

# MONEY MATTERS

## EMPLOYEE STOCK OWNERSHIP PLANS

*Wealth comes from selling your business.*

*For most business owners, the bulk of our wealth is tied to our companies. Financial planners readily bemoan the lack of diversification in our investment portfolios, pointing to the fact that we do not generate wealth by building a business. We actually generate wealth by successfully selling our businesses. As the baby boomer generation faces retirement, there is increasing concern with regards to turning the stock in our companies into cash. For most of us, an initial public offering is not appropriate. Unless one has a buyer standing in the wings, cashing out can be difficult.*

### THE EVOLUTION OF THE ESOP

The Employee Stock Ownership Plan, or ESOP, dates back to the 1950s, when lawyer and investment banker Louis Kelso developed the concept from his belief that the capitalist system would be stronger if all workers—as opposed to just a few stockholders—shared in owning the businesses they worked for. Currently the most common form of employee ownership in the United States, an ESOP is a benefit plan in which a company sets up a trust fund and contributes shares of its own stock or cash to buy existing stock. These contributions are tax deductible for the company. Shares are distributed to employees according to an agreed-upon formula, often based on the workers' relative salaries. Currently, there are approximately 11,000 ESOPs in the United States, covering over 8.5 million employees.

### IS AN ESOP FOR YOU?

Just 2% of MHEDA member distributors have ESOPs. In the near

future, as increasing numbers of baby boomers near retirement age, that number may see a dramatic increase.

In order for an ESOP to work, a company should be worth at least \$2 million and should be fairly stable. It should be somewhat insulated from dramatic ups and downs. The owner of a company who sells his stock to an ESOP must understand that eventually he will transfer the control of his company to someone else. One cannot sell the majority or all of the company to the ESOP and remain in control of its future. Consider the following data provided by the 1,300-member ESOP Association:

- Approximately 95% of the association's members are private, closely-held companies.
- ESOPs exist in large and small business—slightly more than half of the association's members have less than 250 employees.
- While ESOPs are prevalent in a broad range of industries, approximately 38% of the asso-

ciation's members are manufacturers; 13% of its members are distributors.

- Average annual sales revenue for members ranges from \$5 million to \$50 million.
- Nearly 80% offer a supplemental benefit plan in addition to the ESOP, including 401(k) plans, pension plans and profit sharing plans.
- 75% of the association's members report that motivation and productivity increased as a result of the ESOP.
- The average account balances among its members are \$173,224.
- At least 75% of its members used borrowed funds to acquire the employer securities held by the ESOP trustee.

### How It Works

In order for the stockholder to get his cash out of the company, he sells a percentage of the company to his employees. The company borrows the dollars needed to finance the purchase and then loans those dollars to the ESOP, which then writes a check to the business owner. The company repays the loan by making annual payments through the ESOP, treating the payments as an employee benefit. With each payment, the appropriate number of shares is transferred to the individual employee's ESOP account. When the loan is paid off, the employees will own whatever share

of the company is purchased, through the ESOP.

Just as in a 401(k) plan, the employee becomes vested and cashes out when he or she retires, is laid off, resigns or is terminated. At that time, the employee's shares are purchased by the ESOP, at its current value.

### **A VALUABLE EMPLOYEE BENEFIT**

As a compensation/retirement plan set up by a company and funded with its tax-deductible contributions, the ESOP can serve as a powerful recruitment and retention tool, especially for the smaller company that is competing for qualified personnel. Much has been made of the productivity and morale-enhancing aspects of employee ownership. A 2000 Rutgers University study found that ESOP companies outperformed both their own pre-ESOP operation and non-ESOP companies. The study reported that among 343 companies followed from 1988 to 1999, annual sales growth was 2.4 percent greater than what was projected. The average sales per employee also increased by an additional 2.3 percent. ESOP companies typically showed increased employment and added 2.3% more employees than were predicted, prior to the formation of the plan. The Rutgers study also found that ESOP companies were 15 percent more likely to have remained in business through 1999, compared to the non-ESOP companies involved in the project.

Both the research and the number of participating companies suggest that ESOPs "work"; that is, they increase company productivity and strength through a sense of ownership, responsibility and accountability among employees.

### **A SUCCESSION PLANNING TOOL**

In lieu of an initial public offering or transitioning ownership to a successive generation, the ESOP is a viable alternative in facilitating an exit strategy. **Modern Group Ltd.** headquartered in Bristol, Pennsylvania, established an ESOP in

1984. With the retirement of founder Joe McEwen, Modern culminated an 18-year transformation of the company into a 100% employee-owned company in November 2003. "The completion of the ESOP process is a milestone in Modern's history," says David Griffith, president and CEO. "The employees of the Modern Group have always been the backbone of our success, and the 100% ESOP puts the company's ownership directly into the hands of those who will

An annual audit by a CPA is required. The importance of communicating with employees cannot be underestimated. Modern Group's management team, consisting of Jack Smith, chairman, George Wilkinson, executive vice president and CFO, Tom Callahan, senior vice president of human resources, and David Griffith communicate often with employees. Griffith views this communication as critically important. "We are constantly teaching employees the basics

### **If You Want Employees to Think and Act Like Owners, Make Them Owners.**

For more information about Employee Stock Ownership Plans, check out these Web sites:

The ESOP Association [www.esopassociation.org](http://www.esopassociation.org)

The National Center for Employee Ownership

[www.nceo.org](http://www.nceo.org)

**Should You Have An Employee Ownership Plan?** Corey Rosen helps you answer that question in his article that appeared in the Winter 2001 issue. Read it again online.

make our future even brighter."

With an eye toward retirement, Warren Gandall, CEO of **Cisco-Eagle Inc.** (Tulsa, OK), established his company's ESOP plan four years ago. "It was a good way to transition the business. You never know what a third party is going to do after purchasing the company. Our employees had worked hard to build the business and I wanted them to benefit from that effort."

### **IT TAKES A SMALL VILLAGE**

In order to successfully develop an ESOP, the business owner will rely on key relationships with a variety of external providers of professional services. An independent valuation company must provide an annual valuation of the company. Your attorney should have experience in working with ESOPs and should be well-versed in pension and trust matters. A third party administrator will interface with both your attorney and your CPA in the administration of the plan.

in order for them to understand the value of ownership."

At Cisco-Eagle, a cross-section of employees are members of an ESOP Advisory Board and meet monthly. They are responsible for teaching their peers the value of the ESOP program and instilling in each employee the importance of the individual's role in driving the value of their stock. Company-wide quarterly meetings are held in order to keep all employees well-informed. According to Gandall, for an ESOP to succeed, employees must think like owners. "They have to know from the time they walk in the door to the time they walk out that they are driving their success."

While only a small portion of MHEDA members have ESOPs, this number is expected to rise in the near future. For business owners who know that wealth is created when you sell your business, it's important to remember to not discount the buyer under your nose.