The Ultimate Employee Buy-in

Sell the company to your employees? It's a great idea--both for you and for the business you're leaving behind.

From: Inc. Magazine, December 2005 | Page **By:** John Case

One of the great ironies of entrepreneurship is that many people spend years building their companies, only to undo all of that work at the very end by deciding to sell the business to the wrong person. Decisions like that don't have to be made, especially today. Employee stock ownership plans, or ESOPs, have become a mainstream alternative for business owners who wish to sell their business but want it to remain largely intact.

As recently as 10 years ago, employee ownership was considered a maverick strategy; it isn't anymore. ESOPs have now been around for more than three decades, and the legislation affecting them has remained largely unchanged. About 10,000 U.S. companies, most of them closely held, have ESOPs. A number of banks, lawyers, accountants, and consultants specialize in ESOP transactions. Today, when you say the words "exit strategy" to one of these advisers, you're almost guaranteed to hear "ESOP" among the choices he or she ticks off in response.

But if you're like a lot of entrepreneurs, your first reaction may be, "Huh?" Maybe that's your second and third reaction, too. For despite the fact that ESOPs offer some compelling benefits, only a couple thousand company owners a year sell to an ESOP. If you're not among them when the time comes, it should be for a better reason than ignorance or prejudice.

So let's begin by considering the advantages. You can start selling shares in your company to the ESOP whenever you want. You can sell any percentage of shares you choose (including 100%), thereby taking out as much cash as you like. If you sell at least 30%, you can defer capital gains taxes, in some cases indefinitely (for details, see "**The Tax Advantage**").

Regardless of how much you sell, moreover--even if you sell a majority interest--you can run the business pretty much the way you think it should be run for as long as you want. Or else you can decide to leave right away. When you do retire, the company continues its existence--prospering, one hopes--as an independent entity. Your loyal employees keep their jobs. The name you gave your baby is still on the door.

Yes, there are drawbacks and uncertainties. An ESOP is like a leveraged buyout. An employee trust borrows against the company's future earnings to buy the business. As the debt is repaid, shares are distributed. Thus, very small companies and unprofitable companies aren't good candidates (see "**Is an ESOP Right for You?**").

And even if your company fits the bill on other grounds, you still may wonder how a company owned by its employees can run smoothly in today's cutthroat marketplace. Some knowledgeable folks share these concerns. "I worry about the inflexibility of ESOPs," says William Sahlman, a professor at Harvard Business School. "Very few businesses run smoothly and in a positive direction. ESOPs make it hard to make tough employment and financing decisions."

Point taken. Yet plenty of experts argue just the opposite--that an ESOP actually helps a business succeed--and that company owners would be crazy not to consider one. So it's really a matter of sorting out the upsides and the downsides, then making a judgment about what's important to you.

That, more or less, is what Tom Schramski did. A dark-haired, round-faced 53-year-old, Schramski is a psychologist turned businessman who lives in Tucson. The son of a Minnesota gas station owner, he fled as a young man to the sunny Southwest after "one too many subzero mornings" manning his father's pumps. There, he earned his college degree and a doctorate in psychology, figuring he would set up a practice.

But the entrepreneurial itch was strong, and in 1980 he learned that the state of Arizona was beginning to contract out the care of people with developmental disabilities and mental illness, a clientele Schramski knew something about. So he and a partner started a company to provide services to these folks. The partner stayed for only four years, but the company carried on after he left. Over the next 15 years, Community Psychology & Education Services, as the business was then known, grew into a healthy operation with $5.5 million in annual revenue.

By the mid-1990s, though, Schramski was in his early 40s; he was ready to begin thinking about liquidity and an eventual exit strategy. He talked to a couple of potential strategic buyers of CPES. They were interested, even eager. He realized he could walk away with a multimillion-dollar check.

But something didn't sit right, and he found himself lying awake at night. Those buyers, he knew, would consolidate facilities. They would slap their own company's name on the office door, if they even kept the office open. Undoubtedly, they would lay off many of CPES's employees. "My perspective on it was, how would I feel about it when I was 80 years old and looking back?" he says now. "I had employees who had been with me 10 years or more. I couldn't have looked them in the face."

So Schramski began casting about for an alternative, and in the process discovered ESOPs. After considerable research, he decided an ESOP was for him, and in 1995 he began selling the business to his employees in stages. By 1998 he had sold all his shares. In 2004 he gave up CEO duties completely.

Was it the right choice? On the one hand, Schramski paid a considerable price for his decision. As required by law, CPES's valuation for the ESOP sale was determined by an independent appraiser, who put it at $2.5 million. Schramski believes he could have sold the company to a strategic buyer for $3.5 million--though, of course, he wouldn't have received those aforementioned tax breaks, which were worth between $200,000 and $300,000.

On the other hand, his employees kept their jobs, and CPES--now known as Community Provider of Enrichment Services--has done better than ever. The company grew from $5 million in revenue in 1995 to $25 million in 2004; the payroll has swelled from 250 to 775. Families of clients, often mistrustful of for-profit companies in the field, liked the idea of employee ownership. Line employees learned to control key budget items such as vehicle expenses and maintenance costs, thereby boosting the bottom line. Managers who might have left the company, including one who got an offer doubling her salary, stayed with CPES to realize the rewards of equity. "We couldn't have grown like that without the ESOP," says Schramski. Employees help explain why. "The ESOP was really huge for me in terms of my investment in the company--my loyalty and longevity," says Cindy Gallon, an associate director at CPES. "Huge."

Legally, an esop is a tax-qualified retirement plan. It borrows money to buy the owner's shares, then allocates them to employee retirement accounts as the loan is paid off. In certain circumstances the selling shareholders can defer capital gains taxes. But these dry descriptions don't begin to do justice to the concept--and anyway, they beg the question of how on earth the U.S. government came to be offering tax breaks for selling a company to its employees.

The saga begins with an iconoclastic San Francisco lawyer named Louis Kelso, who believed fervently that capital ownership should be more widespread, and who realized even in the long-ago pre-leveraged-buyout era that would-be owners could buy a company by borrowing against its future earnings. Working on his own (and against the advice of his legal partners), Kelso in 1956 set up the first proper ESOP: Employees of a California company called Peninsula Newspapers used it to buy out a retiring owner. For years thereafter he pushed the idea hard. He wrote books and gave speeches. He set up a few more Peninsula-type plans on his own. (They came to be known as Kelso Plans, a name he disliked.) He lobbied politicians for government support to make the idea more palatable to skeptical company owners and their lawyers.

Then came the big break: In 1973 Kelso was introduced to an aide of Sen. Russell Long. Long, a Democrat and son of the fabled Louisiana populist Huey Long, was chairman of the Senate Finance Committee and one of the most powerful men in Congress. Soon Kelso and Long were having dinner together at Washington's Madison Hotel, and Long was buying what Kelso was selling--namely, that American workers should own a piece of the companies they worked for. Between 1973 and his retirement in 1987, Long and his allies sponsored legislation that created the tax preferences that ESOPs now enjoy.

Still, it took a while for ESOPs to catch on, partly because all those lawyers and financial advisers couldn't quite believe what the tax code was telling them. But today, the Kelso-Long legacy is visible for all to see: Sprinkled around the U.S. are hundreds of companies that "went ESOP" long ago, are now wholly owned by their employees, and are prospering beyond any founder's wildest dreams. This elite group includes:

Jackson's Hardware, a 65-employee store in San Rafael, Calif., that goes head-to-head with Home Depot and other big competitors yet continues to grow and thrive. With annual revenue ranging between $18 million and $20 million, it generates a ton of cash for its size--enough to pay off its ESOP loans "about 10 or 12 years ahead of where we originally planned," according to President and CEO William Loskutoff.

McKay Nursery Co., in Waterloo, Wis., which does $14 million in sales, aims for growth of about 5% a year, and has watched its stock increase in value about 8% a year for 20 years straight. Employee owners get anywhere from 10% to 50% of their base wage in cash bonuses every year in addition to their ESOP stock.

Stone Construction Equipment, a $55 million company that has watched competitors move production operations offshore, but itself runs a profitable, growing manufacturing operation out of a sprawling factory in Honeoye, N.Y. Stone's 240 employee-owners can deliver a customized, built-to-order piece of equipment in a few days or less--a level of performance unmatched in the industry.

Having just co-authored a book about such companies, I can testify: These three aren't unique. What unites them and the many others in this high-performing club is that their leaders take the ESOP seriously, spend enormous amounts of time reinforcing the idea of employee ownership, and go to great lengths to encourage employee involvement and innovation. As at CPES, employees return the favor. A Stone team came up with the idea of mounting the tires on cement mixers after the mixers were painted rather than before, shaving six minutes off an extremely tight production schedule. A McKay hourly worker figured out how to reduce the labor required for drainage trenches, saving the company $10,000 a year. "Some of the ideas that get suggested are just phenomenal," says McKay chief financial officer Tim Jonas.

But make no mistake: It can be a long, hard slog from the moment of creation to that kind of business nirvana. Employee ownership is still a weird notion to most Americans. Sell the company to an outsider, sell it to management, pass it along to your kids--in all those situations, everybody knows who's in charge and what's supposed to happen. But selling to the employees? Will the inmates be running the asylum?

The legalities are clear and reassuring to nervous managers. The business runs as usual, with the CEO and the board in charge. The ESOP shares' votes are in the hands of a trustee, who is appointed by the board, just like the CEO. What's not so clear are people's expectations, fed as they always are by hope and fear. Managers who hear that the ESOP is part of an exit strategy may wonder what opportunities will be open to them when the owner departs--not to mention wondering when the hell that is going to be. Employees who are suddenly told they are owners may believe they're now entitled to run things.

One key to success is educating employees about what it means to be an owner. Yes, you will benefit in a major way if the company makes money and grows; here's how. No, you don't get to tell your boss what to do, and no, you aren't automatically entitled to know what she makes.

A second key: making sure that the CEO or his successor is up to the peculiar challenges of running an ESOP. Some ESOPs fail, if that's the right word, not because an ESOP company is any more likely to go belly-up than its non-ESOP counterparts. They fail because a selling owner can't let go, or because new managers don't draw enough benefit from employee ownership by pursuing a participatory management style. In both cases, employees decide that nothing has really changed, so they might as well go back to doing things the old way.

The bugbear of ESOP critics is the fact that employees are also shareholders. Can they be fired? What if the CEO needs to do a layoff or reorganize a department out of existence? The short answer--that he or she has the right to do any such thing, and must redeem only the stock held by departing employees--is true, but it doesn't quite tell the whole story. Successful ESOP companies do treat employees differently, and may indeed find it harder than conventional companies to make "tough employment decisions," as Harvard's William Sahlman puts it. When one ESOP company laid off about 15% of its 150-person work force a few years ago, a worker described it as being like a death in the family.

But there's another dimension that critics overlook, which is that employee-owners can be counted on to go the extra mile to avoid layoffs. Gardener's Supply, a $60 million company based in Burlington, Vt., and partially owned by an ESOP, faced a slow time in 2003. Cindy Turcot, chief operating officer, challenged line employees to reduce expenses. Workers came up with a host of initiatives adding up to $500,000 in savings, a boost to the bottom line that also helped the company avoid layoffs.

Researchers Joseph Blasi and Douglas Kruse of Rutgers University have compared ESOP companies with non-ESOP counterparts in several studies of their own and have reviewed other researchers' work in detail. Their conclusions: ESOPs are indeed associated with greater stability of employment, as the critics might suggest. However, ESOPs are also typically associated with higher productivity, faster job growth, and higher survival rates among companies.

Ultimately, if the outgoing owner is serious about wanting to leave a strong, independent business, he or she has to prepare managers and workers to take over, and then gradually let go of the reins. To do this, CPES's Schramski introduced open-book management prior to leaving the company. He taught line employees, many of whom were social workers, to read financial statements and track their units' spending. He also started asking employees to participate in setting goals, by having them rank their top priorities for improving the workplace every year. He then made a point of delivering on the top vote-getters, such as buying new vehicles and absorbing continuing increases in health insurance premiums.

So CPES was in good hands when Schramski left two years ago. Then, earlier this fall, something unexpected happened: The board of trustees of the ESOP, which was made up of employee representatives, went to the management team with a plan to "freeze" the ESOP. All current staffers would still hold on to the shares they had already, and they would remain on the same vesting schedule as before. But new employees would not be granted shares, and existing employees would receive additional shares only as retirees cashed out of the ESOP and their shares were redistributed.

Why did the board opt for a freeze? "It was a rather sad situation for me," says Sally Lee, one of the trustees, and a seven-year employee of CPES. "But we provide social services on contract to state agencies, and we don't see our profit margins increasing very much. As the liability of the ESOP grew, we were concerned about how to meet that."

CPES's dilemma gets to one of the starker realities. Companies must be pretty sure that cash flow will remain high enough to cover both the front end and the back end of ESOP leverage (see "Facing the Debt Dilemma," at left). Those cash drains are one reason an ESOP company might suffer from lack of flexibility--Sahlman's fear--and why the CFO of a cash-starved company might curse the day it went ESOP.

As for CPES, Davis says that most if not all of the workers understand the decision to freeze the ESOP. And, as she points out, there were two reasons for freezing the ESOP, rather than simply terminating it. First, the company didn't have to come up with a lump sum of money to pay out every shareholder. And second, "anything can happen," Davis says. If margins improve, "we can unfreeze the ESOP at any time."

Zach Zachowski and Barbara Gabel are today roughly where Schramski was in 1996. The husband and wife team are founders of Zachary's Chicago Pizza, a two-restaurant, 110-employee purveyor of gourmet pizza in the San Francisco Bay area. They have run the business for 22 years and intend to maintain control for a while--but they recently sold 35% of the shares to an ESOP and plan to sell another big chunk in the near future. Their goal: "exiting this thing gracefully in a way that we could leave a legacy behind us," says Zachowski.

So far, they seem to be doing things right. They meet regularly with employees to explain the concept and have begun to see signs of understanding. They're working hard on succession plans, even going so far as to begin the groundwork for opening a third restaurant while they're still around. Opening up a new restaurant will be like "training wheels," says Gabel, to give the company's managers and employees experience with starting a new operation from scratch.

The couple themselves never wanted to grow beyond two restaurants, partly for fear that the demands of the business would overwhelm their relaxed lifestyle. But some of their key managers had been urging expansion for a long time, and now they'll get their chance. Like Schramski, Zachowski and Gabel were less concerned with getting top dollar for their business than with giving their managers and employees this shot at an equity stake. "They're smart and energetic and they want to see the company grow," says Zachowski.

Gabel likens an entrepreneurial exit strategy to a dismount after a horseback ride. You want to do it right, she says--otherwise "you've ruined the whole ride." For her and for her husband, giving managers and employees the opportunity to own the business is a way of thanking them, as well as a perfect fit with the couple's aspirations. "It's a reward for them," says Gabel. "But it's also very much a sign of success for us."

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