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Keeping Hometown Businesses at Home

By John H. Brown and Corey Rosen

USING AN EMPLOYEE OWNERSHIP PLAN FOR BUSINESS CONTINUITY

As baby boomers start to retire, two to three times more closely held companies will be for sale than ever before. If these businesses close for the lack of a buyer or are sold to a buyer who moves jobs out of the area, the impact can be devastating. But an employee stock ownership plan (ESOP) provides a highly tax-favored way for these owners to make their transitions at a fair price on their own schedule. The jobs stay put and employees accumulate wealth. It is a great tool for the right companies, but few business owners know about these plans. That is where economic development professionals can help.

keeping hometown

BUSINESSES AT HOME

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In the typical community, about half of all employees work for mid-sized companies owned by baby boomers, most of whom are thinking about exiting their businesses within the next few years. While some of these businesses will be passed on to family members, competitors or private equity firms will purchase many of them. Other businesses will simply close their doors, because the owners failed to plan for transition.

So what does this mean to you, the busy economic development practitioner?

Private equity groups that buy companies are often focused on repaying their investment as quickly as possible. Company acquirers may reduce employment at the acquired firm because they can handle some of these tasks elsewhere (indeed, these assumed synergies are why the companies often do the acquisition). Private equity groups may cut employment as a means to increase short-term profits before "flipping" the company to someone else. Acquirers frequently move all (or part) of the operations of an acquisition to a different location. In any event, local jobs evaporate. Shouldn't you be doing something to retain these businesses in your community when owners retire and exit?

Let's look at how one real owner exited his company and kept the jobs in the community.

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THE CASE OF ROGER RYBERG

New Ulm, Minnesota, was about to lose one of its hometown companies. And no one had a clue.

Roger Ryberg was the 60-year-old owner of a company that employed just over 75 long-time employees. Over the years, a number of professional buyers, usually representing private equity groups, had approached Roger expressing interest to buy.

Additionally, several of Roger's customers had approached him about selling due to the company's expertise and performance.

Roger was well aware that he couldn't work forever, but he just couldn't see how he could orchestrate an exit that would not only leave his family financially set for life, but also preserve the legacy of the company in the community. Roger liked New Ulm, he liked his employees and if he could manage it, he wanted to see the company – and its employees – stay put. Finally, Roger wanted to transition out of his company slowly because he believed that was the best way to ensure its ongoing success.

The first tentative offers by the private equity groups assured Roger that he could reach his first goal: financial independence. But none of these buyers was willing to make any promises about keeping the plant in New Ulm, much less keeping his employees on board. Nor were they focused on Roger's other goal: a slow transition out of the company.

Like so many other owners, Roger struggled with his exit decision. He didn't know who could help him. He hadn't mentioned his non-financial goal to any of the investment bankers he had interviewed but suspected that none had much incentive to help him reach any but his financial goals.

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USING AN EMPLOYEE OWNERSHIP PLAN FOR BUSINESS CONTINUITY

As baby boomers start to retire, two to three times more closely held companies will be for sale than ever before. If these businesses close for the lack of a buyer or are sold to a buyer who moves jobs out of the area, the impact can be devastating. But an employee stock ownership plan (ESOP) provides a highly tax-favored way for these owners to make their transitions at a fair price on their own schedule. The jobs stay put and employees accumulate wealth. It is a great tool for the right companies, but few business owners know about these plans. That is where economic development professionals can help.

DEMOGRAPHICS: A TICKING TIME BOMB

Roger's situation is far from uncommon. In fact, much about him is quite common.

First, he is an early baby boomer. Born in 1941, he preceded the true boomers (born between 1946 and 1964) who, since 2006, are reaching the age of 60 at a rate of 4 million per year.

Second, according to the Edward Lowe Foundation (www.edwardlowefoundation.org), companies with 10-99 employees – like Roger's – account for only about 11 percent of the total 5.5 million businesses in the U.S. yet more than 35 percent of all jobs. Compare that to larger companies (100-499 employees) that represent .6 percent of all businesses but account for 15 percent of all jobs. When combined, these two categories (10-499 employees) are generally described as "lower middle market" and "middle market" companies.

The failure of owners to understand and to plan their exits provides a huge opportunity for economic development practitioners to step in and provide education and facilitate discussions with owners regarding exit plan alternatives. Evaluating exit paths in light of an owner's goals – one of which is retaining the business in the community – benefits both owners and the communities in which they operate.

Third, his internal exit alarm is ringing right along with other boomers. According to a 2008 report prepared by Bain Surveying, Inc., "47% of middle-market business owners 55 years and older are interested in selling their businesses within three years and yet over 90 percent of business owners have not initiated the planning process."

Typical Owner Goals

Roger's goals were also similar to those of most other owners. At the top of his list was "financial security for my family." He had to convert an illiquid business into enough cash to finance a comfortable post-exit life for himself and for his family.

He also wanted to pick his retirement date. He wanted to leave when he was ready and when the company was ready, but not before. He wanted to transition out gradually, building business value up to the point of sale.

He wanted to choose his successor. The business was part of Roger's fiber and he had worked too hard to hand the keys over to a successor who might be unable to continue the company's success.

Roger, like many other owners, had a few other items on his exit wish list. These included: rewarding his long-time key employees, maintaining the company's legacy in the industry and in his community, and if possible, keeping the company in New Ulm. Typically, "keeping the business in the community" does not rank high on most owners' lists because they believe that there's no way to achieve that goal without sacrificing goals higher on the list.

COMMON OWNER APPROACH TO EXIT

Initially, Roger's approach to his exit was similar to most owners: wait for a buyer to appear. According to a 2010 Harris/Decima survey, only 45 percent of business owners in companies with more than 50 employees have a succession plan.[1]

Many owners respond to the first interested buyer and work to negotiate a deal with that buyer. There are a number of risks to a seller in this position: the seller's lack of expertise in transactions and lack of leverage with only one buyer at the table being the most critical. Even if sellers bring in deal teams to help them, those deal teams are generally so focused on maximizing sale price that they offer little support to the owner who wants his company to remain in its community.

In the lower mid-market and mid-market (10-499 employees), most owners sell to private equity groups or, more commonly, to larger companies. Motivated by cost considerations, these companies typically relocate the target acquisition's headquarters and consolidate manufacturing activities into existing plants. At a minimum, buyers tend to reduce the seller's workforce in an effort to eliminate redundancies.

The damage to the sellers' communities is significant: plants close, employees lose their jobs, and tax revenues take a hit. The hometown owners generally played a significant role in community charities and activities, but buyers do not step into these roles.

OPPORTUNITY KNOCKS

There is clearly a dearth of exit information available to owners. Most do not appreciate all of the exit path alternatives available to them and fewer understand how to evaluate various paths in light of their goals.

The failure of owners to understand and to plan their exits provides a huge opportunity for economic development practitioners to step in and provide education and facilitate discussions with owners regarding exit plan alternatives. Evaluating exit paths in light of an owner's goals – one of which is retaining the business in the community – benefits both owners and the communities in which they operate.

Reaching Out to Owners

Consider taking five steps to reach out to the owners in your community.

1. Recognize that business owners' primary exit goal is to secure financial security for themselves and their families.
2. Understand that owners have a variety of non-financial goals:
   a. Security/reward for employees,
   b. Legacy, and
   c. Keep the business in its community.

3. Bring up the community issue! Ask owners, "Assuming that your financial exit objectives can be attained, is it important to you to keep the business in the community for the benefit of employees, customers, and community?"
4. Educate yourself and business owners about exit path alternatives that meet both their financial goals and their desire to keep the business "locally-owned." These alternatives include:
   a. A transfer to family members,
   b. A sale to co-owners,
   c. A sale to an Employee Stock Ownership Plan (even a minority sale),
   d. A purchase by employees, and
   e. A sale to a third party with restrictions on transferring business location.
5. At every opportunity, remind owners of the importance of their businesses to your community.

In this article, we concentrate on "Option C," a sale to an Employee Stock Ownership Plan, because it provides the greatest likelihood that the business will remain in the community. It is also the least understood of the options. We have already introduced you to Roger Ryberg (the owner who completed the sale of his company to employees in 2008), so let's examine this type of sale in more detail.

ARE ESOPS AN ANSWER?

For owners and for their communities, employee stock ownership plans (ESOPS) can be a win-win solution. For the owner, selling a business to employees is a highly tax-favored means to achieve his or her exit goals. The communities in which these companies are located retain jobs, thus supporting and fueling economic growth.[2]

Despite the many advantages of ESOPs for business transition, they are very often either not known to business owners or the information they have is misleading.

Benefits to the Owner

ESOPs are a kind of tax-favored employee benefit plan funded by pre-tax company contributions. Compare that to a corporate redemption of shares: the company must first generate enough cash to pay taxes on and leave enough to buy the owner's shares. With an ESOP, that's not needed. ESOPs can also borrow money to purchase an owner's interest in full or in installments over time, again with the company using pre-tax dollars to repay the loan (no other company loan allows the deductibility of principal and interest). Many owners can then defer the gain they make on the sale by reinvesting in other companies. Ongoing ESOPs have additional tax benefits, and Sub S 100 percent employee-owned ESOP companies do not have to pay any federal or state income tax at all.

Benefits to the Employees

Employees end up as owners of the company, and as owners, the research shows, help their companies generate 2.5 percent more jobs per year than would have been generated without an ESOP.[3] Employees in ESOP-owned companies have two to three times the retirement assets that employees in non-ESOP companies have – money that can further help stimulate local economies.

Benefits to the Company

As noted, only ESOPs can use pre-tax dollars to buy out an owner. Once a company has an ESOP, it can also make tax-deductible contributions to the plan to facilitate acquisitions of new capital or other companies. Even better, if the company is or becomes an S corporation, the percentage of profits attributable to the ESOP is non-taxable. S corporations do not pay taxes – they pass the obligation on to the owners pro-rata to their share of ownership. But ESOPs do not have to pay these taxes, so if a company is 30 percent ESOP owned, 30 percent of its profits are not taxable. If it is 100 percent ESOP owned (and now about 40 percent of ESOPs are or will be), it is not taxable at all at the federal level. That means these companies can spend more on growth.

Benefits to Communities

1. Jobs are protected and often created.
2. New jobs may be created.
3. Employees leave the company with very large nest eggs to spend in the community.
4. Once employees own a company via an ESOP, employees are very unlikely to ever relocate the business.

In the United States, the National Center for Employee Ownership estimates that there are over 11,000 ESOPs covering over 13 million participants, ranging from companies with just 10 or 20 employees to companies with tens of thousands. Table 1 looks at some key performance merits for ESOPs compared to the economy overall.

Table 1: ESOPs and Economic Performance: Key Data

	ESOPs	Non-ESOPs
Job growth	+2.2% per year greater post-ESOP than prior to ESOPs	Net annual job growth between 2001 and 2011 has been close to zero
Wealth accumulation	ESOP participants generate about 2.5 times the retirement assets as non-ESOP participants and are more likely to have a secondary retirement plan than employees in other companies are to have any retirement plan	Over half the employees in the private sector are not in any retirement plan
Default rates on acquisition loans	<.5%	6% to 19% for private equity firm leveraged buyouts

THE BASICS OF ESOPS

ESOPs are funded by the employer's profits, not the employees' own money.

ESOPs cannot be used to share ownership just with select employees, nor can allocations be made on a discretionary basis. All employees who have worked at least 1,000 hours in a plan year must be included. They receive allocations of shares in the ESOP based on relative pay or a more level formula.

ESOPs can be used to buy all or part of a business.

Many ESOPs are set up to provide one or more owners with a gradual exit from the business – an appealing option for many of today's boomers.

The ESOP pays an owner a price established by an independent appraiser. If purchases are made over time, that price is determined at least annually.

THEN WHY ISN'T EVERYBODY DOING IT?

As appealing as ESOPs are to many business owners, most either don't know what an ESOP is or have received misleading information. Business brokers do not generally talk to owners about ESOPs, (even if they know how ESOPs work) because brokers do not earn commissions on sales to an ESOP. Accountants and other financial advisors may have heard about ESOPs, but few are experts and often mistakenly believe that only large companies can be owned by ESOPs.

We hear a number of common myths about why an ESOP won't work:

- It's only for capital intensive companies or, others say, for labor intensive companies (we hear both). In fact, ESOPs are in every kind of business.
- You must have at least some magic number of employees or sales. There is some truth to this because of the costs of setting up a plan, but there are many ESOPs with 15-50 employees and a few even smaller.
- You have to give up control to employees or disclose all kinds of financial information. That's just not true. Employees only must be given the most minimal governance rights (and they almost never are used) and companies only are required to provide annual account statements to employees, not financials (albeit many are very open-book voluntarily).
- They are only for S companies or, others say, C companies. Either can have an ESOP. S corporations are "pass-through" entities, meaning tax obligations are passed-through to owners. S corporations have limited liability, just like other corporations, but the company pays no tax. Instead, the owners pay tax at their own personal tax rates based on their share of the company's annual profits. C corporations are more familiar – all public companies are C corporations, for instance, and about half of all privately held companies that employ more than a few people are as well. These companies pay taxes at the corporate level, and their owners pay taxes on any dividends they receive.
- They cost hundreds of thousands of dollars to install. As indicated here, that's just not true, although some firms do try to charge that much (so don't use them!).

Local development agencies can, at very little cost, help fill the information void and correct owner misconceptions. Publish informational material, hold meetings, educate yourself, and educate owners. The amount of time and money you invest to save the jobs at stake is far less than you invest in most other business development strategies.

Of course, ESOPs are not for every owner or for every company. ESOPs:

- Are subject to specific and complex federal guidelines to ensure they operate for the benefit of plan participants. They do not therefore work for companies that want to provide ownership just to select people.
- Cost $60,000+ to install and from $15,000 and up (depending on company size) to maintain annually.
- Rarely work for companies that do not have sustainable profits or good successor management already in place.
- Are generally not for very small (under 15 or so employees) companies, which usually find ESOPs impractical.
- Cannot pay a synergistic price, as explained below in more detail.

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RECOGNIZING THE ESOP CANDIDATE

As you look at businesses in your community, there are several factors that must be present for a company to be a candidate for an ESOP:

Profitability: The company must generate enough cash to buy the owner's shares, conduct its normal business, and make necessary reinvestments.

Payroll: There are some limits (albeit generous ones) on how much can be allotted to the ESOP's purchase each year so a business with an exceptionally high value relative to its payroll, may not be a good ESOP candidate. (This is a fairly rare situation.)

Minimal Existing Debt: If the ESOP must borrow to buy the owner's shares, the company's existing debt level must be low enough to secure an adequate loan. The company must not have bonding covenants or other agreements that prohibit it from taking on additional debt.

Corporation Status: If the seller wants to take the tax-deferred rollover, the company must be a regular C corporation (or convert from S to C status). S corporations can establish ESOPs, but their owners cannot take advantage of the tax-deferred rollover. S corporation ESOPs, however, have their own tax benefits. For owners selling gradually, the ESOP tax shield means that while they can't defer tax on the first sale, the non-taxability of the ownership attributable to the ESOP should increase the future value of their remaining shares.

Realistic Seller: The seller must be willing to accept fair market value for its shares. Third party buyers may offer to pay more for a company if it expects its acquisition to create valuable synergies. An ESOP will pay only fair market value as established by an independent appraiser.

Management Continuity: Banks, suppliers, and customers will all want assurance that the ESOP can continue to operate the company successfully. It is essential that key employees are motivated and prepared to replace the departing owner.

IF NOT AN ESOP, WHAT CAN YOU RECOMMEND?

If an ESOP is not an appropriate solution for keeping the business in the community, there are other ways owners can sell to employees. These include:

Outright Sale: In this rare scenario, employees, usually through substantial personal borrowing, pay the owner for the company. This type of sale involves considerable cost and risk to the employees. In this – and in all transactions – there are tax implications for both seller and buyers so both parties must seek competent tax advice.

Gradual Sale: If an owner wants to sell to employees, and if he or she is willing to stay in the business for at least five years and if there are employees who can assume the reins, it is possible to design a transfer to employees which keeps the owner in control of the company until he or she is completely cashed out. These sales require careful planning so owners should consult with experienced exit planning advisors.

Installment Sale: The seller holds a note that employees repay with interest, over time. Owners and employees must negotiate a number of issues in installment sales including: interest rate, note structure, contingencies on the use of corporate cash, the future role of the seller, and acceptable security. A variation of this approach cancels the note if the owner dies before the note is completely paid off. The purpose is to remove the asset from the owner's estate (and subsequent estate taxation), although many small businesses are already subject to the estate tax exclusion.

Table 2 summarizes how ESOPs compare to other transition strategies.

THE ROLE FOR ECONOMIC DEVELOPMENT PRACTITIONERS

ESOPs help both the communities in which they operate and the business owners who choose ESOPs as an exit path. Local development agencies charged with keeping their communities economically vibrant can and should be educating owners about ESOPs.

The federal government already provides incentives for employee ownership. Saving and generating jobs via ESOPs requires no new local or state tax incentives, no new special grants, and far less time than typical development projects. The cost of filling the ESOP information void is minimal.

Research

- Find out which owners in the community are age 50 and above.
- Find out which CPAs in the community have expertise in ESOPs.
- Find out which advisors in the community have exit planning experience.
- Fund an ESOP feasibility study of companies in your area.

Educate Yourself

- Use the information in this article as a starting point.

Table 2: Selling to an ESOP Versus Other Transition Strategies

	ESOP	Redemption	Sale to Employees	Sale to Third Party
Price	Set by independent appraiser	Negotiated	Negotiated	Negotiated
Taxation of gain to seller	Capital gains may be deferred in qualifying companies	Capital gains or dividend taxation	Capital gains	Capital gains
Deductibility of financing cost	Company gets tax deduction for funds contributed to the ESOP	Company funds used to buy the shares are after-tax	Employee funds to buy the shares are after-tax	Not applicable
Who provides financing	Company out of future profits or retained earnings; ESOP trust can borrow money to buy shares with company repaying the loan	Company out of future profits or retained earnings	Employees out of savings or loans	Buyer
Can sale be gradual?	Yes	Yes	Yes	Rarely
Who ends up as owners?	Most or all employees	Generally, one or more family members and/or managers	Selected managers	Outside buyer

Educate Owners

- Send out a flyer explaining an ESOP to business owners over 50 in your area.
- Hold series of ESOP information meetings for business owners. Or co-host these meetings with a local CPA firm that represents ESOPs.
- Interview an owner who has sold to an ESOP. Publish that interview in your local paper.

THE REST OF THE ROGER RYBERG STORY

Roger sold to an ESOP because doing so:

1. Met his financial objectives.
2. Offered the opportunity for extraordinary retirement benefits to his valued employees.
3. Assured the company's presence in his community of New Ulm.
4. Could be done over time so that Roger and his employees could continue to increase business value. In fact, during the 10 years between the initiation of the plan and Roger's departure, share price more than tripled. His employees were highly motivated by their ownership of the company through the ESOP.
5. Allowed Roger to retain control of the company until he was completely cashed out.
6. Enabled Roger to continue chairing the Board of Directors, made up of a majority of outside directors.

STEERING YOUR COMMUNITY THROUGH THE PERFECT STORM

No matter where you live and work, you are facing a tsunami: the pace at which baby boomers are reaching retirement age means an unprecedented number of businesses will transfer ownership over the next 10 years. More specifically, roughly 500,000 of these businesses, employing one-half of all employees in the U.S., will likely transfer ownership.

Iowa Enacts ESOP Legislation

House File 2284 created a state income tax exemption for capital gains earned from the sale of employer securities to a qualified Iowa ESOP. The plan must own at least 30 percent of the outstanding employer securities issued by the company once the sale has been completed. S or C corporations qualify. In 2012, Iowa capital gains tax rates were 8.98 percent.

The bill, which passed both houses with virtually no opposition, also initially appropriated $1 million from the state's general fund to the state's Economic Development Authority to establish a loan program and provide technical, educational, and contractor assistance to help companies establish ESOPs that would qualify for the program. Unfortunately, this provision was dropped in the final version of the bill.

While the tax incentive is valuable for owners in Iowa, experience with state outreach programs on employee ownership in Ohio and Vermont shows that states get a better return on investment from these programs than further tax breaks. Federal law already supplies substantial tax incentives. The key problem is that business owners do not know about how these plans work and often need some "hand-holding" to overcome their initial doubts.

Your job must be to keep as many of these businesses in your community as possible and the best way to accomplish that task is to orchestrate a sustained educational program to targeted business owners describing the benefits of planning their exits. Don't forget to include in your education outreach the benefits an ESOP provides to both the owner and to the community.

ENDNOTES

1 Aarti Maharaj, "Succession Planning Not a Top Priority for Business Owners," *Corporate Secretary*, December 8, 2010.

2 See *Selling to an ESOP*, National Center for Employee Ownership, 2010 for details.

3 Research by Douglas Kruse and Joseph Blasi of Rutgers University. For details on this and other performance data, go to the research section of the Web site of the National Center for Employee Ownership at www.nceo.org.