

ESOP option

The benefits to business owners of selling through an ESOP

INTERVIEWED BY ADAM BURROUGHS

A growing trend among business owners is selling their companies to an employee stock ownership plan (ESOP). Such an approach allows owners to cash out their equity interest in the business and, at the same time, stay actively involved with the company.

While a strategic buyer or a private equity fund may offer more money for a business, the opportunity for the owner to control the business and/or stay involved may be significantly curtailed, or not possible, after a sale to a third-party purchaser. Further, the culture of the business will likely be impacted by selling to an outside purchaser — there is no guarantee that current, long-standing employees will be offered positions with the acquiring purchaser after the transaction is completed.

ESOPs offer owners the option of a prolonged exit and the opportunity to maintain control of the company as it's being transferred to employees. Additionally, there are certain unique estate and tax benefits available to owners that may make the ESOP approach a more desirable exit strategy.

Smart Business spoke with Patrick J. Egan, a partner at Brouse McDowell LPA, about the benefits to owners of selling their business to employees through an ESOP structure.

What do owners need to do to prepare to sell their company to employees?

First, owners should talk to their family, financial consultants and business advisers to determine what they want to accomplish through any possible sale of their company. They should ask questions regarding their exit strategy and business succession goals, whether and for how long they want to stay involved with the business, and how

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important it is to them to maintain the same culture and work environment with respect to the employees of the company.

It is also prudent to get legal advisers involved early in the process as they can help the owner consider their options and fully set forth the pros/cons of selling to an ESOP. If an ESOP is an attractive option, legal counsel can then marshal the professionals who will be needed to pursue the same.

For example, the business owner will likely need to engage an ESOP consultant who will conduct a feasibility study. The feasibility study will look at future projected cash flow and other factors to make sure the debt incurred by the ESOP (in buying the equity interest of the owner) can be paid off.

If an ESOP is feasible, then an ESOP trustee (typically a bank) will need to be retained on behalf of the ESOP. The ESOP trustee will then arrange for a business appraisal. It's important to understand that, by law, ESOPs can only buy a company at its fair market value, which only a qualified appraiser can determine.

Why are ESOPs gaining popularity?

ESOPs are increasingly more prevalent in part because many owners like the idea of staying involved with their company, keeping control of the business while it's

transferred to employees. Further, ESOP-owned businesses are found to be more productive and efficient because employees directly benefit from the company's success, which often means greater profitability.

How does an ESOP help owners realize the lifestyle they're hoping to live post transaction?

Owners, after selling to an ESOP, often maintain their current salary and benefits. The ESOP trustee, along with the company's board of directors, will have some say regarding pay and benefits, but as long as the executive's compensation is reasonable, it should be fine.

There's also flexibility that can be negotiated into the ESOP structure and how the owner is paid. Typically, a portion of the sales price is financed through a seller note. There is significant flexibility regarding the payment terms and duration of any such seller notes. The Department of Labor, which oversees these arrangements, is mainly concerned that the ESOP pays no more than fair market value for the interest purchased from the owner. Problems will arise if the appraisal overvalues the business.

Owners who want to stay involved in the business that they have grown and operated for many years while protecting its culture and employees should take the time to explore an ESOP. ●