

Ben Wells and Jim Carlisle – Tales from the Trenches

John: With me today are Ben Wells and Jim Carlisle, two attorneys who focus their practices on business owners and business planning. Jim, why don't you spend a minute and tell us a little bit about your law firm.

Jim: Dinsmore and Shohl is a law firm, a national law firm, with about 650 lawyers, 22 offices throughout California, Colorado, Connecticut, Illinois, Michigan, Ohio, Pennsylvania. We have an office in DC, and we practice in just about all commercial areas. All of the business law areas, intellectual property, litigation, labor and employment. We have substantial practices in many of the main commercial niches.

John: And, Jim, what is it that you do for your clients?

Jim: I'm chair of Dinsmore's national growth and Exit Planning practice group. We have outreach in each one of our offices and we engage with clients from an Exit Planning perspective which leads to the legal work of mergers and acquisition, general corporate work. And, then with my partners and associates in other practice areas, it also leads to a lot of work in all the peripheral areas including estate planning, litigation, labor and employment. So, growth and Exit Planning is a great niche practice, not only to develop the work that I do, but to develop a lot of other work that many of the other outstanding lawyers at Dinsmore will help me to carry through with.

John: Well, that's great. And, I assume that one of those outstanding lawyers is Ben Wells. Ben, welcome to the program.

Ben: Hello.

John: Ben is one of the ESOP experts for the Dinsmore law firm. So, Ben, tell us a little bit about how you work with business owners in this whole ESOP arena.

Ben: Sure. We typically get involved with business owners either, folks who know our reputation in the ESOP community, or business owners who are existing clients or sometimes business owners who are referred to us by accountants, investment people, or frankly sometimes other lawyers who don't have ESOP expertise. And we work with them to see whether an ESOP is an appropriate vehicle for them to consider in their Exit Planning process, because ESOPs, although they're a great tool, aren't necessarily appropriate for every business and for every owner. And then if it looks like after we've explained what an ESOP is and what the process is and made an initial analysis of whether they're a good candidate then usually the next step would be to put together a team to do a more formal feasibility study for the ESOP. And if that produces a result that the business owner likes, then we assemble the larger team to actually structure and implement the ESOP transaction.

John: I think that's really a good point that especially with ESOPs; owners don't have to make a decision of, yes, I'm going to use an ESOP, or no, I'm not going to use an ESOP. It's really a process almost like dipping your toe into the lake to see how hot is to, and you can gradually

accumulate information and knowledge sufficient to make a decision without spending a lot of time, or very much money to make that initial decision that at least feasibility study is necessary. Is that an accurate way of portraying that?

Ben: That's a great point, because really the owner is in the driver's seat in an ESOP transaction. As you know, if you hire an investment banker and want to put your company on the market, that process can sometimes take a life of its own. Competitors find out, people in the community find out that the business is for sale, and it's a train that can be difficult to stop once it gets moving. Whereas, with an ESOP first of all, no one but your advisors has to know that you're considering an ESOP. You don't need to, at least until you're much further down the process, you don't need to tell your employees or anyone else – your suppliers, your customers – you can go pretty far along through the process really without anybody knowing that you're considering this as one of your options. And, as the owner, as I said, you're in the driver seat. So, if at any time, you don't want to continue it, whether it be because you've had a change in heart, or you've had a better offer, or you just decide that you're going to wait a while, you can do that. Really, there are no adverse consequences other than maybe having to pay some initial fees for the time of the folks who've helped you up to that point.

John: So that's a great starting point that it's not a costly venture, at least until you decide to go ahead and actually create an ESOP. So, what is an ESOP and what goes into the decision-making process of creating an ESOP?

Ben: Great question. What is an ESOP? An ESOP is, at its core, a retirement plan in many ways similar to a 401K plan. That is, it's a tax-exempt trust. It's exempt under Section 501 of the Internal Revenue Code, which means the trust doesn't pay federal income tax. Each employee who is eligible to participate in the ESOP has an account, and ultimately, although usually not right away, that employee will have shares of the company allocated to his or her account and those shares provide funds for the employee's retirement. The difference between an ESOP and other retirement plans is that an ESOP first of all, is allowed to invest exclusively in employer stock along with some cash that it keeps on hand for distributions. And, the ESOP can borrow money, including borrowing money from the company that sponsors it or from a selling shareholder. So, it uses those borrowed funds to buy shares of stock in the company. So, those are the two big differences between an ESOP and other types of retirement plans and those are what make the ESOP, able to buy company shares.

John: What then, does an owner who wants to use an ESOP as an exit path, what does the owner do? Does the owner sell his or her ownership to the ESOP?

Ben: That's right. And there are different ways to structure it depending upon the situation. Sometimes the owner will sell shares directly to the ESOP and that allows the owner to, in some cases – if it's a C corporation – to defer taxes on the gain that would otherwise be recognized on that sale. Or, in other cases, sometimes the company will redeem the shares from the owner and then, in turn, the company will sell the shares to the ESOP. And which structure we use depends on the situation, and it's really not something you need to address until you get further down the line. But, ultimately, that's how it works.

John: So, there's clearly some tax advantages to an owner in selling his or her ownership to the ESOP, and I know that when the stock is paid for, really through the revenues of the company at some point, that too is tax deductible to the company. So, it really is a very tax effective way of selling the business.

Ben: It's very tax effective, particularly, and most of the transactions we see now, once the company becomes an ESOP, if it's not already an S corporation, it elects S corporation status, and of course that means that the company is a pass-through entity and doesn't pay taxes itself. So, where we end up is, we have a company that's a pass through, and those profits are being passed through to the tax-exempt ESOP trust. So, in fact, we avoid paying taxes, at least corporate income taxes at any level in an ESOP transaction because the company is passing through its profits to a tax-exempt entity. That savings in tax can, in many cases, be enough to fund the ESOP transaction.

John: And then that cash that goes into the ESOP is used either initially or ultimately to acquire the owner's ownership interest in the company?

Ben: Exactly.

John: We could talk a long time about the tax advantages, but there's no other exit path that provides the tax advantages both to the company and potentially to the selling owner as does an ESOP. But ESOPs aren't used universally in business exits. So, what are the, drawbacks to using an ESOP? Do we have to have a certain size of a business? Are there a lot of costs involved in designing and implementing and using an ESOP? What holds owners back from actually using an ESOP?

Ben: As far as what holds owners back from, from an ESOP, there are a number of things. I would say, first of all, is lack of knowledge. Many owners aren't aware of the benefits of an ESOP. Many advisors aren't as aware of the benefits of an ESOP as they should be. So, in a lot of cases when we describe the ESOP and the benefits that it offers, their first reaction is this can't be true. And, their second reaction is, why doesn't everyone do this? And, as I say, although ESOPs aren't appropriate for everyone, they do offer a lot of great benefits. The downsides are – I mean there are some – first of all, a transaction can be complex. You do have more parties involved than you might in a typical transaction because you've usually have to hire a trustee, the trustee has a financial advisor, the trustee has an attorney. The company will have usually an ESOP attorney that is experienced in the area, in addition to the regular company counsel. So, there's several sets of lawyers involved. Once you get into the transaction, there are different financial advisors involved, and usually there's an independent trustee involved. So, there's several people involved in the transaction. It can be expensive. Although, in the context of an Exit Plan, it's not degrees of magnitude more expensive than other options that businesses usually go through, such as a sale to a third party. Those can be expensive as well.

John: Right. Again, I think most of those expenses are going to be incurred only after the owner has gone through a feasibility study and thoroughly understands the benefits, the disadvantages and all the costs. So, they've got the ability as they move into this planning concept to basically pull the plug at any point before running up all those costs. Is that a fair way of looking at that?

Ben: That's correct. Even once the process starts, the owner can pull the plug on it. And, we've seen that happen on rare occasions. So of course, then the folks that have worked on it to that point would need to be paid, but even then, the fees would be lower than what they would if a transaction had closed.

John: I think that's a great overview of the planning process and what an ESOP looks like. Jim Carlisle, would you give us an example of how you've worked with business owners maybe before they made the decision to sell the business to an ESOP and how they should've transitioned into the decision to go through with an ESOP?

Jim: I'm happy to. So, a recent case was a company that had three owners, had over 200 employees, and about \$60 million in revenue and over \$4 million in EBITDA. And, they came through to engage with us to take them through the Exit Planning process. Through the Exit Planning process, we dug in deep as to what their objectives were and what they were trying to achieve. And what we learned was, they didn't want to necessarily consider a third-party sale due to confidentiality concerns, and due to fear that it would disrupt their culture and their community, and jeopardize some jobs of their employees. And, they wanted to keep the business intact. So, they opened up with the desire that they wanted to structure and to effectuate a management buyout. They confidently said that they had at least four managers that wanted to, and were willing to, step up and to procure financing to trigger this management buyout. So I, as part of the process, the discovery process of the Exit Planning process, I interviewed these employees, and I asked them what their view was of a management buyout. And, in these private interviews, they disclosed to me, first of all, they didn't have much in the way of money to contribute towards the management buyout, and on top of that, a number of them were not willing to incur the kind of risk to kick start the management buyout. Even though we discussed this is a once in lifetime opportunity and you guys as a group can step up to buy this company, it was clear the owner had a misperception about their ability and about their desire to effectuate a management buyout. So, after I went back and talked to the owners about that and disclosed the status, that knocked them back a bit because that really was their expectation, and now their safety net was removed. And, I said, guys, based on your objectives, why don't we consider an ESOP? And, they said, yeah, we're really not interested in learning more about that. And, I said, guys, just listen. Let's have a presentation and listen. And, they said, no, we don't want to talk about it. So, we met with investment bankers at their request, and we walked through that process. Even though they didn't want to do a third-party sale, we still walked through that process. There were some concerns, lingering concerns, that were consistent with their opening concerns and, finally, I said again, guys, as a favor to me, go through some meetings on ESOPs and when you're done, if you say you're still not interested, I'll shut up forever and we'll move on and you don't have to hear from me again. So, they agreed. And, we had a meeting and they took in maybe 30-40 percent of the knowledge. Then we had another meeting where they took in a higher percentage of the knowledge, and they started to come around to the concept. They admitted that opening up, they had almost like a socialist impression of what an ESOP would be like. They felt like the end company would be inefficient and wouldn't be competitive, and it wouldn't be something they'd be proud of. So, we started to focus on the different elements that, for one, you can manufacture your own deal. So, you can obtain full fair-market value. You can retain control, salary and benefits until you're paid in full. You can indefinitely defer your capital

gains tax on your profit and your company post-closing will be a completely income tax-exempt entity. So, when I explained that, I said it's anything but a socialist enterprise because afterwards you have a company that can fuel its growth with the money that it would've been paying in taxes. So, it is an ultra-competitive company, and the employee that had already expressed a reservation about risk and about financial leverage, they can end up owning the company and they don't have to pay a dime for it. They, in essence, can earn it through working for it over the time post-closing. So, after meeting, they decided to proceed with the ESOP and now these guys are so happy that they did it, and they are proud to tell people about it. It gave them the opportunity to exit in style. Like you have said many times over the years, John, that they feel very comfortable that they're taking care of their employees that preserve the company for the benefit of the community and that now they can exit with complete peace of mind knowing that that's been taken care of. So, it was a wrestling match to get them to hear about it, but once they became fully informed, it became clearly the best choice for them.

John: You know, this is a podcast about ESOPs, but I think what this really makes clear, hopefully, to the audience is the importance of working with an Exit Planning advisor like Jim Carlisle because Jim – I may be assuming this, Jim – but from your perspective, whatever exit path the owner took, whether it was selling to management or selling to a third party or selling to an ESOP, your role was really to find the best possible path that met all of their goals and aspirations. You're not personally invested in any particular exit path and so you are able to, in effect, be the devil's advocate almost in having these owners really deeply consider all of these different exit paths. And, in this case, an ESOP worked out best in a large part because, one, the management team which I find to be very common, wasn't willing to risk anything. They're willing to take ownership, but they weren't willing really to pay what it takes to become an owner, which is to sign on the financing and the debt and things like that on a personal basis. And, ESOPs where there is an alternative, and Ben you might want to chime in here, what I found with ESOPs, when they work well, it's frequently – probably often – the case that part of it's the tax benefits, part of it's ensuring the owner has financial security, but a large part also is that it achieves these other goals and aspirations of an owner such as keeping the business in the community, maintaining the cultural value, providing employment for the employees of the company after the owner has exited. And, all of those are what I call softer goals. Is that what you find as well when you work with ESOP companies and owners who are interested in ESOPs?

Ben: Yes, we do. Although let me start by, you don't have to have any altruistic goals in order for an ESOP to make sense. We've had a number of transactions where the owner sold to an ESOP merely because it was the best deal. But certainly, a lot of the owners, and probably a majority of the owners that we deal with, do think about those issues. And let's face it, they've put their heart and soul into this business for a long time in many cases, and sometimes most of their life. And, they don't want to see a private equity firm close it up or move it out of town. They don't want to see employees laid off. They want to see it thrive, they want to see their community thrive, and sometimes they may have family members working in the business, so they have a vested interest making sure that the business continues to do well.

John: Sure. That's a good point.

Ben: So an ESOP for those folks, can make a lot of sense. And Jim mentioned the management buyout. We see the same thing, and in many cases, companies have explored a management buyout before looking at an ESOP, but because of pricing issues, lack of capital – and particularly tax inefficiencies because the management usually is trying to buy the company with after-tax money, and that makes it very difficult. With the tax efficiencies of an ESOP, you can reward those key employees and those management members. They'll have the opportunity to earn a good salary, they will usually get additional incentives in the form of stock appreciation rights even in addition to their participation in the ESOP. So, it can be a great alternative to a management buyout.

John: If we turn for a minute to looking at ESOPs from a perspective of advisors, business advisors, who are not ESOP experts. They might be a CPA for a successful business. They might be the lawyer, the financial planner. What can we tell them, or suggest to them, that they should be talking to their clients about when it comes to an ESOP, because they're not going to be ESOP experts. So, how do they even begin that conversation that maybe business owner you should consider an ESOP. And Jim, let me start with you from your perspective of being an Exit Planner first and then Ben, maybe get some more of the specifics from you of what do you initially talk to clients about when you're talking about ESOPs. So, Jim, if I can get your perspective first?

Jim: I have the belief that the Exit Planning process arrives at the right answer every time. And, I think you earn the right to have that opinion as to what the right answer is. So, when you follow the BEI process and you do the hard work of requesting the documents, receiving the documents, reviewing the documents, providing the documents to a multidisciplinary team, meeting with the multidisciplinary team when they've been fully informed, discussing the owners' objectives and digging into the solutions, I think you end up earning the right to have an opinion as to the direction that it should take. And, when it comes time, if an ESOP is something that the group and Exit Planner believe that the owners should consider, you have to be persistent. You owe it to the client. It's our job to make sure that we articulate what we believe might be the very best answer, and I don't give up. And, so on the ESOPs, I don't go as deep as Ben does being an ESOP expert, but I've been involved in many of these cases that I can speak to the highlights. So, when I say, guys, you can obtain full fair market value. If we go out to a third-party sale, you may or you may not be able to. The market conditions might not permit it right now. So, who knows if you can – I can tell you for sure we can obtain full fair market value through an ESOP. You can emerge with a tax-exempt entity. You can defer your capital gains. You can retain control of the company and your salary and your benefits until you sell your last tranche of stock. So, with those things being said, what more do you need to hear to be willing to sit down with Ben and to become educated? You owe it to yourself, you owe it to your employees, you owe it to the community, you need to learn about this. And, I'll be persistent and I can usually get them to sit through that meeting. And, what I've found through experience is these owners do not ingest the detail all at once. For many of them – and you have to be patient with them because you don't want them to feel bad about themselves. To feel ashamed that they're not bracing the complexity. So, you give it to them in different doses in different sessions, and you help educate them. And, I find once they get educated, it leads to the next session. And, if it truly is the right recommendation, they will hear it and they'll consider it and a lot of times they'll proceed with it.

John: That's really what distinguishes Exit Planning from representing that client as a CPA, or as a lawyer, or as a financial planner. It's that search for what makes the most sense for the owner and providing the owner with information so that the owner can make an intelligent decision based upon the facts, based upon the realities of his situation and the appropriateness of the different exit paths. Like you said, we will always end up with the right decision because it's ultimately going to be the owner determining what he or she wants, and they're going to have the information and the support from you to make that decision and move forward. I think that's part of the beauty of Exit Planning. So that was really well said. So, Ben, when that owner is brought to you by, not by Jim because then they're well informed, but by an advisor who maybe doesn't have the same background and experience Jim does, but they do realize that an ESOP is a possibility, what is your relationship with that advisor? Do they remain involved in this decision-making process or do you bring in the ESOP experts at that point?

Ben: Well, it depends on where we are in the, I suppose, the life cycle of the Exit Plan. If the owner has decided, yes, an ESOP is a direction I want to go and I've been educated on it, I understand it, then we'll proceed from there. But if, in many cases, if an ESOP is just one of the options on the table, then we'll go through a process similar to what an Exit Planning consultant would do. And, that is spend some time talking to the owner trying to find out their goals, what motivates them, what their time frame is for their Exit Plan, how involved are they in the business now, how involved do they want to stay in the business, do they have family members in the business, what's their management team look like? The kinds of things that any good consultant would try to find out. Because that tells us, first of all, are they a good candidate for an ESOP? And secondly, is that the best option for them? Once we determine that, then we can proceed to do a deeper dive. And, of course there are some characteristics that the company has to have in order to be able to operate an ESOP going forward. You have to have some reasonably consistent cash flow. You have to be able to support some amount of leverage. If the company's already leveraged to the hilt, then it's going to be difficult to put an ESOP on top of that. You have to have an owner who is comfortable with the idea of having another seat at the table. The owner still can retain control of the business and its operations, but the owner also has to realize that the employees have a stake in this business now and so he needs to operate accordingly.

John: Right, right. I think this has been a great discussion. I think it really points out something I think a lot of Exit Planners appreciate as in that ESOPs are underused as an exit strategy and as we explain and provide information to owners about the advantages and disadvantages of ESOPs, in the right situation, they make an awful lot of sense. But, at the end of the day, it's always going to be up to the owner to, based upon all the information they would want or need, to make that decision. Jim or Ben starting with you perhaps, Jim, any other suggestions or comments you'd like to make about this before we wind this podcast up?

Jim: Well I think it's very important to associate with the right other professionals so that when you make the handoff to the right person, they are informed and cooperative and work in a style that you're used to in connection with the Exit Planning process. It's worth it as an advisor to take time to research the potential resources out there that can work with you and can help you to effectuate an ESOP and to educate your clients.

John: That's great. My viewpoint is very similar to that, and it's that as our BEI members become members, we really encourage them to work with, what I call, next level advisors. And maybe a client has those next level advisors. But, almost all of Exit Planning clients, business owners, want to get to a higher level, to get to a next level of maybe business value or business growth or cash flow or a tax strategy that might be more sophisticated than what they're used to seeing. And, that often requires finding and using the best advisors in your community. And that's one of the benefits of Exit Planning; we tend to increase the level of expertise and effectiveness of advisors through this Exit Planning process. Ben and Jim are two good examples of that. Ben, any other thoughts that you have on ESOPS and the whole Exit Planning process?

Ben: No. I would just, echo what you and Jim have said, and that is if you're considering an ESOP, first of all try to educate yourself. There's information out there that as an advisor you can learn more about them. Learn to recognize clients that might be a good candidate for an ESOP. Then don't be afraid to contact specialists who do ESOP transactions all the time because they'll be able to – the good ones – will be able to give you a candid view on whether or not your client is an appropriate company for an ESOP and how you might go about doing the best job for that client.

John: Well, thanks again for both of you, Ben and Jim. this has been a very useful podcast both for owners and for their advisors.