Exit planning for the small business owner can be very challenging. One strategy often used is the sale of stock to an employee stock ownership plan (ESOP). An ESOP is an attractive exit strategy because it can provide significant tax savings to a selling shareholder and the business entity owned by the selling shareholder. However, sale of stock to an ESOP can be problematic if the business owner is unable to secure financing on acceptable terms. If financing is a problem, the business owner should consider the ESOP loan program offered by the Small Business Administration (SBA). Under the ESOP loan program, the SBA guarantees loans made by SBA-approved banks. Although historically there has been little use of SBA-guaranteed financing for ESOPs, there is an increasing interest in such financing.

The following is an illustration of a transaction using SBA guaranteed ESOP financing:

Example: Barry Pike wanted to sell a very successful environmental consulting firm located in downstate Illinois. The business operated as a corporation and Barry owned 100% of its stock. The business assets consisted of accounts receivable, goodwill, and other intangibles. Barry’s accountant estimated that the business was worth $6 million. Despite a diligent search, Barry was unable to find a buyer for his business.

At the suggestion of his financial advisor, Barry explored the sale of his stock to an ESOP. However, no bank or other lender was willing to lend money to the business to facilitate an ESOP transaction. Lenders told him that intangible assets do not provide them with satisfactory collateral for loan repayments. One of the lenders suggested Barry explore the loan programs offered by the SBA.

Barry approached a local bank that was an approved SBA lender. After extended negotiations, the bank agreed to make a $3.1 million ESOP loan under the SBAs 7(a) program. The loan was 75% guaranteed by the SBA. It was for a seven-year term and the interest rate was the prime rate plus 2%, adjusted each quarter. As collateral for repayment of the loan the company was required to pledge to the bank all of its assets and the ESOP was required to pledge to the bank a portion of the stock it acquired from Barry. No personal guaranty was provided by Barry, but he was required to loan the company $900,000. The company had $1.1 million of excess working capital that was available to help fund the purchase of Barry’s stock.

Although the ESOP loan program has not been widely used, interest in the program has been increasing.
To facilitate the SBA guaranteed loan and the ESOP’s purchase of Barry’s stock, the company established a new employee stock ownership plan and trust and appointed an independent trustee of the ESOP trust. The ESOP trustee hired an independent appraiser to advise it on the purchase of Barry’s stock. Following negotiations between Barry and the ESOP trustee, Barry agreed to sell 100% of his stock to the ESOP for $5.1 million. Financing for the ESOP’s purchase of stock was provided by the $3.1 million SBA guaranteed loan from the bank and by a $2 million loan from the company. The transaction steps were:

1. Barry loaned the company $900,000, repayment of which was subordinated to the bank’s loan.
2. The company used the $900,000 loan from Barry and its excess working capital of $1.1 million to make a $2 million loan to the ESOP.
3. The ESOP borrowed $3.1 million from the SBA-approved lender.
4. The ESOP used the $2 million loan from the company and the $3.1 million loan from the bank to purchase 100% of the company stock owned by Barry for $5.1 million. The company was then 100% ESOP owned.
5. The company agreed to make future contributions to the ESOP, in amounts necessary to enable the ESOP to make payments on the loans.

By taking advantage of the SBAs ESOP loan program, Barry was able to effect the sale of his company in a tax-efficient manner, retire, and generate the liquidity he wanted.

Why would a business owner want to sell to an ESOP?

An ESOP is a special kind of retirement plan that gives employees an ownership stake in their company by investing primarily in shares of the sponsoring employer’s stock. It is governed by the laws of private retirement savings plans, such as the Employee Retirement Income Security Act of 1974 (ERISA) and the Code, and must meet most of the general participation and benefit requirements applicable to qualified retirement plans. The sponsoring employer’s shares are owned by a trust managed by a board-appointed trustee, who may be an officer or other insider, or an external independent trustee. The ESOP can acquire shares on a ‘pay-as-you-go’ basis, or it can borrow funds to purchase shares from the plan sponsor or shareholder. The ESOP provides a way for employees to share in the future growth of the company and otherwise be given an incentive to work harder and more efficiently.

The use of an ESOP as an exit strategy may offer significant tax benefits to the sponsoring employer and its shareholders. For example, if certain conditions are met and the sponsoring employer is a C corporation, a selling shareholder who sells to an ESOP may be able to defer (and in some cases eliminate) income taxes on the sale of stock. If the sponsoring employer is an S corporation partly or wholly owned by an ESOP, the ESOP’s share of the company’s income will be exempt from federal income taxes.

Often, transactions are structured to obtain both benefits. One or more selling shareholders will sell 100% of a C corporation’s stock to an ESOP and, immediately after the sale, the C corporation will convert to an S corporation. As a result, the selling shareholders are able to defer the gain on the sale of stock to the ESOP, and no income taxes are paid on the corporation’s income. The ESOP exit strategy is the only shareholder exit strategy in which the shares owned by a selling shareholder can be acquired on a pre-tax, rather than after-tax, basis.

An ESOP may give shareholders a measure of liquidity, for events such as retirement, death, or other financial reasons. It can facilitate a company’s buyout of a shareholder in a shareholder dispute. The ESOP provides a ready market for such shares as well as the possibility of a flexible payment schedule for a company and a selling shareholder. The ESOP can also be a financing vehicle for a company. If a company requires funds, the ESOP can simply purchase additional shares from the company. The price paid by an ESOP occasionally exceeds what a third-party buyer would pay, thereby providing the selling shareholder with top dollar for his or her stock.

What is the SBA’s ESOP loan program?

The SBA is an agency of the federal government that is authorized through the Small Business Act to guarantee loans made by lenders to eligible small businesses. The SBA does not make direct loans to small businesses. Instead, it guarantees loans issued by approved lenders to encourage those lenders to provide loans to small businesses that might not otherwise obtain financing on reasonable terms and conditions. The ESOP loan
program is a component part of, and is governed by, the SBAs 7(a) Loan Guaranty Program. To qualify for an SBA-guaranteed ESOP loan, the sponsor of the ESOP must be a "small business." The SBA uses two measures to determine if a business is small: (1) SBA-derived, industry-specific size standards or, (2) a combination of the business's net worth and net income. The industry size standards vary by industry, but in general, the SBA considers $7 million in average annual receipts as the upper limit for businesses in the services, retail trade, construction, and industries with receipts-based size standards; 500 employees as the upper limit for the wholesale trade industries. A business is a "small business" under the net worth and net income test if it (a) has a tangible net worth of up to $15 million and (b) the average net income, after federal taxes, over the past two full fiscal years is not more than $5 million.

How can the loan proceeds be used?
Small Business Act section 7(a)(15) authorizes the SBA to guarantee a loan to an ESOP for the following purposes:

- **Provide funds for exit transaction.** The ESOP can borrow funds from an SBA-approved lender and use the funds to purchase a controlling (51% or more) interest in a company from one or more of the company's shareholders. The ESOP will often acquire 100% of the company's stock in order to maximize the tax benefits. There is a great deal of flexibility in structuring the financing for the transaction. Many times, the financing for the transaction comes from multiple sources, including SBA-guaranteed loans, seller financing, mezzanine financing, and balance sheet funds.

- **Provide financing for company.** The ESOP can also use an SBA-guaranteed ESOP loan to provide additional financing for a company. The ESOP can borrow the funds from an SBA-approved lender and then "releand" the funds to the company by purchasing the company's stock. The company can then use the funds for SBA-approved purposes, such as financing start-ups, business acquisitions, working capital, purchase of equipment, and certain refinancing of existing debt.

The SBA-guaranteed ESOP loan is repaid by the ESOP using tax deductible contributions received from the company. Because the company gets a tax deduction for its contributions to the ESOP, use of an ESOP as an exit/financing tool may provide significant tax benefits to the company and its shareholders.

**What tax requirements must be satisfied?**
To participate in the SBAs ESOP loan program, a small business must adopt an ESOP. The ESOP must meet all of the requirements of the IRS and Department of Labor regulations. This includes the general participation and benefit requirements of qualified plans. It also includes certain other requirements specific to ESOPs. One such requirement is that the sponsor of the ESOP must be a corporation. Although partnerships, LLCs, and sole proprietorships may qualify as a small business for SBA loan purposes, the Code prohibits them from sponsoring an ESOP. As a result, these types of entities cannot participate in the SBAs ESOP loan program.

However, it often is not difficult for a partnership, LLC, or sole proprietorship to convert to the corporate form of business. Many states have conversion statutes that enable a partnership or LLC to convert to a corporation using the process provided in the statutes. Generally, under the conversion statutes, the new corporation will automatically assume all of the rights, duties, and obligations of the predecessor partnership or LLC. The conversion usually does not trigger any income tax liabilities, but a business owner should check with his or her tax advisor before doing a conversion. After a business owner has satisfied the ESOP tax requirements, he or she can turn to the SBAs financing requirements, explained below.

**What are the terms of the SBA-guaranteed ESOP loan?**
Although the loan is made to the ESOP, the sponsoring company must agree to make contributions to the ESOP to provide the funds the ESOP needs to repay the loan. The company's ability to make contributions to the ESOP from the cash flow of the business is a primary consideration in the SBA loan decision process. The SBA will consider both the employer's earnings history and its projected future earnings. Good credit history, an experienced management team, acceptable collateral, and significant equity contributions are also important.

Generally, the terms and conditions of an SBA-guaranteed loan to an ESOP are:
• Maximum amount of loan. The SBA will guarantee loans of up to $5 million.
• Amount of SBA guarantee. The SBA will guarantee 75% of the principal of the loan, up to a maximum of $3.75 million.
• Repayment. The loan will be a term loan with a seven- or ten-year maturity date. Payments of principal and interest will be monthly, with no balloon payment permitted.
• Interest rate. The maximum interest rate on the loan will be prime (per the Wall Street Journal), plus 2.75%. The interest rate is floating, with no floor.
• Shareholder guarantee. No shareholder guarantee will be required if the company is 100% ESO P owned following the transaction. Otherwise, all 20%-or-more shareholders must provide personal guarantees backed by personal assets.
• Loan fees. SBA fees will range between 1.5% and 2.77% of the loan amount. The bank will determine the fees it will charge.
• Collateral. The business assets of the company.
• Financial covenants. Generally, there are none.
• Key man life insurance. The SBA may require assignment of an insurance policy on the life of one or more key employees for the amount of the loan.
• Equity. The SBA requires 25% cash equity as part of the transaction. The equity can be provided by either the buyer or the seller. A seller-financed note or a loan from a corporate officer may count as equity, as long as the note is subordinated to the SBA-guaranteed loan and no payments are made on the seller notes for at least two years. The SBA can insist that there be no payments of principal or interest on the notes until the SBA guaranteed loan is fully repaid.
• Termination of seller’s involvement in the business. The SBA requires that the selling shareholder sever all ties with the business following the shareholder’s sale of stock to the ESOP.

However, a one-year consulting contract is allowed.
• Bank’s terms and conditions. In addition to the terms and conditions imposed by the SBA, the lending bank may impose its own terms and conditions on the loan.

Bank’s decision to make loan
The bank usually decides whether to offer the loan to the borrower. If the bank considers the borrower to be strong financially, the bank may fund the loan without the SBA guarantee. If the bank is uncomfortable with the risk level, it will often structure the loan to fit within the 7(a) guidelines. The SBA guarantee assures the bank that it will get at least 75% of the loan back. SBA-guaranteed loans usually have a more favorable interest rate, a longer term, and less required equity than a conventional loan. The SBA-approved bank, not the SBA, makes the primary underwriting decision and administers the loan, subject to SBA guidelines. The SBA will step in to cover its obligation to fulfill its guarantee of 75% of the loan only if the borrower goes into default. Even though a borrower may fall within the SBA guidelines, the SBA cannot force a bank to make the loan. The SBA has no money of its own to lend. When making an SBA-guaranteed loan, often only the bank has contact with the SBA—there is usually no need for the borrower to have contact with the SBA.

Conclusion
ESOPs can provide a very effective, tax-efficient exit strategy for selling shareholders. However, many small and middle-market companies have not been able to use ESOPs because of their inability to obtain financing. Hopefully, increasing interest in SBA-guaranteed financing will encourage banks to reach out and make ESOP loans that they would not otherwise have made.