By James G. Steiker
President, SES Advisors

STRATEGIC PLANNING

BUSINESS SUCCESSION PLANNING

The ESOP Alternative

"What will happen to my business when I leave?" All too often, business owners find themselves asking this question when they are ready to retire. Interestingly enough, an answer to succession planning woes might be in the company's employees.

An Employee Stock Ownership Plan – or "ESOP," is a tax-qualified retirement plan that invests primarily in employer stock. However, ESOPs offer much more than just employee benefits. To owners of closely held contractor firms, an ESOP can be used as a tool of corporate finance and a vehicle for owner buyouts. The ESOP essentially creates an internal market for the company's shareholders as it can purchase all or a portion of a firm's stock in one or more transactions, and may borrow money to acquire a significant block of company stock in a single transaction. What may make the ESOP most attractive are the ESOP's significant tax incentives for the company and the shareholders selling to an ESOP. Structured properly, ESOPs provide owners with both liquidity and succession at a controlled pace, while creating a management and employee focused company.

ESOPs were created with the passage of ERISA (Employee Retirement Income Security Act) of 1974. As qualified retirement plans, ESOPS are an employee ownership structure that is tax-favored. The non-profit National Center for Employee Ownership (www.nceo.org) reports that there are about 10,000 ESOP companies nationally covering about 10 million employees – about 11% of the non-governmental U.S. workforce. ESOP companies generally outperform their non-ESOP counterparts, measured by productivity and profitability. Owning stock in an ESOP allows participants to share in the growth of their company, creating an "employee owner" mindset.

Most ESOP transactions are leveraged, utilizing borrowed money to fund a purchase of shares from shareholders. The borrowed funds, usually obtained from a bank, are re-lent to the ESOP which uses the proceeds to purchase company stock from shareholders.

There are several key benefits from an ESOP transaction. First, ESOPs create an internal process for liquidity and succession. Second, because ESOPs create a stock-based employee retirement benefit, the borrowed funds are repaid effectively with tax deductible dollars. Third, a selling shareholder may potentially defer capital gains tax on the sale of shares to an ESOP under a special tax code provision.

An ESOP transaction must be properly organized and structured to realize these benefits. The ESOP financing must be coordinated with any special limitations on a contractor, such as bonding reserves or requirements. ESOPs may be the wrong tool for liquidity and succession if the company perceives little or no benefit from employee ownership. Finally, ESOPs should be used in conjunction with other equity incentive tools to make sure that key senior management receives a significantly enhanced ownership stake.

CONCLUSION
Compared to the "usual methods" an ESOP may be an attractive alternative for contractors pondering liquidity and management succession.