TESTIMONY ON *ACT ESTABLISHING AN EMPLOYEE OWNERSHIP PROGRAM TO PROMOTE BUSINESS RETENTION AND GROWTH*

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Companies with 1,000 or fewer employees, almost all of which are closely held, provide almost 60% of all private sector jobs in the U.S. Over the next ten years, baby boomers will be retiring in record numbers, and as a result more than twice as many of these companies will be for sale than has normally been the case. Surveys show that over half of the owners of these plans have no business transition plan, and sales data show that only a quarter to a half of all closely held business with 10 or more employees find a buyer when they are put up for sale.

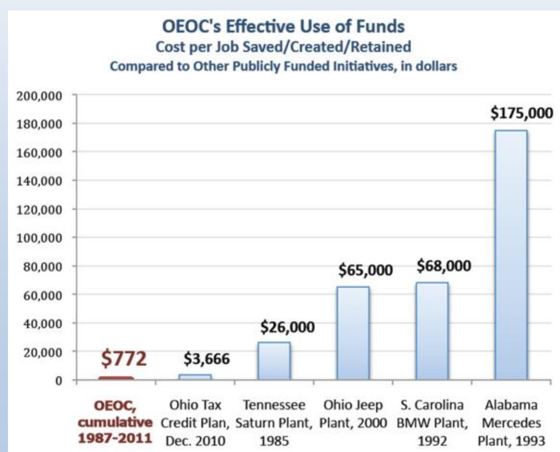
As a result, too many Connecticut companies, including healthy, profitable ones, will end up closing or being sold to out-of-state buyers who may initiate layoffs or move the company out of the state.

States are largely ignoring the opportunity to retain and create new jobs by addressing this problem through low-cost education programs for owners of closely held companies on business transition planning. One business transition strategy is particularly overlooked—employee stock ownership plans (ESOPs). ESOPs were designed specifically by Congress to be the most tax-effective, flexible way to provide for business transition, and they provide numerous advantages from a state's perspective:

1. Businesses remain open and in-state.
2. Less than 0.5% of ESOPs default on their loan (compared to 6% to 19% for private equity buyers).
3. Employees accumulate 2.5 times the retirement assets as employees in other plans (which they can then spend locally).
4. ESOP companies generate 2.5% more new jobs per year than these same companies would have generated if they did not have an ESOP.
5. According to the General Social Survey, employee-owners are far less likely to be laid off, at one-quarter the typical rate.

Creating Jobs at a Fraction of the Price:
The Ohio Employee Ownership Center (OEOC)

Housed at Kent State University, OEOC is a nonprofit that provides services to Ohio businesses interested in exploring employee ownership. The OEOC is funded by grants from a public and private agencies and foundations, program income, and fee-for-service work. OEOC has assisted employees in buying all or part of 92 companies, creating 15,000 employee-owners, at a cost in state funding of $772 per job created or retained.



To create an ESOP, a company sets up an employee benefit trust. The owner sells her shares to the trust, and the company pays for those shares over time by making contributions; the employees do not pay for the shares. The shares are allocated to employee accounts based on relative pay or a more level formula. When employees leave the company, they receive a retirement benefit based on the appraised market value in the trust. ESOPs are similar in many ways to 401(k) plans, and are subject to substantial federal regulation to ensure they operate fairly. Studies have shown that businesses' profits can increase after ESOPs are established and combined with employee engagement structures. We estimate that there are about 2,000 to 3,000 companies in Connecticut employing about 300,000 people are potential ESOP candidates over the next ten years.

So given these advantages, why are there not more than the 12,000 or so ESOPs (or ESOP-like plans) in the U.S. covering 11 million employees? By far the most common reason is that business owners are just not aware of ESOPs or how they work, or if they are, they often have misconceptions. Business advisors often do not know about ESOPs, and business brokers, who do not get commissions from selling a company to an ESOP, have no incentive to tell owners about ESOPs. Most business owners rely on advisors they know when considering transition alternatives, but the reality is that few of these advisors know much about what is a specialized area of law.

This presents an important opportunity for states. By making more business owners aware of ESOPs, many more companies can become rooted in local communities at a nominal cost to the state. Compare that to the $80 billion that is estimated to be spent nationally on incentives to get companies to relocate from one state to another, ultimately a zero-sum game that comes at a cost of tends or even hundreds of thousands of dollars per job.

States can take on this task in a variety of ways, but the most cost-effective by far is to increase awareness by creating an organizational capacity to provide timely, objective, and widespread information. This organization would work to:

- Create greater awareness through outreach programs such as seminars, webinars, and brochures, often done in conjunction with local business organizations.

- Refer owners to qualified professionals in the field.

- Help owners do an initial assessment of whether an ESOP makes sense on a one-to-one basis if state staff members can develop basic expertise.

- Provide additional training, networking opportunities, and information for ESOP companies after the transition to help grow profitable ownership cultures.

Providing this assistance through an intermediary organization funded by the state, as this bill provides, is a particularly good approach that should limit state overhead costs. The winning bidder should already have extensive knowledge of the field and contacts with relevant professionals and intermediary organizations in the state that would make start-up easier. Long-term, many of these efforts should be partially self-funding as well.

In the late 1980s the National Center for Employee Ownership looked at the rates of ESOP adoption in three states that had employee ownership centers at the time like the one described here (Ohio, Washington and New York; the latter two programs eventually lost their funding due to state budget crises). We found that the number of new ESOPs in these states was 25% to 30% higher than what would otherwise be expected based on national trend lines at the time.

The appendix below describes how ESOPs work as a business transition tool.

Appendix

Using an Employee Stock Ownership Plan (ESOP) for Business Continuity in a Closely Held Company

One of the most difficult problems for owners of closely held businesses is finding a way to turn their equity in a business into cash for retirement or other purposes. The decision to sell is more than an economic one, however. After putting years into a business, an owner develops a strong feeling of identity with the company. At the same time, the owner often has a sense of loyalty to the employees and would like to see them have a continuing role in the company.

For some business owners, the answer to these problems will be to turn over the company to an heir or sell to a competitor. But many owners do not have heirs interested in the business, and outside buyers are not easy to find. Even if they can be found, they may want to buy the company for its customer lists, technology, or facilities, or may just want to put a competitor out of business.

ESOPs (employee stock ownership plans) can be a very attractive and tax-favored alternative. For the owner of a C corporation, proceeds on the gain from the sale to the ESOP can be tax-deferred by reinvesting in the securities of other domestic companies. If these securities are not sold prior to the owner's death, no capital gains tax is ever due. If the company is an S corporation, LLC, or partnership, it can convert to a C corporation before the sale to take advantage of this tax deferral. If the company stays S, the owner does pay capital gains tax on the sale, but reaps all the other benefits of selling to an ESOP. The most important of these is that the owner's shares are bought in tax-deductible dollars, either from company contributions or plan borrowings. The sale can be all at once or gradual, for as little or as much of the stock as desired. For the employees, no contributions are required to purchase the owner's shares. The owner can stay with the business in whatever capacity is desired. The plan is governed by a trustee who votes the shares, but the board appoints the trustee, so changes in corporate control are usually nominal unless the plan is set up by the company to give employees more input at this level.

An ESOP is a kind of employee benefit plan, similar in many ways to qualified retirement plans and governed by the same law (the Employee Retirement Income Security Act). ESOPs are funded by the employer, not the employees. Stock is held in a trust for employees meeting minimum service requirements and allocated to employees based on relative pay or a more level formula over item, then distributed after the employee terminates. ESOPs cannot be used to share ownership just with select employees, nor can allocations be made on a discretionary basis.

Financing an ESOP

The simplest way to use an ESOP to transfer ownership is to have the company make tax-deductible cash contributions to the ESOP trust, which the trust then uses to gradually purchase the owner's shares. Alternatively, the owner can have the ESOP borrow the funds needed to buy the shares. In this way, larger amounts of stock can be purchased all at once, up to 100% of the equity. Normally, the bank will loan to the company, which then reloans to the ESOP, not necessarily on the same terms. In some cases, such as when the total debt would exceed current book value, the bank may also want a personal guarantee, or may be willing to loan only part of the total sought. In that case, the ESOP would buy part of the shares now, and part after some of the debt has been paid.

If a commercial lender cannot be found, the owner can take back a note. In this scenario, however, the rollover would apply only to what is reinvested in the first year. The entire amount of the sale could only be reinvested, therefore, if the seller has other funds available or, as normally happens, the seller borrows money from a bank to buy special ESOP bonds that qualify for this kind of sale (an increasingly common approach). The seller then repays the banks with the proceeds of the note. However the money is obtained, the price is set by an independent appraiser, as discussed below.

If the company is a C corporation and the owner has held the shares for at least three years, once the ESOP owns 30% of the company's shares, the owner can reinvest the gains in the securities of other U.S. companies (other than real estate trusts, mutual funds, and other passive investments) within 12 months after or three months before the sale, no taxes are due until the replacement securities are sold. If the owner buys income-yielding securities and lives on the proceeds, giving them to an estate at death, no capital gains tax is due. If part of the securities are sold, tax is due only on a prorated basis. (This tax incentive is not available for S corporation owners.)

Tax Benefits of Selling to an ESOP

Compare the ESOP buyout to two other common methods of selling an owner's shares: redemption or sale to another firm. Under a redemption, the company gradually repurchases the shares of an owner. Corporate funds used to do this are not deductible. A $3 million purchase in a redemption might require over $5 million in profits to fund once taxes are paid. Moreover, the owner must pay tax on the gain, at capital gains or dividend rates. In a sale to a C corporation ESOP, the money made is considered a capital gain, not ordinary income, and taxes can be deferred. Even more important, the company only needs $3 million to fund the $3 million purchase, something that applies as well to sales to ESOPs in S corporations. Or consider the second alternative, selling to another company or individual. In a cash sale, taxes would be due immediately. If the sale is for an exchange of stock in the acquiring company, taxes can be deferred until the new stock is sold, but 80% of the company must be sold all at once and the owner ends up with an undiversified investment for retirement.

How the Price the Selling Owner Receives Is Determined

The price the ESOP will pay for the shares, as well as any other purchases by the plan, must be determined at least annually by an outside, independent appraiser. The appraiser's valuation will be based on several factors. Most appraisers try first to find comparable public companies and use their price/earnings ratio, price/assets ratio, and other guides for setting a price. Discounted cash flow, book value, the company's reputation, future market considerations, and other factors will be considered as well. The appraiser will try, as much as possible, to determine how much the business would be worth if there were a market for it. The appraiser is assessing what a financial buyer would pay, one who would operate the business as a stand-alone entity. A strategic buyer, such as a competitor, by contrast, might pay an additional premium because when the target company is acquired, there are perceived operational synergies that make the target more profitable to the buyer than it would be as a stand-alone entity. The ESOP cannot match this price because it cannot generate these synergies. Sales to synergistic buyers do trigger capital gains taxes, however, and often come with numerous contingencies.

How Employees Get Stock

ESOPs are much like other tax-qualified retirement plans. At least all employees who have worked at least 1,000 hours in a plan year must be included. They receive allocations of shares in the ESOP based on relative pay or a more level formula. If there is an ESOP loan, the shares are allocated each year based on the percentage of the loan that is repaid that year. The allocations are subject to vesting for as long as six years. Employees do not receive a distribution of shares until they terminate, and then the distribution can be delayed for five years if for reasons other than death, retirement, or disability. The plan is governed by a trustee appointed by the board; employees only have very limited required voting rights (they do not have to elect the board, for instance), although companies may provide additional rights.

It is important to understand that ESOPs do not allow employers to pick and choose who can get stock or to make allocations based on discretionary decisions. It is also critical to remember that ESOPs do not entail employee using their own money to buy shares. The company funds the plan.

S Corporation ESOPs

If a company is an S corporation, the profits attributable to the ESOP are not taxable. So if the ESOP is a 30% owner, income taxes are not due on 30% of the profits; if it is a 100% owner, no taxes are due, a rule that has led to the rapid growth of 100% S corporation ESOPs, often conversions from C corporation companies with ESOPs after they make the final purchase of shares.

Making the Decision

All of this may sound appealing, but it is not feasible for every company. Several factors must, at a minimum, be present:

1. *The company is making enough money to buy out an owner.* The company must be generating enough cash to buy the shares, conduct its normal business, and make necessary reinvestments.
2. *Payroll must be adequate to cover the purchase.* Because there are some limits (albeit generous ones) on how much can go into the ESOP each year, if a business has an exceptionally high value relative to its payroll, it may not be a good ESOP candidate, although this is an unusual scenario.
3. *If the company is borrowing to buy the shares, its existing debt must not prevent it from taking out an adequate loan.* Similarly, the company must not have bonding covenants or other agreements that prohibit it from taking on additional debt.
4. *If the seller wants to take the tax-deferred rollover, the company must be a regular C corporation or convert from S to C status.* S corporations can establish ESOPs, but their owners cannot take advantage of the tax-deferred rollover described above.
5. *The seller(s) must be willing to sell their shares at fair market value, even if the ESOP pays less than an outside buyer would.* An ESOP will pay the appraised fair market value based on a variety of factors, but sometimes an outside buyer can pay more for a company if it has a particular fit that creates synergies that go beyond what the company is worth on its own.
6. *Management continuity must be provided.* Banks, suppliers, and customers will all want to be persuaded that the company can continue to operate successfully. It is essential that people be trained to take the place of departing owners to assure a smooth transition.

Conclusion

For many owners of closely held companies, an ESOP is an ideal solution. For others, it simply will not work. To make a decision, create an initial business plan, factoring in legal costs, the costs to buy the shares, and the company's cash flow. If that looks encouraging, talk to an accountant about your figures. If things still look promising, have a valuation done. Your valuation specialist will tell you how much your stock is worth and should also give you a more detailed idea about the practicality of selling these shares. If things still look good, hire a qualified ESOP attorney to draft your plan. As you consider an ESOP, find some other ESOP company executives to talk to, attend an ESOP meeting or two, and finalize your plans with all the key players.