Financing alternatives in ESOP deals for small business

DALE VLASEK | TAX AND BENEFITS CHALLENGES | JUN 12, 2015

Finding the right buyer for one's business is not an easy task. A seller faces the natural concerns about price, how one's customers will be handled, and how one's employees will be treated.

In trying to satisfy those concerns, business owners often consider Employee Stock Ownership Plans (ESOPs) as potential buyers. ESOPs have significant tax advantages to the seller and the company, but also can give the seller the peace of mind knowing employees will be taken care of and customers will be handled by the same people who have been doing so for years.

However, in selling to an ESOP, one problem that sellers may face is arranging adequate financing to complete the transaction. Commercial lenders are often reluctant to lend when the cash is going "out the door" to pay a shareholder and not to increase the assets of the business.

A lending option that may be worth investigating is the use of the ESOP loan program offered by the Small Business Administration (SBA). The SBA does not make loans directly but guarantees loans issued by approved lenders.

To fit under the program, the employer sponsor of the ESOP must be a "small business." The SBA standards of what constitutes a small business vary by industry standards and/or net worth and net income tests.

For a company that constitutes a small business under the SBA program, the SBA guarantees 75 percent of the principal of an ESOP loan up to a maximum of $5 million; which means $3.75 million is guaranteed. The loan will have a 7-10 year maturity with an interest rate of prime (per *The Wall Street Journal*) plus 2.75 percent. The interest rate is floating with no floor.

No shareholder guarantee is required if the ESOP owns 100 percent of the company. Otherwise, all of the 20 percent or more shareholders must provide personal guarantees. The SBA requires a 25 percent cash equity, either by the buyer or seller. A seller-financed note or a loan from a corporate officer may be used to satisfy the equity requirement. These need to be subordinated to the SBA-guaranteed loan and no payments are permitted on the seller note for two years. The SBA will require the selling shareholder to sever ties with the business, but may retain a one-year consulting agreement.

While the SBA program has important issues one must consider, it can open up financing for shareholders seeking an exit strategy. Our Corporate and Employee Benefits attorneys can assist in evaluating the use of an ESOP as an exit strategy and our Commercial Finance attorneys can assist in evaluating using the SBA ESOP loan program.

DALE VLASEK

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