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Insider View: ESOPs can make business transition a little bit easier

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It's your 55th birthday and you have finally begun thinking about retirement. You have built a successful business and always figured that it would be at the center of your retirement plan, but first you have to get enough money out of the business to finance the kind of retirement you have in mind.

Here are your options:

* IPO: Many successful businesses do not have a model that can scale sufficiently to justify an IPO in these more sane times.
* Third-party sale: There is often no obvious buyer, and there is also an emotional component involved in turning over your baby to a stranger.
* Management buyout: If you've hired and trained a group of strong managers that can continue to run the business successfully, you may want to transition control of the company over to them.
* Keep it in the family: Often the preferred option. But what if your offspring lack the seasoning of a mature manager?

There is another potential buyer: the company's work force. Through an employee stock ownership plan (ESOP), employees can purchase some or all of the company. As a result, you get some cash on very favorable terms, employees get a motivating benefit, and none of your other exit options are eliminated.

An ESOP can borrow the funds to buy your shares from institutional lenders. If structured correctly, you can sell shares of your company to the ESOP and invest what you get for your shares in replacement securities without paying any tax on the capital gain.

Most interestingly, an ESOP can be a participant in a management buyout or in a family transfer. You get your cash to reinvest from the ESOP. Your managers or your family can buy the rest of the company's stock with some combination of upfront cash and payments over time. Because you have received a substantial, tax-free payment upon the sale to the ESOP, your need for follow-on payments is reduced. Or you can sell the entire company to the ESOP, and none of the proceeds will be taxed for capital gain when you receive them (after you pass a 30 percent threshold).

An ESOP is a qualified retirement plan, like a 401(k) or profit-sharing plan, so it requires the same attention to procedural details as your other retirement plans. You will need to file annual reports. Your loan payments will be restricted to a certain percentage of your company's employee compensation (plus dividends, in certain circumstances).

Not all companies are good ESOP candidates. Generally, a company should have an upward-trending profit line. Debt should be small. Payroll should be a relatively high percentage of costs. Receipts should not be subject to wide swings. The number of pre-ESOP shareholders should be small.

Shares purchased by the ESOP are held in an ESOP trust. When the loan is eventually repaid, the shares are allocated to the individual accounts of the ESOP's employee/participants. As long as the ESOP trust holds the shares, the ESOP trustee -- usually the founder or selling shareholder -- votes them. The right to vote ESOP shares must only be passed on to account holders for issues such as approval of mergers or other consolidations, recapitalization, liquidation, dissolution or a sale of substantially all of the company's assets.

The ESOP trust is a tax-exempt entity, so any dividends or proceeds it receives are not subject to tax in its hands. Some corporate structures, when fully owned by an ESOP, are not subject to income tax, which results in a significant competitive advantage.

Shares are only distributed from the ESOP trust when a participant with a vested account balance terminates employment. Participants have the right to demand that their account balances be distributed in shares, although most elect to receive cash. The ESOP can require participants to take cash in two circumstances: if the company is an S corporation or if the articles or bylaws of the company limit ownership of substantially all employer's securities to employees or an ESOP trust. If a company's shares are not publicly traded, participants have a limited right to put ESOP shares back into the company. Closely held companies can impose transfer restrictions and a right of first refusal on shares distributed from the ESOP.

The initial sale to the ESOP and subsequent distributions and repurchases must be under a fair valuation formula. Prior to the sale, and each year thereafter, a formal valuation of the company's shares must take place. The results of the valuation must be used for all ESOP transactions, and the existence of this valuation can make it extremely difficult and risky to use different valuations for different purposes.

While the ESOP is subject to a strict regulatory regime, it is still just another stockholder. It should not prohibit or deter an interested potential buyer from pursuing his or her interest. If the ESOP owns less than a majority of shares, then the votes of ESOP account-holders will not be determinative. Even if the ESOP is a majority shareholder, employee participants should be expected to vote based on their economic interest, so if the offer is a good one, it should be accepted.

An ESOP can be terminated in exactly the same way that any retirement plan can be terminated. Typically, the plan will be "frozen." No new allocations are made to the plan. As employees terminate employment, their shares are repurchased.

The biggest downside for a selling owner is that he or she can expect that an institutional lender will want them to sign on to remain in charge during the period when the initial ESOP loan is outstanding, so it is important to start this process well before you want to exit the business.

You set up an ESOP now. You begin grooming your managers or your children to take control of your business from you. You manage your way out. In the meantime, you and your financial advisers have invested the proceeds from the sale in securities that do not require you to pay the tax on your gain. You begin developing a plan for the transfer of the rest of the business, either a sale to your managers or a sale/gift to your children.

You have successfully brought your retirement dream much closer to reality.

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