

# ESOP's Myths, and the Benefits of Employee Stock Ownership Plans

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Owners of closely held businesses under-utilize Employee Stock Ownership Plans (ESOPs) as an ideal vehicle for achieving key business and tax deferral goals. Many of these owners have no exit strategy when they are ready for retirement. An ESOP will provide a market for the business owner's stock and allow him or her to achieve liquidity while still controlling the business. In addition, the business owner will enjoy substantial tax benefits under Section 1042 of the Internal Revenue Code if he or she sells at least 30 percent of his or her shares to an ESOP.

Despite these advantages, many closely held business owners fail to consider the ESOP alternative—and fail to do so for the wrong reasons. Most of the reasons used to reject an ESOP are simply not valid. This article reviews a few of the reasons commonly used to reject an ESOP and explain why, for the vast majority of business owners, these reasons amount to nothing more than “myths” about ESOPs and ESOP transactions and, therefore, why business owners should give careful consideration to an ESOP.

Business owners reject ESOPs primarily for the following reasons:

- 1) the owner is looking for a strategic buyer who will pay a premium for the business;
- 2) the owner does not want to give his or her employees control of the business and/or provide too much information to the employees about the business;
- 3) the employees do not want to buy the business; and
- 4) an ESOP transaction is too complex.

After carefully reviewing all the alternatives, however, it is abundantly clear that the sale of shares to an ESOP is highly advantageous to the closely held business owner and in many cases represents the best alternative for achieving liquidity from his or her business.

At some point in their careers, most closely held business owners decide that they want to

divest their holdings and liquidate some of their investment in the business. While seeking liquidity, most business owners are not quite ready to give up control of the business. Unfortunately, it can be difficult to find a buyer who is willing to purchase a minority share in a closely held business, even a highly profitable one. The most likely buyers—key employees of the business—rarely have the financial resources to acquire a significant portion of the company and they want to be given the stock as a reward for past efforts (as opposed to purchasing such shares).

Some business owners believe that a sale of shares to a third-party investor presents a viable alternative. However, in the author's experience, a third-party sale rarely is a good option because the third party rarely is willing to pay what the company is worth. In those rare cases in which a strategic buyer is willing to pay a premium for a closely held business, the owner is usually willing to give up his or her control. In other rare instances, the business is large enough and profitable enough to raise capital through public offering or private placement. More frequently, a potential buyer will want to purchase a controlling interest in the business at far below its value and will insist upon some degree of management control.

In other cases, the owner would like to leave the business to his or her children. However, it is uncommon for children to have an interest in continuing a family business. Even when such an interest exists, in most cases, only one of an individual's children possesses that interest and the owner needs a mechanism to convert the interests of the other children into cash.

When one also considers the tax advantages of ESOPs, it's surprising that the number of ESOPs formed in this country is relatively small. In the author's view, the reason for this is that the disadvantages of ESOPs are misunderstood and overblown.

**Myth #1: The owner is looking for a “strategic” or other third-party buyer for the business.**

One hears this refrain frequently from closely held business owners. The truth is that few

closely held business owners have a realistic assessment of the true fair market value of their business. Many wrongly assume that a strategic buyer is always waiting in the wings with a generous cash offer. These optimistic assessments, however, rarely prove to be true. Strategic buyers do exist, but are very rare and are looking for targets in "hot" industries of the moment. The problem for closely held business owners is that they can never rely on the availability of strategic offers because the investment community is notoriously fickle. Today's hot industry may be tomorrow's "has been."

The vast majority of closely held business owners stand no possibility of realizing a premium from a strategic buyer. For these owners, finding a third party willing to buy their business at any price is a challenge, particularly if the success of the business is largely dependent upon the personal efforts of one or two owners. In the event one of these owners is too old or ill to continue operating the business, it will lose most of its value. In most cases, the problem is that the owner does even begin to search for a buyer until he or she is unable or unwilling to continue operating the business. A significant number of closely held business owners simply abandon their businesses without receiving any significant compensation.

An ESOP is a far more advantageous alternative. By selling a minority interest to the ESOP, the business owner can "cash out" part of his equity at a fair price and keep control of the business. Moreover, in a properly structured transaction, the owner can sell his minority interest without taking a "minority interest discount" and do so without paying any federal income tax on the proceeds of the sale.

Consider this example.

John, age 55, owns 100 percent of ABC Corp., a closely held business worth \$10,000,000. He decides to sell 30 percent of ABC to an ESOP. To finance the transaction,

the ESOP borrows \$3,000,000 from a bank, for which ABC guarantees repayment. John sells 30 percent of ABC's stock to the ESOP for \$3 million in cash. Provided that John invests the \$3 million in stocks or bonds of any domestic corporation (known as Qualified Replacement Property or QRP), he pays no tax on the gain he realized on the sale. Assuming a 25 percent combined capital gains tax rate, John defers payment of \$750,000 in tax. By holding the QRP for the rest of his life, John can permanently avoid payment of tax on the gain (as his heirs receive a step-up in his tax basis upon his death).

Over the next several years, the ESOP will repay the bank loan from annual contributions that ABC makes to the ESOP. Because these company contributions are fully deductible, for federal income tax purposes, the government, in effect, pays almost 40 percent of the cost of repaying both the principal and interest on the loan.

Depending upon the economics, John could have sold more than 30 percent of his shares to an ESOP. In any event, once the ESOP loan has been repaid, or even as the loan is being repaid, John is free to sell additional shares to the Plan.

**Myth #2: The owner does not want to give employees control over the business.**

Many business owners wrongly assume that they will lose control over their business the moment that they sell a few shares of stock to an ESOP. In reality, quite the opposite is true. In addition, many closely held business owners do not realize that sale of stock to an ESOP does not mean sale of their stock to the employees themselves.

In a typical ESOP transaction, only 30 percent of the company's outstanding shares are sold to the ESOP. While Section 409(e)(3) of the Code requires a vote with respect to major corporate transactions (such as a merger, consolidation, recapitalization, reclassification, liquidation, dissolution, or sale

of substantially all of the company's assets) to be "passed through" to ESOP participants, the business owner will still control 70 percent of the outstanding shares and, in most states, will retain super majority status. Even in these transactions, employees do not vote all of the stock in the ESOP but only the shares allocated to their accounts. The remaining portion, *i.e.*, the amount held as security for the unpaid loan, is voted by the trustee of the ESOP. Furthermore, transactions that implicate Code Section 409(e)(3) are rare occurrences for most closely held businesses. The day-to-day operation of a closely-held business is not affected by the existence of an ESOP as a minority shareholder.

While it is prudent (and generally recommended) that the company appoint an independent trustee to protect the interests of the ESOP and its participants with respect to a transaction to purchase company stock, many employers replace the trustee with a corporate officer or shareholder after the completion of the transaction. To be sure, the officer has a fiduciary obligation under the federal pension law known as ERISA to act "solely in the interest of the plan and its participants." However, in most cases, the interests of the ESOP and the company will not diverge. In general, the ESOP holds only the rights of a shareholder, which generally do not include the right to actively participate in the operation or management of the business. In short, the ability of the owner of a closely held business to manage the day-to-day operation of the business will not be affected by the existence of an ESOP serving as a minority shareholder.

The rights of the employees themselves to participate in the management of the sponsoring employer are even more limited. As noted above, employees have no right to vote the shares held by the ESOP on their behalf unless the shares have been allocated to their accounts (which occurs as the loan is repaid) and even then can vote only on major

corporate transactions. Similarly, as it pertains to the ESOP, it is the trustee of the ESOP, not the employees of the business themselves, who generally has access to financial information concerning the business. Such information would need to be provided to the employees only in the case of a major corporate transaction subject to Section 409(e)(3) of the Code.

**Myth #3: The employees do not want to buy the business.**

This is another common refrain and is based upon a mistaken assumption that employees should be involved in the decision making process of establishing an ESOP. From a pure legal perspective, employees have no role in the decision making process—the decision to establish an ESOP is one that is reserved exclusively to management. More importantly, the reason to establish an ESOP is because the owner wants to sell the business, not because the employees want to buy the business. The owner of a business would rarely hesitate to sell his or her business to an unrelated third party because of perceived employee objections.

Furthermore, the sale to the ESOP is a gradual process. Typically, the business owner sells only 30 percent of the business in the first transaction. The term of the loan to the ESOP generally lasts from five to seven years. Over that period of time, the owner continues to retain full management control of the company and its affairs. In most cases, the ESOP transaction is a successful one and the loan is fully repaid. When the loan is fully repaid, the owner can consider a second sale of stock which involves another five to seven year loan. Because the process is gradual, many employees who initially had no interest in buying the business when the ESOP was established will begin to develop the skills

and desire to become involved in management. In the alternative, the owner will have time to attract outside talent capable of assuming management control of the company.

**Myth #4: ESOPs are too complex.**

This is probably the most commonly misunderstood aspect of ESOP transactions. Many prospective ESOP sponsors are put off by explanations of fiduciary duty and independent trustees. While it is true that there are many complex rules that govern what can and cannot be done in an ESOP transaction, a sale of the stock of an employer to an ESOP is not materially more complex than selling the stock to a sophisticated third party. Knowledgeable professionals can guide even the least sophisticated employer through the transaction.

It is also true that the subsequent administration of an ESOP is more complex than the administration of a 401(k) or profit sharing plan. The sponsoring employer must make a contribution sufficient so that the ESOP is able to pay both interest and principal on the loan and shares representing the principal repaid must be released from escrow. However, the administration of an ESOP can be separated into two distinct elements—allocating shares and routine administration. Once the shares that are to be released from escrow are determined, the allocation of such shares to participant accounts is very similar to the process for profit sharing or other defined contribution plans. Routine administration involves such tasks as enrolling new employees and processing distributions. Again, there are many knowledgeable professionals to walk the ESOP sponsor through the administrative process.

Similarly, it is undisputed that there are costs associated with an

ESOP transaction and ongoing administration of an ESOP. However, the cost of selling an ESOP is generally not much greater than the cost of selling a closely held business to any sophisticated buyer. The cost of ESOP administration is somewhat higher than the cost of administering a comparable profit sharing or 401(k) plan. However, these additional costs are far outweighed by the tax benefits available to ESOP sponsors and selling shareholders.

In some cases, the notion that ESOPs are overly complex is exacerbated by some of the employer's professionals, including accountants and general practice attorneys. Undoubtedly, some of specialized rules that one must follow in order to obtain favorable tax treatment for an ESOP sale may seem daunting to those professionals who are unfamiliar with ESOP transactions. However, these rules are mechanical and are relatively simple to understand and follow if one is willing to take the time to learn them.

Many of the professionals who are familiar with ESOPs recognize that educating the business owner's trusted professionals is an essential first step in the process of implementing an ESOP.

**CONCLUSION**

In many cases, an ESOP is the most attractive method for an individual to realize value from a closely-held business and to diversify his or her assets. It is in the interest of any business owner to seriously consider an ESOP as an alternative to any of the other available strategies.

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