ESOPs: The Overlooked Potential Buyer of a Closely Held Business

Business owners who are seeking to sell all or a portion of their business frequently overlook one of the best options available, namely, selling stock in their company to an Employee Stock Ownership Plan (ESOP). An ESOP is an employee benefit plan that buys and holds company stock for the benefit of the business' employees.

Unlike most business sales, where the original owner or owners lose control of their business, an ESOP represents the interests of the employees which usually align with the interests of the original owners. The stock that is sold to the ESOP is held in trust by a trustee for the employees, but typically is not dispersed to the individual employees. Consequently, the original owners need not deal with multiple new owners. Moreover, the ESOP serves as a strong motivational tool for the business' employees. Like the original owners, the employees will want the business to grow so that their beneficial interest in the ESOP trust increases in value.

When selling stock to an ESOP the seller receives payment for his interest – just like when he sells to an outsider – but, under a special provision of the Internal Revenue Code, he does not pay tax at the time of the sale. In order to enjoy this tax break, several requirements must be satisfied, the most significant of which is that at least 30% of the stock must be held by the ESOP after the sale. Because the 30% threshold is fairly low, ESOPs can be effectively used in a wide array of situations. Consider the following situations:

- A father has spent the last forty years of his life building a business. He has one or two children who are active in the business, to whom he wants to pass the business. At the same time, he wants to take some money out of his business to use and enjoy during his older years and, perhaps, to pass on to his other children who don't work in the business. The father sells a minority interest in the business to an ESOP and passes the rest of his stock to his children who remain in the business.

- A business has been run successfully for many years by three partners. Two of the owners want to continue on, or to bring in their children, but the third does not. For a variety of reasons, it is not practical to have the two remaining partners buy out the third. The third sells his interest to an ESOP on a tax-advantaged basis, and the business continues to be run by the two remaining owners.

- An individual has worked hard to build a business over many years. He gets divorced and has significant maintenance obligations to his former spouse. He doesn't want to sell his business or bring in a new partner. He sells a minority interest to an ESOP in an installment sale and uses the sale proceeds to make his maintenance payments.

As these examples suggest, an ESOP can provide a creative solution to a variety of scenarios involving the sale of a business. Business owners should therefore always consider this option when looking to sell all or a part of their business.

Our attorneys have worked on a wide array of ESOP transactions. If you think that an ESOP might have application to your situation, please contact Jay Fenster, Esq., jfenster@dmlawyers.com, 914.948.1556, ext. 8005 or Robert B. Danziger, Esq., bdanziger@dmlawyers.com, 914.948.1556, ext. 8006.