NEITHER A BORROWER NOR A LENDER BE

November of 2007 was a time of great economic uncertainty. Lehman Brothers had collapsed. There was a meltdown in the credit markets as a result of the subprime debacle. We were in the midst of the second-worst stock market in history. This might not seem like the best time for a business owner to begin a business succession planning project, especially if the company is in the contracting/construction business. But that is exactly what one company did.

This client was referred to us by his CPA, Don. Don and I had known each other for 20 years and had a number of mutual clients.

The Company was owned by a gentleman in his early 70's. He had three long-term key employees who were his anointed successors. He had begun his succession planning several years ago when the Company purchased $2 million of life insurance to fund a buy-sell agreement with the successors. However, the Company was now worth $4 million and the owner was uninsurable.

The Company wanted to use an ESOP to fill the gap between the Company's value ($4 million) and the amount of life insurance funding that was in place ($2 million).

Our first thought was that the Company should implement a leveraged ESOP. Under this structure the Company would borrow money to fund the ESOP's purchase of $2 million of stock from the owner. The loan could come from the Company's bank, from a Seller Note or from a combination of these two sources. However, because of the credit market meltdown, it was virtually impossible to get a loan during November 2007. Therefore, we suggested that the owner consider funding the entire sale with Seller Notes. We had many clients who had used this approach during the credit crunch. It gave them the ability to implement a plan without being dependent on bank credit.

While Seller Note financing was more attractive to this business owner than bank financing, he wanted to take a super-conservative approach that would eliminate the need for any debt. After all, even if he were the "bank," the Company would be increasing its debt during a time of great economic uncertainty. To a conservative business owner, this didn't seem like a prudent decision.

The plan we implemented was an "unleveraged" ESOP, meaning that there was no debt. Under this approach, the Company would evaluate its financial situation at the end of each year and determine how much, if any, stock it would have the ESOP purchase from the owner. At the end of 2007, the Company had a profit of $500,000, which it contributed to the ESOP. The ESOP used this money to purchase $500,000 of stock from the owner.

There are several key points to keep in mind when considering an unleveraged ESOP.

Value of the stock to be purchased

When selling to a leveraged ESOP, an owner sells a block of stock for a price established pursuant to an independent professional valuation. The price of the stock is established as of

the date of sale. Any increases or decreases in value following the sale will have no impact on the seller. In this example, the owner would have sold half of his stock for $2 million.

With an unleveraged ESOP the price is determined in the same way. However, the price of future sales cannot be locked-in at today's value. Therefore, the business owner assumes the risk that the value of the stock may decrease in the future. If this Company had 1,000 shares issued and outstanding at a $4 million valuation, each share would be worth $4,000. Therefore, $500,000 would purchase 125 shares. However, if the Company's value decreased the next year by 15%, each share would be worth $3,400 and $500,000 would purchase 147 shares. Please note that for the sake of keeping this example as simple as possible we have ignored minority interest discounts used in valuations.

The point is that an ESOP cannot enter into an agreement to purchase stock in the future at a predetermined price. The ESOP cannot pay more than fair market value of the stock determined "as of the date of the sale" by an independent professional appraiser/valuation consultant. Therefore, when using an unleveraged ESOP, the owner assumes the risk of future fluctuations in stock price. Of course, if the price the ESOP can pay for stock at some point in the future is not acceptable to the owner, he doesn't have to sell. It also should be noted that if a company's value is increasing, it could benefit an owner to do an unleveraged ESOP and to reap the benefit of future stock appreciation.

Allocation of stock to participants' accounts

With a leveraged ESOP, shares that are purchased are initially held in the ESOP "suspense account" and are allocated to participants as the ESOP debt is repaid. In contrast, with an unleveraged ESOP, there is no ESOP suspense account and all shares are allocated to participants' accounts immediately upon being purchased.

Consider the following example that illustrates the difference in share allocations between a leveraged and unleveraged ESOP. Assume that in each case we have 500 total shares to be purchased for $2 million. In the first example we'll assume that the 500 shares will be purchased by a leveraged ESOP, using a 7-year loan. In this case, shares will be released (using the principal only method of share release) in equal amounts over seven years resulting in 71.43 shares being released each year. If we had used an unleveraged ESOP and the Company had contributed $500,000 per year – assuming that the stock value didn't change – all of the shares would be purchased and allocated in four years. This would result in 125 shares being allocated to participants each year – a much faster share allocation than the leveraged ESOP.

The faster share allocation often is not an issue for business owners. However, it should be quantified and evaluated prior to implementing a plan.

Owner's income tax consequences. If the owner had taken the Company's $500,000 year-end profit as a bonus, his federal income tax liability would be $175,000 (35% of $500,000). However, if the Company contributes $500,000 to the ESOP, which it uses to purchase stock from the owner, his federal tax liability will be $75,000 (15% of 500,000). The owner saves $100,000 in taxes as a result of paying capital gains tax on sales proceeds as opposed to paying regular income tax on a bonus. The total tax savings on the full $2 million stock value would be $400,000.

We structure many more leveraged than unleveraged ESOPs. However, unleveraged ESOPs have an important role in business succession planning, especially during times of economic uncertainty and tight credit markets.