Institute for the Study of
Employee Ownership and Profit Sharing

Five Reasons Why Business Owners Sell Their Companies to the Employees

Adria Scharf, PhD
December 2021
School of Management and Labor Relations

This document draws from qualitative interviews conducted with Employee Stock Ownership Plan (ESOP) companies in 2021.

When owners of family-owned and other closely held businesses think about retirement or exit, they weigh several considerations. They often ask themselves and their advisors such questions as: *How do I cash out? How do I best handle succession, estate, and tax issues? What will happen to the business that my family members or partners, together with company employees, have built?*

Owners' choices matter. For family owners, succession and exit decisions are weighty. They have financial consequences and may be colored by family dynamics and legacy considerations. For employees, the business owners' succession decisions are consequential as well. They potentially affect wages, benefits, working conditions, and whether their jobs continue.

There are several reasons for owners of closely held businesses to consider selling their companies to their employees through an Employee Stock Ownership Plan (ESOP), a worker cooperative, or another form of employee share ownership. Selling one's company stock to employees represents an alternative to other common exit options. (Other common exit options may include a strategic sale to a competitor, vendor, or supplier; a financial sale; a private equity sale; generational succession; or a sale limited to senior management.)

Here are five reasons that the founders or owners of closely held businesses may choose to transition ownership of their business to employees through an ESOP or another vehicle.

1. Tax Advantages

First, ESOPs and worker cooperatives provide **unique tax advantages** to selling business owners. The money used to fund an ESOP is tax-deductible. The selling party may be able to defer capital gains taxes using Section 1042 of the U.S. Internal Revenue Code, a provision known as the “tax-deferred rollover.” For the company, too, there are tax advantages: A 100% S-Corporation ESOP can be federal income tax-exempt. A C-corporation that uses an ESOP to borrow money does pay corporate income taxes but can deduct contributions used to repay both principal and interest in the loan, not just interest as in non-ESOP companies.

Reflections by Company Leaders

- At family-owned Max Auto Supply based in Toledo, Ohio, the CEO shares: “The more I learned about the ESOP structure, the better it looked. It checked a lot of boxes. It allowed my sisters, my cousins, and me to avoid a large estate tax bill.” *–Randy Katz, CEO of Max Auto Supply*
- At S&C Electric Company, the storied Chicago-based employee-owned company, when owner and former CEO "John Conrad passed away, his three daughters inherited the company. Two of the three daughters intended to sell it to an outside buyer. IRS Section 1042 meant that their capital gains taxes could in essence be deferred permanently. With Section 1042, the sisters in the end cashed out through the ESOP, saving the company and a lot of jobs.” *–Sue Keyes, S&C Electric Company*
- At ComSonics, Inc., one of the oldest ESOP companies in the country, an employee leader reflects on the tax advantages that come with being an S Corporation ESOP: “There have been some years when things were very lean. If we’d had to pay taxes in those years, we would not have had the reserves or have been liquid enough to maintain our presence.” *–Markita Madden-Puckett, ComSonics, Inc., an S-Corporation ESOP*

2. Liquidity

Second, ESOPs are a tool for liquidity. (Liquidity refers to the ease with which an asset can be converted into cash.) The ESOP becomes the buyer of some or all of the owner's shares of stock. This way the ESOP, as buyer of the stock, provides an **internal alternative to a third-party sale**. If a lender is financing the transition, the owner may receive cash for their shares. Often however the owner finances all or part of the sale him or herself, receiving a promissory note from the ESOP. The note contains a specific promise to pay the owner back and a timeline for repayment.

Some selling business owners appreciate that selling shares to an ESOP allows flexibility. Selling owners may sell just a portion of their shares, sell tranches of shares in stages over time, or they may sell 100% of shares all at once to the employees through the ESOP.

Example from an ESOP Company

At Parksite, Inc., when co-founder Ray Biggins started to think about retiring, that presented a transition challenge. His business partner John Morrisroe was still in his 40s and nowhere near ready to retire. John did not want to sell the company, but he could not afford to buy out Ray. Two men in Chicago were expressing interest in buying the firm, but that meant “we’d be taken over by somebody larger,” recalls John Morrisroe. “That’s not what we wanted.” Advisers explained a novel solution: Employees could buy Ray’s shares. John would remain co-owner, together with the ESOP, keeping ownership of his portion of the company shares until he was ready to retire by selling his shares to the ESOP years later.

3. Desire for Continued Role

Third, ESOPs give family owners the **option to remain in an executive or other role** in the company’s operations after they have sold their shares. At the same time, they can give those family members who wish to sell and exit, the ability to do so. That is, in businesses in which some family members wish to continue to lead the company but others wish to sell their stock and exit, an ESOP sale can provide **a solution that meets or balances multiple family members’ needs**. This is not only important as part of the transition for the family owners, but the continuation of some family members who have served as active managers may offer a level of managerial competence during the transition to the new employee-owners.

Reflections by a Company Leader

As Richie Morgan of North State Grocery tells it, in 2006 his sister's shares were purchased by the company, then re-sold to the ESOP, making 46% of the company employee-owned. "I think that's the beauty of an ESOP," Richie Morgan says. "When you have one family member who's passionate about the business, but maybe they don't have the capital to buy the other person out and allow that person to exit," the ESOP makes such a transaction possible. With the ESOP you can "put the company entirely in the hands of the people who are passionate, along with the employees." In 2016 the company purchased the remaining shares from Richie and became 100% employee-owned.

4. Continuation of Company Name and Culture

Fourth, with a conversion to employee ownership, **a company's name, and aspects of its culture and core values, can be preserved and continued** rather than be dismantled in a sale to a third party. Many family-owned businesses are known for trying to develop a familial corporate culture. An employee ESOP buyout may help preserve, or evolve, such a culture where it exists:

"The philosophy that Parksite has today [as a 100% employee-owned company] is very similar to what we had when we started the company, and I'm so proud of that." *–John Morrisroe, retired co-founder of Parksite Inc., who remains on the board of directors.*

5. Legacy and Values

Fifth, by selling to the ESOP, the company may protect jobs, share the benefits of future success with employees, and remain locally owned. For some business owners, these things are **important to their legacy.** Transitioning to employee ownership may be the route most consistent with their values and their sense of loyalty to their employees. For some selling business owners selling to the employees is **an expression of their values** that affirms their legacy as conscientious business owners and employers.

More Reflections from Business Founders and Leaders in ESOP Companies

What does sharing ownership with employees mean to you?

"I am left with a lot of pride seeing the people who have come and gone and what their interaction with Parksite has done for them and what it meant and means to them. We have some people who are very comfortable now in their lives going forward. Their stock turns to cash at a certain point, so they are very very comfortable. There are 35 to 37 of them [retired employees] that are in an income range that they never dreamed of.'" *–John Morrisroe, co-founder of Parksite, Inc.*

"Do you do the right thing and it grows the value of the company and you end up better off for doing that and you bring everyone along the way? Or do you think 'Gee, I could have had all this money to myself?' I'm sure there are some people in the world who think that way but I think most folks are just happy to see everybody win." *–Richie Morgan, co-founder and CEO of North State Grocery, Inc.*

What are some unexpected benefits associated with transitioning to employee ownership?

"We believe this gives all employees 'skin in the game' and 'a stake in the outcome' which helps drive good business results." *–Chad Ware, Central States Manufacturing Co.*

"It's a differentiator. A lot of other companies can't say 'in two years you're going to own a piece of the company. It makes the candidate ask more questions about your company when you tell them that. They're more curious about the work here as a result." *–Gerry Mundt, National Van Lines*

"We don't see a lot of turnover." *–Markita Madden-Pukkett, ComSonics, Inc.*

"Instead of [employees asking] 'why don't we have more people?' It's 'how can we do this better?'" *–Richie Morgan, North State Grocery, Inc.*

"Well, I sure think it does add to the culture. If you're gonna slack off, really, you're hurting yourself and more. If you can get that point across to people, almost all the time they will reach down and find the stuff it takes to go beyond. I don't know that it would happen without an ESOP. Otherwise, everyone is just collecting a check and going home at the end of the day tired and grousing. This way, it's 'Hey, I had a big day today. *We* sold this, this *we* sold that, *we* fixed this *we* got that.' It's a lot more exciting, a lot more." – *John Morrisroe, Parksite, Inc.*

Notes:

ESOPs are best suited to stable profitable companies with 20 or more employees. For smaller companies, a worker cooperative, employee ownership trust or another employee ownership vehicle may be more suitable.

This reading is part of the Rutgers SMLR video course "Our Share: Employee Ownership as a Wealth Sharing Tool." The course introduces employee ownership through short videos presented by 15 experts. Find the full course at: https://www.coursera.org/learn/employee-ownership. (Click "Join for Free" to access.)