

Is an ESOP the Right Exit Plan for Your Business?

BY GEORGE RAFTOPOULOS



Business owners face many daily dilemmas: employee issues, deadlines, operational challenges and competition. The reward of profits and the satisfaction of controlling your own destiny, though, can make the risk of building a business worth the painstaking decisions and sacrifices made along the way.

But when it comes time to retire, there can be just as many feelings of confusion, heartache and indecisiveness caused by not knowing all your options.

One common way to retire is selling your company to a competitor or a financial buyer. But the thought of selling to a competitor may conjure up other mixed emotions. Who knows if the buyer will ruin the reputation that you've built, and what will happen to your loyal employees?

Another option is to sell your company to a few select managers who will continue to run the firm, hopefully, in the same successful manner you did. The benefit of selling internally is that you already know the people who will run the operation, and they already know the business. However, an internal sale can come with its own set of problems including, among others, financing.

So what's a business owner to do when he or she wishes to leave a legacy intact and provide for employees? The answer may lie in an ESOP, or an employee stock ownership plan. For the right size firm, an ESOP may be the best of all worlds.

Employees as Owners

An ESOP is a retirement plan that is governed under the regulations of ERISA (Employee Retirement Security Act) just like any other retirement plan, such as a defined benefit or 401(k) plan. This means it

must be available to all employees, based on certain criteria such as age and years with the company. It is regulated by the Department of Labor. These regulations assure the plan will benefit all eligible employees and not just the owners.

An ESOP is a trust that is set up to purchase the shares of outstanding stock from an owner or owners and then redistribute beneficial ownership of this stock to each employee. In contrast to selling shares to a competitor, an owner sells shares to the ESOP trust that serves as the buyer. An owner may choose to sell some or all of his or her shares now or in the future to the ESOP. Depending on whether you file income taxes as an S corporation or a C corporation, there may be tax advantages by selling stock to the ESOP. (You should consult your tax and/or ESOP advisor for more detailed information.) Since you are selling your stock to the ESOP trust, a certified business valuator values the company.

When the shares are sold to the ESOP and redistributed to employees, employees are apportioned a beneficial interest in value equating to the number of shares they receive. The ESOP trust may own a majority or 100 percent of the company, but the company's operational control remains with you and/or company officers. This is important because employees cannot control the company, and no one employee may have majority control—a fear of many business owners.

The value of each employee's interest in the ESOP retirement plan may therefore increase or decrease as the company's value changes. If the ESOP is presented properly, employees' dedication and focus should strengthen and, often, owners see a positive cultural change that can further drive up the company's value.

Help Along the Way

Different advisers and professionals must be hired throughout the process. An ESOP trustee is required to be the buyer of the shares and to represent the beneficial interest of all employees. Legal counsel must represent both the ESOP trustee and the company, as would be required in any company sale. A valuation company will be required on an ongoing basis to value the company. Employees will receive a report of their beneficial pro-rated interest in the shares of the company. Finally, consultants familiar with all the nuances of different plan scenarios must weigh all the tax and financial benefits and costs.

Fees to install an ESOP may be up to \$125,000 in the first year, and there are costs to managing the plan annually (subsequent years cost much less). For perspective, consider the cost of selling a company valued at \$10 million to an outside buyer. Intermediaries or mergers and acquisitions advisers would require a fee that could range from 3 percent to 5 percent of the company's value, or up to \$500,000. Quick math shows the costs of selling your business to an outside buyer can far outweigh the costs of setting up and running an ESOP. This also allows you to sell your shares and reward your employees into the future, thereby assuring the ongoing success of the enterprise you've built. ■



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