

Entrepreneur®

July 2006

MONEY

[DOLLAR SIGNS] Mutual Benefits

AN EMPLOYEE STOCK OWNERSHIP PLAN LETS YOU TAKE SOME CASH OUT OF YOUR COMPANY WHILE GIVING YOUR WORKERS A STAKE IN THE BUSINESS.

BY C.J. PRINCE **THANKS TO THE** media hype surrounding United Airlines' blockbuster bankruptcy in 2002, employee stock ownership plans got a reputation for being mainly a big-business tool. The troubled parent company of United was partially owned by an ESOP until it filed Chapter 11. But ESOPs are far more common at companies with \$20 million to \$50 million in revenue, says J. Michael Keeling, president of The ESOP Association in Washington, DC. "When one big company like United Airlines gets involved with an ESOP," he says, "the impression is [that only big companies are] doing them. But that's not correct."

For the entrepreneur who wants to start getting liquidity out of his or her company in anticipation of a transition, but doesn't want to sell and risk the displacement of employees and the loss of a legacy, an ESOP is worth a look. In addition to giving workers another incentive to do their best, ESOPs offer lucrative tax benefits for both the company and its owners. Contributions to the plan are tax-deductible, and S corporations don't pay federal taxes on the percentage of earnings owned by the ESOP. Also, a C corporation owner selling at least 30 percent can defer paying capital gains tax on the proceeds, as long as they're invested in other U.S. companies' securities. "There are no other ways a company can use its own funds to buy out an owner on a pretax basis," notes Corey Rosen, co-founder and executive director of the National Center for Employee Ownership in Oakland, California.

The tax benefit was a big draw for Mary-

land Office Interiors, a 23-year-old Baltimore company that set up an ESOP in 2001. The owners didn't want to sell outright and weren't thrilled about the idea of bringing in VCs. "[VCs'] valuations are a little more aggressive, but their expectations for growth are a lot more aggressive," says company president David Noel, 44, who oversaw the setup of the ESOP plan, which began with a 30 percent allocation.

Setting up an ESOP is also a way to cash out gradually, maintaining full control of the company for as long as you want, notes Keeling. "You can begin to get liquid and diversify your assets, and still be CEO of the company," he says. "Lenders love to hear that because most of these companies are healthy, and they want to hear the same leadership is going to be there."

Getting bank approval is significant because companies typically have to borrow to fund the first ESOP transaction. There are ways around that, though. When M. Nelson Barnes & Sons Inc. decided to set up an ESOP, the Cockeysville, Maryland, contractor chose to fund the trust account for four years prior to the first stock purchase for 30 percent of shares. "Historically, we had never carried a lot of debt, and we wanted to keep the balance sheet clean," says CFO Greg McGowan, who adds that as of March, the company is 100 percent employee-owned.

There are other challenges besides debt, to be sure. An ESOP will be a greater administrative burden for the CFO and will



require an independent valuation every year. The company also must be able to shoulder its repurchase obligations in the future, when vested employees leave, die, are disabled or retire. "Even at 35 percent, that [amount] can get very large and become a drag on capital investments," says Keeling.

The National Center for Employee Ownership recommends that all companies do a feasibility study, either with a simple business plan in-house or with **an outside consultant, such as Morristown, New Jersey-based SES Advisors (www.sesadvisors.com)**. Although costs vary by size and complexity, expect to pay about \$50,000 to \$60,000 to set up the plan, Rosen estimates. "That seems like a lot compared to a profit-sharing plan—and it is," he says, but not necessarily when compared to selling the business, if that's the ultimate goal. "It's tough to sell a business [spending] less than 10 percent of its value. With an ESOP, it's a fixed amount." And while you're at it, you get a retention vehicle that makes employees feel like part of the family.

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75%
of entrepreneurs are aware of direct deposit, but only **26%** use it to pay employees.

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