

Some pain, huge gain

How ESOPs can be the most cost-effective exit strategy **Interviewed by Matt McClellan**

For many entrepreneurs, the thought of selling the business they've poured so much of their lives into is difficult. Leaving the company, or even simply beginning to plan for succession, leads many owners to worry about the financial health of their business and the welfare of their longtime employees.

Glenn M. Gelman, managing director of Glenn M. Gelman & Associates, says an employee stock ownership plan may be the solution that benefits the owner's heart, conscience and wallet.

"ESOPs are the ultimate in golden handcuffs and succession planning," he says. "Both owners and employees become true stakeholders in the success of the business."

Smart Business asked Gelman about how to tell if this distinctive ownership structure is right for you.

How can an owner plan a succession strategy without closely involving his or her competitors?

One of the biggest risks owners have when they decide to exit the business is that potential outside buyers have the right to conduct due diligence. While prospective buyers must sign both a noncompetition and a nondisclosure agreement, these documents have a time limit and are very difficult to enforce. So in reality, this competitor, who may or may not buy your business, gains access to much of your company's most valuable data — key employees, major customers, as well as proprietary systems and procedures. The prospective buyer gains insight into your company's strengths and weaknesses, all of which exposes you to substantial risks.

In contrast, creating an ESOP completely avoids that situation, because no one in a position to compete with you is given any confidential information.

Why should business owners consider an ESOP?

There are several reasons creating an ESOP is so attractive. The value of your business is generally established using a fair market arm's length appraisal so you will receive an equitable price for your shares. Many believe an ESOP sale is an 'earn out' and to some extent that's true. While you are earning yourself out, Uncle Sam is helping you by potentially remov-



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ing the burden of federal taxation since, in the case of a 100 percent sale and an S election, the company would no longer be subject to federal income taxes. Moreover, your employees are much more motivated because the sooner the owner is repaid, the sooner the company belongs to the employees. Lastly, in many cases and if structured properly, the ESOP has great flexibility in awarding warrants, which allow the former shareholder some share of the upside, generally up to about 25 percent in the form of warrants or synthetic equity. So, the owner who worries he might have sold too soon still has up to 25 percent of the upside and can retain his job for as long as he wants to.

In a sale to an outside party, any third-party financing to pay for the acquisition probably has strict covenants and restrictions, which could prove burdensome if the company experiences difficulties. With an ESOP, you generally are the lender or the single largest creditor, and you are not going to foreclose on your own company. You are going to be much more lenient and allow the company to breathe during tough times. Both you and your employee stakeholders can take a long-term perspective. Employees don't have to worry that they are paying too much for the company. It's only when people retire that the value of

their ownership interest is cashed out. It's in everyone's best interests to keep building the value of the company.

What types of companies are best suited for ESOPs?

The first criterion is the company must be profitable. If it's not very profitable, then all the tax benefits and intangible values that can be enjoyed through an ESOP aren't present. Second, it has to have a lot of employees because otherwise there is not enough of a payroll base to calculate an adequate payback contribution each year to the selling owner. If you have a small company that is extremely profitable with very few employees, it is a much tougher fit than a large, nonunion company. Union companies can be owned by ESOPs; it is just a little more complicated.

How can a closely held business retain and empower key nonfamily employees as an ownership generation nears retirement?

An ESOP is the perfect vehicle for forming 'golden handcuffs' around employees. They eventually will become beneficial owners. However, they do not own shares of stock. Although you've sold your business to your employees, you've actually sold it to a trust that benefits the employees. The employees literally don't ever physically own any shares. However, they have units of participation, with accompanying rights attached to those units like any other qualified retirement program. The ownership trust invests solely in the stock of their employer. The employees' retirement economic interest is tied to the value of that stock. When they retire, they are given their interest paid in cash based upon the equivalent value of the stock.

The employee has every reason to stay until he or she is fully vested and to stay until normal retirement age, when the employee is entitled to distribution without penalties. Benefits are always paid immediately to employees who die or are disabled but are subject to vesting and other limitations found within all qualified benefit plans. The ESOP is a 'win-win' for the right employer. <<

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