Memphis Business Journal

Friday, October 23, 2009

ESOP opportunities

Program gives owners cash, employees equity

Memphis Business Journal - by C. Richard Cotton

To ESOP or not to ESOP? That is the question. And it's a good one, with myriad reasons for and numerous reasons against.

ALAN HOWELL | MBJ

Ben Buffington says ESOPs are primarily used as a transition vehicle for company owners.

View Larger

The employee stock ownership plan, just by its name, sounds like a good thing. Offer employees ownership in that company and you immediately build a stronger company whose workers are more dedicated to the success of the business.

Well, yes.

But the reality, according to experts in the field, is this: Most ESOPs happen because the company owner seeks to pull capital out of the company while avoiding taxation on that capital.

"They were traditionally used by banks to get stock benefits and tax breaks," says Ben Buffington, executive vice president of **Executive Financial Services**, Inc., a Memphis-based employee benefit consulting firm. "Now they're primarily a transition vehicle. At the end of the day, the employees are the owners."

The transition of ownership via ESOP is one of few available ways for businesses to change owners, according to Buffington. He estimates 20% of ownership changes are through ESOP, while purchase by a third party comprises 60%. The remaining 20% are through various other means, including bequeathing to heirs.

Buffington says the nation's economy and demographics play a big part in whether an

owner seeks to establish an ESOP: "People are using (ESOPs) more because of supply and demand. A large group of employees are reaching retirement age."

For the employee, an ESOP is basically a retirement plan that is supplemental to any 401(k) or pension plans the company might have in place, says Buffington. But the current market for selling a business is pushing many owners toward the ESOP option.

"There are more sellers than buyers," he explains.

But the bottom line, Buffington says of ESOP establishment, is "primarily about tax breaks." Federal law allows practically tax-free liquefying of a company's assets when the owner forms the ESOP, while selling to a third party presents capital-gains tax liability.

"Owners want cash out of the business," Buffington says.

There is, however, a substantial cost to setting up an ESOP because of the need to employ companies such as EFS, hiring of financial advisers and retention of attorneys. Buffington says the costs vary by company, depending on factors such as size, revenue and number of employees.

According to John R. Windsor Jr., principal of **Windsor Law Firm** in Memphis, an average company pays \$15,000-\$50,000 to set up an ESOP: "But it's all over the map. One trust company in Memphis wants \$100,000 up front.

"Then you have to hire an evaluation analyst to study it every year."

In his practice, Windsor has been attorney of record for numerous ESOP start-ups. He says the vast majority of them are legitimate deals that benefit both owners and employees, but that's not always the case.

"There are some real benefits to them, but there is certainly a scandalous side to them," says Windsor. "There are problems sometimes. You don't hear of the 50 that work well because of the one that hits the news."

He points to a recent case, though he wasn't involved with the transaction: A large printing company sought to buy a smaller printing company in the Midwest. They were days away from signing the deal when it came to light that the Midwest firm the owner was trying to sell was an ESOP company, amounting to fraud.

Windsor says the best ESOP candidates are companies that enjoy "enough of an employee base to work well" and firms staffed by long-term employees, as opposed to firms with a lot of turnover.

"I have a positive view of ESOPs," he adds, "but they're much more of a marriage than a date. And they can become a real tar baby, hard to get unstuck from."

Michael New says **Evolve Bank & Trust**, where he serves as senior trust officer, is trustee for ESOPs all over the country but, oddly, not many in the Mid-South. He points out that, of the 10,000-12,000 ESOPs in the nation, Ohio and California are home to the most. The number nationwide has been relatively stable the last few years.

"Many new ones are formed every year and many are dissolved," he says. As for why the Mid-South is not home to more ESOP companies, New figures it's a matter of maturation.

"Industry is not as mature in this area and there are not a lot of practitioners specializing in it," says New. "I hope in five to 10 years to catch up in this area."

New says that ESOPs run the gamut when it comes to what share of the company they comprise: "We have one client whose ESOP is only 5% of the company and several clients where it's 100%.

"We're working on one right now in Virginia that's 49% ESOP. The owners are close to retirement and want some money out."

The time frame for setting up an ESOP runs 60-100 days, accomplished after completion of a feasibility study, analyses and negotiations over terms. New says he usually returns to a company two to three weeks after the plan is unveiled to meet with employees and explain the details to them.

"They're the beneficiaries of a trust. It's free money," says New. He has returned to some companies after the plan has been in place for some time; employees have gotten on board, turning off lights and conserving paper towels, for example, to save the company money and put more of it into their own shares of stock.

"The value really sets in after they get that first statement," he says of employee support and enthusiasm. "I've seen employees making $14 an hour changing bedpans who have six-figure stock portfolios."

Executive Financial Services, Inc.

Employee benefit consulting firm
Founder and president: Kelly O. Finnell
Address: 7660 Poplar Pike, 2nd floor
Phone: (901) 682-7581
Web site: www.execfin.com

CONTACT freelance writer C. Richard Cotton at rcotton4@earthlink.net