

# THE EMPLOYEE BUYOUT

## A COMPELLING EXIT STRATEGY FOR PRIVATE SELLERS

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### Introduction

This article will demonstrate how an employee buyout using an Employee Stock Ownership Plan (“ESOP”) structure can bring over 100% of the transaction value in *additional* financial benefits to the buyer and seller(s). This article explains how these benefits are achieved and demonstrates that an employee buyout should be seriously considered when selling a privately owned or closely held company. To visualize this, imagine a \$100 million employee buyout transaction and note that at least another \$100 million in additional financial benefits would be available to allocate among the parties. That’s an effective doubling of the original purchase price. There are also compelling reasons for using an employee buyout structure that are not financial in nature.

Why would a seller of a highly successful and growing manufacturing company turn down a premium, full cash offer from a private equity group backing a management-led buyout in favor of selling his or her stock to the employees and an ESOP? Why would the owner of a rapidly growing publishing company choose an employee buyout over a very attractive offer from a well-capitalized buyout group? Why would an owner of a highly profitable retail firm turn down a very high offer from a strategic buyer and sell to the firm’s employees instead? The answers are different in each case.

In the first case, the seller did not want his company to be consolidated into a larger group or to be sold again to the highest bidder in five to seven years. In the second case, the seller was interested in the continued rapid growth of the company. In the third case, the strategic buyer could not bring enough additional financial benefits to the table to compete with the employee buyout. In each of these cases, the sellers wanted to keep their companies locally owned and maximize the after-tax proceeds of the sale transaction. They also learned that virtually all employee buyouts using an ESOP are competitive in terms of what they can bid, as well as how much cash the employee buyout can bring to the table. Employees can afford to buy most owners out—provided the employees find the right partners and bring their own resources into the transaction wisely. An employee buyout can pay fair market value, and fair market value is a range that includes the value indicated by these third party offers. An employee/ESOP buyout will beat a financial buyer almost every time because it doesn’t need a venture capital targeted rate of return. Many times even strategic buyers cannot compete with an employee/ESOP buyout. Sometimes, though, the greater fool theory will bring a third party offer no one else, including the employees, *would* want to match. Notice the emphasis on “would.”

### Overview

For sellers of privately owned or closely held businesses, an employee buyout using an ESOP is generally accomplished in whole or in part through an ESOP structure combining employees, management, investors and an ESOP trustee. An employee buyout is different than an ESOP—an ESOP may be included in an employee buyout, but it is not necessarily true that an employee buyout will contain an ESOP. We will occasionally call this combination an employee/ESOP buyout.

An employee buyout is a change of control transaction where the purchase of a majority interest in a company is made by most or all of that company’s employees. Most often this is done in ways that almost all employees are able to participate in the buyout. Most employee buyouts are generally accomplished, in whole or in part, through an ESOP structure within the employee buyout structure, leaving employees,

management, investors and an ESOP trustee as the new owners of the majority interest. More extensive definitions may be found at [www.BenefitCapital.com](http://www.BenefitCapital.com).

Generally, only shareholders of closely held corporations (“Private Sellers”) are eligible for the full array of tax benefits of the employee/ESOP buyout. The Private Sellers can be individuals, partnerships, trusts, or estates. Shareholders of C corporations are eligible for all the tax advantages, while S corporations and LLCs are eligible for most of these benefits. Although most of the benefits of an employee buyout are also available to other entities, that discussion is outside the scope of this article.

As their businesses mature and the Private Sellers begin the planning process for their business succession and exit, several choices are available to them:

- a) Do an initial public offering,
- b) Sell to a strategic buyer, financial buyer, outside third party, or supplier,
- c) Redeem stock,
- d) Sell to management,
- e) Sell through an employee buyout, or
- f) Combine the best of b, c, d and e.

Instead of undergoing the expense and uncertainty of a public offering or attempting to sell their equity portion of the company to an outside buyer, Private Sellers can sell to the ready-made built-in buyer, the employees of their own company. In so doing, they can enjoy tax and financial benefits unrivalled by *any* other exit strategy.

### **Why Do an Employee/ESOP Buyout?**

Perhaps the following facts best demonstrate why an employee buyout may be better than a sale, merger, or public offering:

If the owners sell their closely held company to another company or third-party buyer, as Private Sellers they will pay an immediate capital gains tax, lose control of their company, and probably not be able to retain any residual equity.

If they sell their stock to the public, they will incur an immediate capital gains tax, become subject to the jurisdiction of the SEC, and risk the possible loss of control.

If they enter into a tax-free merger, the capital gains tax will be deferred; however, they will still have all the risk associated with a concentrated investment position, but likely without the control.

If they sell through an employee/ESOP buyout, they can defer the federal capital gains tax, maintain local control and/or management of the company, retain residual equity, and invest the proceeds in a diversified, low-risk portfolio of stocks and bonds, all while rewarding the loyal people who helped them build their business.

### **What are the Disadvantages of Employee/ESOP Buyouts?**

There are three aspects of employee/ESOP buyouts that might be considered “disadvantages.” The first is that the employee buyout structure will usually require debt. The second, if an ESOP is used, is the mandatory obligation of the corporation to repurchase stock from participants who die, retire, become disabled, or otherwise terminate service, and to provide liquidity to participants at certain ages. The third is that employee buyouts using an ESOP are perceived as complex. Each of the first two disadvantages can be turned into advantages if the ESOP is properly structured. [Specifically how this is done is beyond the scope of this article; however, we would be happy to explain if you would contact us at (800) 922-3767 or email us.]

The third, unfortunately, is accurate, since in fact employee buyouts and ESOPs are complex. And only a relatively few advisers have made the effort to understand their complicated workings. Further, the government has made the hurdles to a successful transaction more burdensome over the years by adding rule upon rule. On the other hand, the government allows the additional financial benefits in exchange for following the rules and regulations, something thousands of companies with employee owners and ESOPs do successfully every year.

Possible problems? Yes, everything that is worthwhile has problems. Being married has problems. Having kids has problems. Yes, and running a business has problems—and complexity. Nevertheless, we do these things because having what is worthwhile is clearly more important than the possible or even real problems and complexities.

### **Employee/ESOP Buyout Financial Benefits Compared to a Non-Employee Buyout Transaction**

Following is an overview of the potential benefits an employee/ESOP buyout transaction could provide to sellers. For purposes of this example, we have assumed a 100% employee/ESOP buyout from Private Sellers with a transaction value of \$100 million (and a negligible or zero tax basis in the securities sold). The proportionate benefits of using the employee/ESOP buyout with an ESOP being used as a technique of corporate finance can inure to the parties to the transaction regardless of size. In contrast to a sale to an outside buyer, transaction costs are generally less for an employee/ESOP buyout.

If an ESOP structure is used in the employee buyout, section 1042 of the Internal Revenue Code enables the Private Sellers (qualifying shareholders) of privately held C corporations who have a three-year holding period to reinvest the proceeds of a sale of that stock, to an ESOP for the benefit of the employees, into the securities of domestic, active corporations (debt or equity, public or private) on a tax-deferred basis that can become a permanent tax savings. The example assumes a 100% sale of the securities to the ESOP segment of the employee buyout.

#### Section 1042 Tax Deferral Benefit Comparison

	<u>Non-ESOP</u>	<u>ESOP</u>
Gain on Sale	\$ 100,000,000	\$ 100,000,000
Tax-(Combined Federal and State) <sup>1</sup> (20%)	<u>20,000,000</u>	<u>-0-</u>
Net Proceeds	<u>\$ 80,000,000</u>	<u>\$ 100,000,000</u>

<sup>1</sup> Assumes state of residence sale where this benefit is recognized for both state and federal tax purposes (rounded).

#### Reinvestment Benefit (assumes a let-it-ride and compound approach)

Additional Proceeds from Sale (taxes saved)	\$ 20,000,000
After-Tax Reinvestment Return (Assumed Rate)	.05
Life Expectancy - Years (Assumed)	21
Total Future Value of Reinvestment Benefit	<u>\$ 55,720,000</u>

#### Computation of Additional Total Financial Benefits to the Sellers

Section 1042 Rollover Benefit	\$ 20,000,000
Sellers' Reinvestment Benefit	<u>35,720,000</u>
Sub-Total of Additional Financial Benefit to Sellers	<u>\$ 55,720,000</u>

As evidenced above, the total *additional* benefits to the sellers attributed to the employee/ESOP buyout are approximately 50% of the transaction value. It is the overall magnitude of the additional financial benefits and enhancements an employee/ESOP buyout can provide that appeals to potential Private Sellers and makes an employee/ESOP buyout worthy of further evaluation.

### **Corporation's ESOP Principal Payments Tax Deductible**

Principal payments on the ESOP financing are tax deductible for the ESOP portion of the employee buyout. This gives rise to another financial benefit of up to \$40,000,000 on a \$100,000,000 transaction (or 40% of the transaction value). Another way to look at this is to recognize that the corporation has to earn \$166,666,670, pay \$66,666,670 in taxes at a 40% combined federal and state rate, to be able to pay \$100,000,000 toward principal. That's approximately 67% of the transaction value.

### **100% ESOP-Owned S Corporations Pay No Federal Income Taxes**

Once a company has been acquired through an employee buyout using a 100% ESOP, by electing the S corporation status for its tax structure the company becomes a virtually tax-free operating entity. This comes about as a result of the S corporation passing its tax obligations through to its shareholder, which in this case is a tax exempt, qualified trust, and not liable for the payment of federal income taxes. This is an enormous benefit for the company and its new shareholder (the ESOP), in that the pretax cash flow enables the ESOP to more rapidly repay any transaction debt, fund future growth and provide benefits to the employee/owners.

For the employee buyers (through the ESOP), the additional financial benefits of electing S corporation status can exceed 50% of the transaction value. Imagine a corporation 100% owned by the employees that has to pay no federal income taxes. For more information, please contact us.

### **Employees as Equity Holders**

Employees, who often favor long-term growth over short-term profit, can now be motivated to regard the company through the eyes of an owner. Upon receipt of distributions (usually upon retirement) the employees are eligible to pay a combination of capital gains and ordinary income taxes. This usually results in a *much* lower overall tax rate than for other qualified plans that do not distribute employer securities.

### **Conclusion**

An employee/ESOP buyout structure can bring over 100% of the transaction value in additional financial benefits to the buyer and sellers. The employee/ESOP buyout provides many benefits for sellers, both for the initial transaction and for years afterwards. The employee/ESOP buyout provides a versatile transaction format that can be applied to a wide range of transactions and a format that produces substantial tax savings and financial benefits to both buyer and seller. Is an employee/ESOP buyout worthy of further exploration? Knowledgeable Private Sellers consider an employee/ESOP buyout to be the most compelling exit strategy ever devised. Sellers (and their advisers) not totally familiar with the full value an employee/ESOP buyout can provide have much to gain by learning more about them. Our offices would be pleased to discuss with you the various ways and means of properly structuring this exit vehicle. Benefit Capital has been involved in over \$5 billion in employee/ESOP buyout transactions.

*"Business owners spend a lifetime building equity in their businesses. When it is time to convert some or all of this equity into cash, the employee/ESOP buyout may be their ultimate exit strategy."*

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### **Employee Buyout Information Hotline**

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### **About the Author—Robert W. Smiley, Jr.**

Robert W. Smiley, Jr. is Chairman of the Board and a Managing Director of The Benefit Capital Companies Inc., a national group of merchant banking and financial advisory firms headquartered in Southeastern Nevada, with offices in Irvine, CA; Los Angeles, CA; Katonah, NY; Dallas, TX; and Honolulu, HI. His principal functions include the implementation of management and employee buyouts using employee stock ownership plan (ESOP) and other tax advantaged financing techniques.

Mr. Smiley has been involved as a principal, consultant or adviser to over \$5 billion in successful transactions in diverse industries over the past 30 years. He is a member of the management team of Benefit Capital Partners, which provides equity financing for management, employee, and other buyouts.

Mr. Smiley is a founder, past president and lifetime member of the Board of Governors of The ESOP Association, a nonprofit trade association for ESOP companies with over 2,200 current members and a full-time Washington, D.C. staff. He is a member of the Association's Advisory Committee on Legislation and Regulatory Issues. Mr. Smiley is also a director of The National Center for Employee Ownership and a founding editor of and contributing author to its flagship publication, *The Journal of Employee Ownership Law and Finance*. He is also a former trustee of The Employee Ownership Foundation.

Mr. Smiley has testified before the Committee on Finance of the United States Senate in regard to pension legislation. In recognition of his contribution to pension policy in the United States, he received the President's Special Achievement Award from the President's Commission on Pension Policy. He is the senior editor and a co-author of *Employee Stock Ownership Plans: Business Planning · Implementation · Law and Taxation*, first published in 1989 with current annual yearbooks published through 1998 by Warren Gorham Lamont, and currently undergoing a major revision for publication in 2004.

Mr. Smiley has served on the faculty of the University of California, Los Angeles (UCLA) Extension. He served as a trustee of the Reason Foundation, a free-market think tank, for nine years. Mr. Smiley received his A.B. in Economics from Stanford University and an LL.B. from LaSalle University, Chicago. Prior to entering Stanford he served a tour of duty in the United States Navy. He is a current member of the State Bar of California and the American Bar Association. He is listed in *Who's Who in America*. He has served as a director for a number of companies, both public and private.