

Employee Stock Ownership Plans:

**Business Succession Planning
in New Hampshire**

Final Report

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A. Definition of the Problem

Planning for small business succession is a major challenge and opportunity for community economic development. Surveys indicate that less than half of New Hampshire small businesses have succession plans. Nationally only three in ten family businesses survive to the second generation and one in ten make it to the third. Small business is defined here as firms with fewer than 400 employees. Firms larger than 400 tend to be of sufficient complexity to have more sophisticated accounting systems and succession planning.¹

Without a succession plan in place, the death or retirement of the founder, or the dissolution of partnerships, or the desire for divestiture by owners of closely held corporations often results in the dissolution of the small business firm and the sale of assets. There are significant and negative tax consequences following the death of an owner without a succession plan. The sale of existing businesses, even if successful, often results in their relocation, dissolution by competitors, or collapse under absentee owners. The lack of succession planning for small businesses is also a reflection of the lack of resources available for planning and a lack of attention to succession details which are typically postponed while dealing with the pressing matters of ongoing business at hand.

Communities, the firm's workers, and the stability of the local economy are jeopardized by the failure of businesses to plan for succession. In industries, such as small manufacturing that are undergoing structural change and consolidation, a lack of succession planning typically means the end of a firm and the permanent loss of what are often well paying jobs. In addition, even when successful businesses are sold to new absentee owners, these owners often will use the business as a cash cow and fail to make needed long term capital investments to maintain the profitability of the firm leading to its closure once its assets

¹ Information on family succession planning from C.N. Howe, "UNH Forums Offer Advice, Direction to Family Owned Businesses," *New Hampshire Business Review*, 9/29-10/12/95.

have been depleted.²

Clearly without effective business succession plans many small businesses will continue to fail. Beyond continuation of businesses, succession planning may be used, as well, as a means for developing worker ownership and heightened community control of small business enterprises.

The Employee Stock Ownership Plan (ESOP) is a potentially highly effective means for business succession planning applicable to many small firms, as well as, a means that can lead to heightened employee ownership and community control. The Employee Stock Ownership Plan was established under the tax and retirement law as a benefit program that provides improvement in the company's financial performance, offer very significant tax and financial benefits to owners, and build employee ownership and a succession plan for the firm.

An ESOP can be of two basic financial types: Leveraged and Non-leveraged. In a non-leveraged ESOP the firm makes payments to the owner for some or all of the ownership of the company stock. These payments are considered expenses under the tax code and improve a company's balance sheet. The payments received by the owner may be reinvested in the stock of another firm and are exempt from taxation. Thus in the basic non-leveraged ESOP the workers gradually gain ownership of the firm as an employee benefit while the owner cashes out the value of her/his holdings.³

In a leveraged ESOP a bank loans money to the ESOP, generally guaranteed by the assets of the firm. Second, the ESOP uses the loan money to buy shares from the owner. Third, the owner transfers stock to the ESOPs. Fourth, the firm makes ESOP contributions each month equal to the loan payments. Fifth, the ESOP passes the contributions through from the firm as loan payments to the bank.

In both ESOP arrangements a trustee acts as a fiduciary to protect the interests of the employees and assures the firm is being purchased at a fair market value. This requires an objective and honest assessment of the firm's value, often a difficult procedure for existing owners who may have an

² See John Logue and Steven Clifford, "Designing a Model Outreach Program For Business Succession and Closely Held Firms," Northeast Ohio Institutional Small Grant Program Project Report, July 18, 1995, Photocopy.

³ See appendix for technical information on ESOPs from the Industrial Cooperative Association.

unrealistically high estimate of the value of their firm.

ESOPs are extremely technical legal and financial structures. Their nature in detail is not generally familiar even to bankers, lawyers, and accountants unless they are trained in ESOP matters.

By its nature, ESOPs are useful for *profitable* firms. A prime benefit for the firm in using an ESOP is to be able to expense payments and therefore reduce taxes. If the firm has no net income, there is little attraction either for the firm or its workers to undertake an ESOP. An exception is the use of ESOPs as part of a restructuring plan, whereby workers use an ESOP in association with a workout plan that may include wage reductions to both save and restructure a firm. Such an ESOP plan was used, for example, in the ESOP purchase of Market Forge, a kitchen equipment manufacture, assisted by the ICA.

The ESOP offers a means to heighten democratic control of the firm, as well as transferring ownership. In a democratic ESOP the workers voting rights for stock are passed through by the trustee to the workers who will instruct the trustee how to vote the shares that they hold before they have full control of the firm. The construction of democratic ESOPs is dependent upon the willingness of both the workers and the owners to pursue such a path. Cooperation can not be imposed upon either.

In sum, the ESOP is a useful tool to solve some of the problems of business succession planning. ESOPs are generally not useful for failing firms. ESOPs generally do not apply to very small firms, for example, less than 20 or 25 employees. ESOPs cannot reverse the business cycle or structural economic change. They can, however, offer a means to maintain community employment and moderate cyclical and structural economic change. They offer a way to help maintain a community economy and keep its resources circulating for the benefit of the community.

B. Project Goals

The project goal was to advance community based business succession planning in central New Hampshire through encouragement of employee stock ownership plan implementation. Analysis of the small business scene demonstrated that small businesses were generally not knowledgeable about the ESOP mechanism. There have been few ESOPs in small companies in New Hampshire. The ESOP appears as an interesting but rather esoteric and unavailable technique in the tool kit of small business owners.

Similarly, most bankers, attorneys, accountants who service small businesses are also relatively uninformed of the details and opportunities presented by ESOPs.

To advance the ESOP process, it was decided to use an indirect approach to the small business sector. That is, by educating financial and business service providers such as bankers, lawyers, and accountants small business owners would become acquainted with the possibilities of using ESOPs for succession planning.

The various professional service providers would find it in their interest to educate small business owners about ESOPs. The ESOP would become one of the financial products employed by bankers, lawyers, accountants with their small business clients. Not only does the ESOP provide a way for these professionals to market services, ESOPs keep the firm as a long term client for the benefit of the provider as well as for the community. Thus it is in the self-interest of the bankers, lawyers, and accountants to become knowledgeable about the details of ESOP organization and to advance the ESOPs as an option for business succession planning to their clients.

The Industrial Cooperative Association (ICA) has over a number of years provided detailed ESOP training and implementation for a variety of businesses involved in succession planning and employee buyouts. The orientation of the ICA is for the organization of democratic ESOPs. However, the ICA does not limit its activities to those ESOPs where there will be active worker participation, although that is preferred. The ICA has developed programs to educate a variety of constituencies including providers as well as business owners on the basic dynamics of ESOPs.

The project goal was to provide a basic seminar from the ICA for bankers as the lead group who would provide ESOP services. This is particularly relevant in New Hampshire because of the active concern of the banking community around the question of meeting their obligations under the Community Reinvestment Act (CRA). The activities of the citizen group, the New Hampshire CRA Association has led a number of banks to be quite mindful of the responsibilities under the CRA. Therefore, the situation was suitable to approach banks with the idea that an active program for ESOP promotion could impart fulfill the bank's requirements for a CRA strategic plan. This line of argument was suggested by Woullard Lett, the project advisor and New Hampshire College CED Program Administrator. Such a design was of interest as well to the New Hampshire CRA Association and its staff and board people including Martha Yeager and Arnie Alpert. They viewed the ESOP mechanism as a potentially useful organizing tool for CRA outreach to banks, as well as a useful tool for the community and its workers.

Providing ESOP training for bankers and other service providers clearly is a step towards advancing the business succession planning goal. It is, however, only one step both toward developing an effective ESOP implementation plan and toward resolving the business succession problem. ESOPs are a useful tool in the CED kit, but certainly cannot be said to represent a complete answer to the business succession problem, nor to the larger and more general problem of employment and community economic dynamism. Nevertheless, the ESOP strategy is a considered step towards engaging members of a key financial sector and involving them for the benefit of the community and its businesses.

C. Methods

The basic method was the ESOP training seminar to be offered by the Industrial Cooperative Association. This was accomplished in a two hour morning session at Franklin Pierce Law Center in Concord, NH.

The session satartes with refreshments at 8:00 a.m. To facilitate conversation by participants followed by a presentation by a skilled staff person of the Industrial Cooperative Association, Assistant Director Gail Sokoloff, on the dynamics of ESOPs.

This presentation, focused on bankers, included analysis of particular balance sheet items as well as general exploration of the tax and financial benefits of ESOPs.

The recruitment for the seminar was assisted by the N.H. Bankers Association. Jerry Little, President of the Bankers Association, was supportive. After reviewing the materials and qualifications of the ICA he decided to support the Bankers Association viewing ESOPs as a useful financial product and as a possible element of the CRA strategy development for bankers. The Bankers Association included the advertising materials for the October 1996 seminar in mailings that were distributed by the bankers. In addition invitations in the form of a flyer plus materials about the seminar and the Industrial Cooperative Association were mailed directly to a list of bankers compiled with the assistance of the New Hampshire CRA Association. These bankers expressed interest in working on community related economic issues.

In general the bankers were responsive to the idea of ESOP training and its value for them in their business.

It's interesting to note that over the term of the project as reflected in the appendices containing the original project contract and ongoing reports, the approach and methods hadchanged. The original focus for ESOP work was to be a training seminar for business owners. This proved not to be possible due to some resistance on the part of local business groups to get involved in such a process without, for example, joining the local Chamber of Commerce as a member at a substantial cost. The participation of attorneys in the seminar was also handicapped by a rather bureaucratic position taken by the N.H. Bar Association which made it difficult and somewhat costly to obtain certification for continuing education credit for

attorneys and addresses of those attorneys interested in this line of work.

Therefore, the focus shifted away from business owners and attorneys and toward the recruitment of bankers for the ESOP seminar.

Bankers are of course an important and often central player in business succession activities. I believed that by focusing on bankers we would open the door to future activities to both lawyers and accountants, as well as to small business owners. If business owners, it is theorized, are presented with the information that bankers are interested in such an activity as ESOP planning or are approached by their bankers, they would necessarily be much more likely to respond.

In general, the constellation of people concerned with community development activities such as the town officials, development directors, Chamber of Commerce people, attorneys, and bankers expressed an interest and a supportive orientation towards ESOP training. The major state business organization, the Business and Industry Association did not view it as something that their members would be interested in. The BIA in New Hampshire includes not only the very large businesses but a considerable number of those that would fit the category of 400 employees or under. The BIA President, John Crozier, decline to participate.

In general, the ESOP training was pursued as a rather conventional business development matter and was advanced in a way to be acceptable to those normally working in these areas. The method was to make information about ESOPs easily available and comprehensible within the context of their regular work.

D. Results

We held our ESOP seminar on October 23 from 8:00 to 10:00 a.m. at the Franklin Pierce Law Center in Concord, NH. There were 4 people in attendance. There were three line bankers. One from Laconia Savings and two from Bay Bank from Nashua. One of the members of Bay Bank was visiting a firm in Durham the next day to discuss a possible ESOP arrangement.

In addition to the bankers, Woullard Lett of the New Hampshire CED program was in attendance. Other bankers had called to pre-register but did not attend, including one who had sent the \$30.00 check for attendance.

A number of simultaneous conferences out of state resulted in key New Hampshire CRA people and staff members of the N.H. Community Loan Fund being unable to attend.

Paul Bradley of the New Hampshire CLF called and discussed the ESOP seminar at some length and indicated plans to continue the program. In general the project has helped bring attention to ESOPs as a viable means for business succession planning to a much larger number of key New Hampshire decision makers. While attendance at the morning seminar was limited, those bankers in attendance clearly profited by the activity.

This has encouraged us in the belief that future seminars targeted to bankers in a particular city or area in New Hampshire could be a successful means of increasing the awareness and participation in ESOPs as a means for business succession planning. Basically the project succeeded in beginning to put ESOPs on the map as both a viable means for business succession planning in New Hampshire and as a venue for the development of a CRA strategic plan for bankers. Follow up work needs to be done to capitalize on the efforts made in the project. Paul Bradley of the N.H. CLF has indicated an interest in continuing with such ESOP work in conjunction with the Industrial Cooperative Association.

E. Analysis - Conclusion - Recommendations

I would characterize the project as a qualified success. As indicated under results, it brought the question of ESOP formation to the attention of the New Hampshire banking community. Attendance was light at the seminar but it was supported by the N.H. Bankers Association which helped distribute material.

In order for this opening to be exploited, a follow up strategy of additional educational meetings and plans need to be pursued.

Similarly, the actions of the N.H. CRA Association in pursuing ESOP planning as a basis for engaging bankers in the creative pursuit of a strategic plan is crucial. The project has helped open the door for ESOPs. It is now necessary for people to walk through that door to take advantage of the opening the project has helped create.

One of the surprising lessons of the project was that bankers, who are often viewed as the least interested and most intractable forces for community economic development, proved in this case to be quite interested in entertaining the ideas of ESOPs as a financial product and as a community service. In contrast, small business owners who on the surface seem to have the most to gain by such a project, proved to be rather difficult to approach. This is consistent with the experiences of other attempts to contact small business owners. The owners of such companies are generally extremely busy and depend on the advice of a core group of people that often have little or no knowledge about the ESOP mechanism.

It seems clear that the interest of bankers in ESOP planning for business succession suggests that an effective strategy is to educate and interest the service providers and then pursue the business owners.

The initial approach of the project was to do the opposite. The project pursued the owners and not the bankers. This apparently was an error. The initial approach was also to concentrate on Concord, N.H. The response of bankers was to express interest from a much wider area of operation and the scope of activity was widened.

Certainly, in retrospect it appears to have been an error not to follow up more aggressively on the initial contacts for those who had planned to attend the seminar. I assumed incorrectly that the flurry of calls after the bankers' mailing announcing the seminar suggested that we would well attended.

The \$30.00 fee was a marginal amount of money. Probably the bankers were not prevented in coming by that amount. In fact, for bankers a \$50.00 or \$100.00 fee might be appropriate. The hourly rate of those bankers attending the seminar would be quite substantial, at least \$20.00 to \$30.00 an hour or more.

The pursuit of business succession planning as a part of a strategy of business retention and community development requires a considerable number of different tools that provide education, technical support, and community assistance for small business owners and their employees. Such as comprehensive provision of resources and services is generally not available from anyone, and certainly not offered in most cases by those advancing a community economic development perspective and agenda.

It is suggested that we need to plan and act systematically to build a tool kit of a number of interrelated services and options to strengthen the community based economic sector and maintain it in the face of the destructive forces of economic change. The ESOP mechanism is a useful tool. It gives business owners, bankers, lawyers, and accountants a chance to do both well and good. For workers and community members it is a useful means to maintain and strengthen communities.

Appendices Follow