimes take the company private by tendering an offer for the public's shares so as to resume control again and build the company for long-term objectives the way they had done before the IPO, which had demanded short-term objectives.

#### **4.4 THE MANAGEMENT BUYOUT ALTERNATIVE**

Logical buyers of a private corporation are the managers, using management buy-out (MBO) techniques whereby the MBO group of managers puts up some of their own equity capital, borrowing the balance of the amount needed to acquire the stock or assets of the company. The managers might attract equity capital from an investment group, who may or may not demand a control position.

The greater the equity, the smaller the debt that must be incurred. Without a source of outside equity, the company's future stream of earnings might be insufficient to service the debt, and banks might be resistant to providing the funds. Conversely, the greater the amount of debt that is available, the smaller the amount of equity that will be required. Equity is more expensive than debt.

Assuming that debt financing is available and the MBO succeeds, the burden of servicing principal with after-tax dollars through a leveraged buyout will retard growth, and it might take years for the company to regain its ability to resume its earlier growth trend.

In spite of this, MBOs can and often do succeed. It might take longer for the managers to reap the reward, because a corporation in the 41 percent tax bracket must earn \$1.7 million to repay \$1 million of principal, not considering interest payments.

#### **4.5 THE ESOP ALTERNATIVE**

The ESOP can be an alternative, or it can be used to facilitate a sale to an outside investor and can enhance an MBO's chance for success. By selling some of his or her stock to an ESOP, a founder can avoid the disadvantages that may be inherent in making an outright sale of the company to an outside investor.

The owner of the company can sell some of his or her stock to the firm's own ESOP, pay no capital gains tax, diversify personal assets—thereby receiving a supplementary income—and continue to effectively vote the stock sold to the ESOP.

After selling all of the stock that the founder needs for retirement, the balance of the shares can be transferred to one's offspring or other heir by means of a gift or

purchase by the successor at such time as the founder wishes to relinquish control. Meanwhile, the selling shareholder can retain effective control as long as he or she wishes.

The employees not only will avoid displacement but will receive tax-free equity in the company and greater retirement security than any other program is likely to provide.

The ESOP and sale to an outsider are not mutually exclusive. The founder can sell a large percentage of his or her stock to the ESOP, deferring or possibly avoiding the tax on the appreciation. The remaining stock can then be sold to the outside buyer, transferring effective control over the ESOP shares as well to the buyers.

The ESOP does not preclude going public as well. Many public companies do have ESOPs. The IRC Section 1042 transaction (the ability of the selling shareholder to defer or possibly avoid taxes) is not available to public companies, but the other tax-advantaged benefits are.

The ESOP for the right company can serve as an exit for the founding generation on a stand-alone basis or in conjunction with other methodologies.



## CHAPTER FIVE

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# Planning for Succession

Owners of private corporations do a great deal of planning as to the direction the business should take in order to capture market share. They put great thought into matters pertaining to personnel and into the purchase of equipment. They are loath to plan for business succession, however.

There are a number of possible reasons for owners being reluctant to plan:

- *Inertia*—Entrepreneurs, as a breed, are optimistic and often believe they will be able to work for many more years. There is therefore no sense of urgency in terms of thinking about eventually replacing oneself.
- *Confidentiality*—Owners of private companies often play things close to the belt and do not tend to share financial information about the company, something that would be necessary if one were to start grooming a successor.
- *Emotional blocks*—Making decisions relating to future involvement of family members in the business can involve dynamics that affect relationships among those other family members who are not to be involved in the company. It is no longer simply a business decision.
- *Fear of control erosion*—The entrepreneur does not want to create a situation that will undermine any element of control over his or her “baby,” the company, whether real or imagined.
- *Lack of activity alternatives*—Owners of private companies all too often have devoted their entire energies to building the company, leaving little time for

other interests. This can be a deterrent to replacing oneself in their primary area of interest.

- *Fixation on eventually selling the company*—Although the owner would prefer to have his or her child or a manager carry on the business, they have no cash which the owner will need in retirement and knows of no alternative.
- *Not good at training*—Entrepreneurs are often hands-on people and find it easier and more satisfying to make all decisions without taking time out to transfer this ability to possible successors.

Is there any wonder, then, why only one out of twenty family companies fail to reach the second generation?

Ownership transition should be anticipated five to ten years in advance. This requires foresight and the willingness to initiate a game plan. The owner should decide upon what his or her objectives are and work out a practical methodology and a timetable for achieving the objective.

Some of the more obvious approaches that will come to mind are:

1. Selling the company to an outside buyer.

Problems:

- (a) The seller must pay taxes on the gain.
- (b) The deal might be structured on a work-out arrangement and the seller might have to remain on a consulting basis for a few years to help gain the maximum value. The results will nonetheless be under the full control of the buyer.
- (c) The seller might have pangs of guilt for having abandoned some of the loyal managers whose future might be in jeopardy.

2. Selling the company internally.

Problems:

- (a) The managers seldom have adequate personal resources to buy the company.
- (b) If the owner bonuses the cash to the manager for the buyout, the owner is using his own money to buy himself out.
- (c) The owner will be taxed on the proceeds.
- (d) The manager will be subject to a phantom tax on the bonus.
- (e) If the company becomes leveraged, the owner will usually be a guarantor and must remain involved to assure the debt will be retired.

Is there any wonder many company owners simply throw up their hands and do nothing?

The ESOP can be designed to create an internal market for the stock with special tax advantages to both the sponsoring corporation and the selling shareholder.

It can be used in various ways so as to blend in with the owner's timetable and its very presence will keep succession planning on the owner's mind. The owner might wish to sell a small part of his nonliquid stock portfolio to the ESOP at first and may decide to go into the planning more aggressively in a few years.

At any rate, the ESOP can help the owner keep focused to the idea of succession planning by its very presence. The ESOP will make it much more likely that the balance of the stock—which controls the ESOP—can be transferred to the managers or to the owner's child who is being groomed to run the business.

The ESOP can remove the feeling of helplessness that many owners face when contemplating transition of ownership planning because the ESOP is such a practical tool that has unusual tax advantages and can be very flexible in the way it is used.



## CHAPTER SIX

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# ESOP versus Going Public versus Selling the Company

### 6.1 GOING PUBLIC

As noted in Chapter Four, a public offering is costly and the results are uncertain. It is in no way a panacea. An owner who wants to exchange stock for cash will consider the possibility of going public. In order for this to be a serious consideration, the company should have management strength, financial stability, good prospects for growth, and be in an economic environment that is conducive to a successful public offering.

If the objective is to get capital out of the corporation by creating a market for the stock, the entrepreneur may be disappointed. The offering price is determined at the due diligence meeting of the underwriters. The determining factor is the marketability of the issue. This, in turn, is related to the then current status of the stock market. The stock would quite possibly be offered through a regional exchange and there would be a thin market for the security. A sale of a significant portion of the owner's stock at the initial offering would be suspect. If the company is so good, why is the owner selling?

A thin market refers to the fact that the stock is held by relatively few stockholders and would not absorb large block sales of the securities. The price that the entrepreneur could hope to receive for his or her holdings might be well below the original offering price or even less than liquidation value.

Assuming the offering has been successful, it would still be impractical for the founder to plan on selling the bulk of his or her stock because of the rules prohibiting control persons from selling more than a fairly insignificant amount of stock at any point in time.

Underwriters do not come cheaply. They frequently demand a portion of the company in addition to their large fees. There are other significant expenses that

detract from the attractiveness of a public offering, such as the burdensome costs for meeting the requirements of the securities laws. These are first noted with the filing of the 10K. Nonproductive expenses of such items as public relations-oriented annual and quarterly reports for the stockholders as well as the ongoing filings required by regulatory agencies divert additional working capital and management energies from the task of building the company.

One of the most dramatic aspects of going public from the entrepreneur's standpoint is the move from the picket fence home to the goldfish bowl. The owner will be under public scrutiny and will no longer be able to run the company on a shoot-from-the-hip basis.

This is not to say that private companies should never go public. Some corporations are made to order for having their stock widely held. Sadly, the ones that make it to the extent intended are few and far between. A private company has greater control over its true value than a public company because the latter is subject to the whims and vagaries of the public marketplace. Having said this, the valuation of private companies partially reflects the value of the public corporations in related industries.

It is important to remember that none of the companies on the New York or American Stock Exchange started there. There was a long road between the regional or over-the-counter exchanges and the big board. Those companies had the staying power to reach that austere status that made it big for their original stockholders.

On analysis, going public would probably be relegated to a distant second position when compared with the alternatives of selling to an outside investor, a group of investors, or the company's employees through an ESOP-assisted leveraged buyout (LBO) or partial buyout. The existence of an ESOP will not serve as a deterrent to going public. More and more public companies are implementing ESOPs for many of the same reasons that motivate private companies to do so in addition to reasons unique to public corporations.

## **6.2 LEVERAGED ESOP LOAN VERSUS PUBLIC EQUITY FINANCING**

Private companies that require financing often consider going public as a means whereby the corporation can reach out to the public for equity financing. Where applicable, this can be a viable alternative to leveraged ESOP debt financing.

In the case of a public offering, the corporation would raise cash by selling a predetermined amount of stock on the open market, the value of which equals the cash requirement. It is always problematic as to whether a corporation will be able to realize the true worth of its stock in an initial public offering (IPO); if not, the offering would create equity dilution. Share and equity dilution to the shareholder's position is another possible cost factor created by a public offering. If the IPO succeeds in increasing the stock's value, the stockholder made the right choice.

A factor in the cost comparison with ESOP financing that is sometimes overlooked is the question as to whether the corporation has a qualified retirement plan for its employees that might be replaced by an ESOP. Contributions to such plans erode working capital and dilute equity. Had the equity raised in the offering gone to the employees instead of to the public, this would replace the benefits that the corporation would otherwise have had to purchase in order to maintain comparable employee benefits when compared with similar corporations.

The public offering, however, requires no debt service whereas the leveraged ESOP does. These are some of the tradeoffs. Interestingly enough, a number of companies that this author has assisted in going public have since gone private.

### 6.3 SELLING TO OUTSIDERS

This route is probably the most disruptive of all. It represents cashing in the chips both monetarily and activity-wise for the owner(s) as well as their loyal management team. A buyer will frequently tell the owner of the target company that he or she will not even consider buying the company unless the seller and top manager remain with the company for “X” years. The marriage generally lasts long enough for the new owners to learn the ropes and establish themselves with suppliers and customers. Then the relationship all too often falls apart. If the sale is stock for stock, it is tax-deferred but there is no diversification. Sale of the securities that are acquired in the merger triggers a tax on the gain down to the original investment in the founder’s own company. A cash sale is taxed down to the basis.

### 6.4 SELLING TO AN ESOP

The stockholder wishing to sell stock in the private corporation can do so with tremendous advantages through an ESOP. The corporate owner can sell stock at a price that has been determined independently by scientific methodology. He or she can still operate the company with no new venture capital investors looking over his or her shoulders with bated breath wondering how quickly they can cash out and not concern themselves with the long-range welfare of the corporation and the people who devote their careers to making things happen. Through the ESOP, the selling shareholder creates no new direct stockholders or other bosses as one does in the public offering or in the selling to outsiders scenario.

The tax savings through an ESOP tends to help offset the dilutionary effect on the stockholders as does the fact that the ESOP can replace other forms of qualified plans which dilute equity. The owner can bring home a greater equity value by using an ESOP rather than the public or private sale. The deductibility of principal and the deferment of taxes through the ESOP route makes ESOP financing very compelling.

