

Part VI

The Part of Tens

The 5th Wave

By Rich Tennant



“I don’t take ‘no’ for an answer. Nor do I take ‘whatever,’ ‘as if,’ or ‘duh.’”

In this part . . .

This part is called The Part of Tens because each of these chapters offers ten points of interest on critical topics we introduce throughout the book. This part gives you a chance to get a little more familiar with these issues. In this part, we spell out reasons to consider a prenuptial agreement, things to build into a partnership agreement, and things to consider before transforming a conventional business into an employee stock ownership plan (ESOP).

Chapter 22

Ten Reasons to Consider a Prenup

In This Chapter

- ▶ Defusing money fights during a marriage
 - ▶ Using a solid agreement to protect family members' jobs in case of a divorce
 - ▶ Preserving a family's financial and business legacy
 - ▶ Linking today's prenup to tomorrow's business valuation if there's a divorce
 - ▶ Keeping all the money from going to the accountants and lawyers
-

Ah, love and marriage — they go together like a horse and carriage, as the old song goes. But love, marriage, and money? You just never hear much about dollars and cents in a love song, unless it's in some twangy old country song about love gone wrong.

But what if a worldwide law forced new-spouses-to-be to sit down at a table for a few days with smart legal and tax advisors who'd force them to share credit reports, bank and brokerage accounts, and most importantly, their feelings about money and what they want to do with it for the rest of their lives?

That doesn't sound like a bad idea, does it? How many couples do you know who talked extensively about money before they got hitched? If you answered, "the divorced ones!" that's just what we wanted to hear.

Prenuptial agreements are a way to sort out financial issues before a marriage starts so that a couple knows what they have and where they're going with it. Even if one spouse doesn't own a business before the wedding, this subject is important to consider if one of them wants to start one later.

Why does a book about business valuation even mention this subject? Have you ever read a news story about a celebrity divorce and murmured to yourself, "There goes her money down the drain"? Prenuptial planning is good business planning — when done correctly, both sides have an exit plan that may not minimize pain but does go a long way toward fighting uncertainty. So without further ado, here are ten reasons to consider a prenup.

It Gets You to Talk Honestly about Money at the Start of a Marriage

First, we take a minute to define our terms. A *prenuptial agreement* is a legal and binding agreement between two potential spouses indicating how their finances will be handled in the case of a divorce. It's not about how you're going to raise the kids or whether one plans to convert to the other's religion — it begins and ends at money, period. A *postnuptial agreement* is the same, but it's hammered out after the couple is married, usually because some significant assets or other money issues have changed since the marriage.

The word *prenup* tends to set people's teeth a bit on edge. For most people, it conjures up an image of you and your future spouse in an adversarial role even before you walk down the aisle. Who wants to talk about divorce before the honeymoon, anyway?

But believe it or not, in the right hands — meaning family law and tax attorneys who really know their stuff — this process doesn't have to be an adversarial one. Think of it as a way to discover not only what money and assets the two of you have but also all the fears, hopes, and dreams about the use of that money.

A lot of couples don't talk about these issues before they get married, and this oversight costs them down the line. A prenup forces two individuals to come clean about their credit, what they have at the bank and in their retirement accounts, and finally, what they want to do with an existing business or a business they hope to build someday either together or separately.

Your Life's Work Shouldn't Go down the Drain

Say you're the spouse who's going into a marriage with a successful business with excellent prospects. No, you'd never expect your future wife or husband to someday try to take over the business to force you out and liquidate it, but read the papers — it happens every day.



Roughly 40 percent of all marriages fail. No, that doesn't mean that yours will be one of them, but if you've created a company, you need to think seriously about how both you and your company would survive a divorce.

For this reason, involving a valuation expert in the prenuptial process is helpful because it gives you an idea of what your company is worth in terms of not only brick and mortar but also all the intangibles that may well exceed the value of whatever hard assets you own. Your ideas, your employees, and your branding are part of the valuation process, so doing two valuations may be wise: one for peacetime, one for wartime. The first would value your business as if you were going to sell your company in a friendly deal on your terms, and the second would help you defend yourself and your company if a spouse petitioned for those assets.

In essence, a prenuptial valuation may become a way to support a defensive strategy for a company when it's threatened in divorce court. Obviously, if you have extensive fears that this situation may happen, you may want to rethink your relationship with your intended spouse. Running the numbers and being honest about those fears with your potential partner right now may save considerable time, expense, and agony later.

If Both Spouses Have Sacrificed to Build the Business, They Need to Share

You've heard the scenario before. The wife or husband works hard to put the other one through medical or dental school and then settles down to raise the kids (forgoing any salary) after the practice takes off. Life is good, but a few years down the line, the marriage screeches to a halt and suddenly the spouse with the lucrative partnership doesn't want to share so much with the nonworking spouse. The nonworking spouse faces years of catch-up on building a career, as well as affording retirement and huge expenses for the kids if they're not properly taken care of in the divorce settlement.



We didn't identify the losing spouse by gender, but today, women still face the greatest financial risk in a divorce by virtue of the following:

- ✓ As of 2008, women still aren't at an even pay level with men. Most estimates say women earn only 76 to 80 cents on every dollar a man earns, so they typically bring fewer assets into a marriage and they never really catch up when working.
- ✓ Women frequently bear the child-care responsibilities, and many still give up or take breaks from full-time paid work to address that need.
- ✓ On average, women live five to six years longer than men. Thus, they need at least that number of years' worth of savings to see them through their retirement years and end-of-life expenses.

When an entrepreneurial effort is underway or planned, a prenuptial agreement forces a discussion on what both spouses think they're entitled to if the marriage fails. Again, this conversation can force a shocking reality on the relationship — or an agreement that makes the marriage seem even stronger.

The Working Spouse Shouldn't Lose the Business Entirely

Often, you see an argument made in a divorce that one spouse may have contributed the business idea and the financial knowledge to start a business, but the other spouse provided the occasional office support and kept the home fires burning during its early days. For this reason, some states take the upper hand and decide that all community property will be divided 50/50. But in some cases, a legal agreement amends or supersedes such arrangements — which is why prenups were created.

For this reason, it's critical for both sides to seek respective legal counsel in deciding how business assets should be split. A prenuptial agreement can not only protect ownership and a control interest in a closely held business but also declare a set formula that the married couple can use to value and split stock in the event of a divorce.

More is involved in this process than having both spouses come to an agreement on assets. Also important is structuring this agreement in a way that preserves the business if it's expected to be passed on to the kids or sold someday as an asset that will benefit all members of the family.

Kids from Earlier Marriages Need Protection

Families with considerable wealth may have businesses that have lasted several generations, which means that many more people than just the current CEO depend on that business. In a private company, stakeholders may include children and other family members from previous marriages.

And we're not talking about family members who sit on their butts and wait for checks to show up in their mailboxes. We're talking about generations of family who are active workers in the business — and those who may join in the future.

It's not so easy for the mega-rich, either

In the annals of great American family wealth, many people may not know the name Pritzker, but they probably know the name Hyatt Hotels. The Chicago family's \$20-billion empire was thrown into disarray after the death of the family patriarch, Jay Pritzker, in 1999. Various cousins began to fight for what they thought was their fair share of the family assets after the new head of the empire, Jay's son Tom, took over.

The dispute within this intensely private family exploded after Liesel Pritzker, the daughter of Jay's brother Robert from an earlier marriage and, at that time, a young actress in Hollywood, challenged the distribution of family assets among all the cousins. Liesel, whose parents divorced when she was a young child (Robert had other children as well) charged that she and her brother Matthew were being cheated out of their \$1-billion inheritance; they eventually settled for a reported \$500 million, making them two of the richest people in America younger than 30.

This lesson shows that, within even the most private of families, separation of assets requires a long-term plan and a fair amount of transparency.

Now consider for a moment the family situation of Rupert Murdoch, global media baron. At press time, the 76-year-old Murdoch was on his third marriage, with six kids total: one daughter from his first marriage, three kids from his second, and two kids from his latest. Granted, his company's stock trades publicly, but family members control the company.

Murdoch is just one more captain of industry who has shown no desire to retire, but during the writing of this book, he was already positioning one of his two sons from his second

marriage — James — as the heir apparent. Will James keep that advantageous position within the family business by the time Rupert gives up the reins? Who knows? But it's an interesting scenario that applies to virtually any couple with previous families to think through before they marry. Consider why:

- ✓ When you're talking about involving kids in the family business, it's great if you have one kid who's a clear, recognized choice to take over. But when half-brothers and half-sisters (and maybe *their* kids) abound in a company, you have to set a structure that nurtures both talent and the family relationship. Today's black sheep can be the company's savior a decade from now. This subject certainly goes beyond what legal documents can solve, and that's why prospective spouses need to talk about it.
- ✓ Depending on how you've allocated the stock for the business over the years, it's possible that a former mother-in-law (who may have written a check to start the business in friendlier times) may want a say in who gets put in charge now that you're on your third wife or husband. Prenuptial discussions need to address how all the individuals who are part of a power structure in an existing business may affect the value of the company's assets going forward.

Oh, one more thing about the Murdoch example: Rupert and his third wife have two kids who are currently under age 10. Couples with previous families who are going into a new marriage need to think not only about the kids who have come before but also about those who may arrive in the future.

Kids from Your Next Marriage Need Protection, Too

The emotional competition between siblings from a single marriage can be cutthroat enough in a business setting; that competitive fever escalates with the kids from Dad's second or third wife or Mom's new husband.

Understandably, a child from someone's first marriage may feel both happy and uneasy about the arrival of a new sibling, even if the little one is a full generation younger. If a clear succession and ownership structure isn't laid out for the business before the founder retires or dies, warring factions of siblings and other family members can deplete the value of a business by fighting for their share of the pie.

Granted, no parent can anticipate everything their kids may do in the future, but as you prepare to marry, this topic deserves plenty of exploration.

Planning for Worst-Case Scenarios Is a Good Habit

In Chapter 24, you see the benefits of doing an exit plan for a business; the thought process that goes into a prenup is similar. Business owners must think of worst-case scenarios within every new initiative they try.

If a business already exists at the time of a marriage or becomes a reality afterward, optimally, both parties will take the time to think through the role a marital breakup would have in the overall course of the business.

Also important is realizing that business problems and marital problems don't occur in separate vacuums. Any number of entrepreneurs can tell you that industry downturns or sudden shifts in a company's fortunes have a real impact at home.

Your Business and Personal Finances Really Are Connected

Particularly for small, closely held companies, business assets can really be marital assets, and it makes sense for any business owner to take a tough look at anything that can go wrong in a marriage and in a business concurrently.

Toward the beginning of this chapter, we mention a couple in which the husband or wife paid the educational bills for the other to start a professional practice. Many spouses have surrendered their paychecks or personal investments as startup funds for all kinds of businesses.

When doing a prenup, you need to talk about the possibility of these sacrifices going forward and how they're connected to marital assets based on state and local laws governing such subjects.

Family Legacies Need Protection

Whether it's the gas station on the corner or the regional bank your great-grandpa started back in the 1800s, a family business is more than a cash register. It's an important source of history to people who share blood, skills, and experiences, regardless of whether they get along.

A business may also be a critical asset to the community. In an age of globalization and sameness across all industries, closely held companies that keep family members as employees and managers have a unique way of touching everyone around them. After generations of tough economic times, daunting competitors, and other business threats, a marriage going bad shouldn't be what finally kills a family legacy.

When spouses begin talking about a prenuptial agreement, if the family legacy is critical, it should be one of the first issues to come up in conversation.

When a Marriage Ends, a Prenup (Or Postnup) Can Save You Both Money

One of the reasons couples resist the idea of a prenup is that it's such an unpleasant idea. What couple in love and with all hope of staying together a lifetime wants to talk about a breakup?

But if a business exists before marriage or is created after marriage, it's best to talk about how that business will live — and for what reasons — if a divorce happens. And it's absolutely best to discuss those possibilities while both sides are friendly and have the benefit of independent counsel to take them through a valuation process and the creation of an ownership structure that ensures the future of the company for one or both spouses or their children.

It's not unthinkable that everything you've worked to build will go to the government, lawyers, and tax experts. Is that what you want? This concern may also create the need to review your prenuptial agreement whenever business conditions change.

Chapter 23

Ten Questions to Answer Before Considering a Partnership Agreement

In This Chapter

- ▶ Discovering why partnership agreements are important
 - ▶ Finding out how the structure of a partnership can affect its valuation
 - ▶ Understanding the role of intangible assets and intellectual property
 - ▶ Looking at the pluses and minuses of partnership agreements
 - ▶ Planning for future disputes
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Partnerships are unincorporated businesses in which two or more individuals manage the business and are equally liable for its debts (see Part IV for details). You can find variations on the level of liability based on the legal definition of the partnership. Partnerships are a particularly interesting valuation challenge because they typically don't have many hard assets to value. In fact, a lot of partnership value is intrinsic — it's tied up in the skills of the individuals who form the partnership. Individuals may change their legal business status from a partnership to another designation over time — becoming a corporation or a limited liability company (LLC), for instance — when the purpose or sheer size of the business changes.

But even in the earliest stages, partnerships shouldn't be informal arrangements between individuals, even if they're siblings, spouses, or close friends. As with any business contract, partnership agreements aren't written for the good times; they're written for the bad times — or at least, for times of big change for the business, which can be positive or negative.

Why put a chapter on partnership agreements in a book on valuation? Because partnerships have their own valuation challenges. In many cases, the main asset value of a partnership isn't something you can physically touch. Many law firms and medical offices start off as partnerships, and aside from a few hard assets such as office furniture and computers, you don't actually see the real value of these businesses. The real value resides inside the heads of the partners. Partnerships are almost always about intellectual capital.

Both intellectual capital and financial capital are required to run a partnership. So take a look at the ten critical elements that a partnership agreement should cover.

Who Will Be in the Partnership?

The partnership agreement must spell out the name of the business, its location, the names of both partners, and their places of residence. It also must state the starting date of the partnership to define the start of the legal connection between the partners.

This point may seem rather obvious, but in case of the breakup of the partnership or a legal challenge from outside, having this information recorded in a legal document is important.

How Much Capital Does Each Partner Have to Kick In at the Start?

Particularly important is stating the exact amount of money or other assets each partner brings to the enterprise on the first day of business. Yet it's not so important that partners do an even split of the business — in fact, doing so may be a bad idea from a management standpoint. Here's why: The business needs a dominant partner (or partners) who can break a tie over strategic key decisions (we get to this issue in more detail shortly).

In most partnerships, money isn't the only form of capital. In various professional practices, and particularly in medical practices, professionals with great reputations (or great potential) may be wooed into joining a new practice. They may be asked to join up with a certain contribution of consultation hours or a commitment to certain services that benefit the overall partnership. They may even be responsible for developing a whole new division of that partnership. And here's where intrinsic value comes in: A partner who comes in without a major cash or hard asset infusion may have his part of the partnership agreement drawn with certain performance targets to meet.



If partners can't agree on which partners will be responsible for key functions of the business, maybe they have no business being partners after all. Creating a partnership agreement may unearth power-sharing problems that can sink a business, and knowing this information in advance can save time, money, and most importantly, professional and personal relationships.

How Will Decisions Be Made?

Some professionals are born managers; others are born innovators. Some are born salespeople; others are born bean counters. A business needs all these personalities and skills, in addition to the basic professional skill (medicine, law, consulting, and so on) the practice is built around.

The partnership agreement should spell out, in as much detail as necessary, how much authority each partner has and over which specific issues and areas of the business each partner has that authority.

For instance, do all partners have the right to solicit and sign contracts with specific vendors or investors? Isn't that a little like having a joint checking account in which both spouses write checks like crazy and don't figure it out until the overdraft notice arrives? Also, will one partner have 1 percent more ownership in the partnership than the other partners to break tight votes over particular decisions?

Do You Have a Plan for Resolving Disputes?

This particularly important point is the exact reason you need to write such agreements for the bad times, not the good ones. Planning how you'll handle disputes within the partnership involves not only exploring the various deal-breaking issues between partners but also looking at all the potential outside conflicts and occurrences that could sink the partnership.

Many partnership agreements specify arbitration for most disputes simply because that process is generally less expensive to pursue than disputes in open court. A trained mediator or arbitrator usually handles arbitration.

Addressing how the immediate family of a deceased or incapacitated partner may fit into the dispute-resolution process is also wise. Depending on how the total partnership agreement is written, spouses and children may have leverage to endanger the partnership by making a claim on the departed partner's assets.

How Will the Firm Admit New Partners?

Recruiting new partners is necessary for some partnerships but not for others. Valuation may be an important consideration in this issue because in the case of partnerships intended to continue beyond the founding partners' retirement (such as medical or dental practices), recruiting new, talented partners over time is critical to the overall value of the practice.

Requirements may change over time, but founding or managing partners must decide before recruiting new partners exactly what will be required of these new partners to enter the practice. Will they have to cough up considerable capital to join? Will some in-kind arrangement with experienced or younger professionals allow them to earn their way into the practice? Will new partners have to promise a certain number of hours to the practice or start up a lucrative division that the original partnership did not have?



Bringing in new partners is often more complex than bringing in new salaried employees because you're giving them an ownership stake that affords them whatever power you grant them. Founding or senior partners should confer with an attorney who is experienced in partnership agreements about related growth and power issues.

How and When Will Profits — or Losses — Be Shared?

The issue of sharing profits and losses speaks to the operating and ownership structure of the partnership. Depending on the kind of partnership you create, you and your partner may share profits or losses in certain conventional ways, but think through these key considerations:

- ✓ Will all the partners — junior as well as senior — share profits and losses equally? (The answer generally is *no.*)
- ✓ How often will profits be paid out, and in what form?
- ✓ What are the tax implications of the way this money is paid out?
- ✓ What safeguards are in place to make sure that individual partners can cover losses?

What Happens If a Partner Leaves or Dies?

Welcome to the world of buy/sell agreements, which are perhaps the most important segment of a partnership agreement. Why? Because these agreements can save a partnership when a partner dies, becomes incapacitated, or leaves the practice (under a variety of circumstances) or when the deceased's family members come knocking on the door for what they believe is their share.

Buy/sell agreements have two primary structures: *cross-purchase agreements*, in which the remaining partnership owners buy the departing partner's stock or partnership interest, and *stock-redemption agreements*, in which the company buys the stock of the departing owner.

Get advice from tax experts and experienced business attorneys about which model works best for your situation. Cross-purchase agreements may have certain tax advantages that stem from the way the market value of that business is calculated at the time the agreement is triggered. Shareholder models can get complicated based on the number of shareholders the partnership has and based on any valuation issues that come into play.



The partnership agreement that you and your two or three founding partners write in year one of the business may not fit you or the firm in years 15 or 20. Make a plan to revisit the efficacy of the agreement throughout the life of the partnership.

How Will the Partnership Be Sold or Dissolved?

We spend plenty of time in this book discussing exit plans, which are particularly important in partnerships. Succession takes on a slightly different tone in a partnership because of the multiple-owner structure.

An owner of a corporation designates the successor, who may or may not have an ownership stake in the corporation. In a partnership, all partners are owners (possibly to varying degrees, but they're still owners). Addressing retirement, departure, and succession issues is in their best interest, to ensure the highest ongoing valuation for the firm.

The buy/sell agreement may address some of these issues, but if the partnership is terminal — meaning that it ends when the current set of partners leaves, dies, becomes incapacitated, or retires — that ending must be planned and spelled out for designated parties to execute.

How Will Legal Disputes inside and outside the Partnership Be Handled?

We've already talked about internal disputes being subject to arbitration or mediation. Depending on the industry the partnership is in, you may be able to blunt the impact of lawsuits or other complaints against the business from clients, suppliers, or other constituencies in certain ways.

No one-size-fits-all solution applies to this issue, and because such threats may affect the valuation of the firm, it's extremely important to get legal advice on such protections.

Will Noncompete Issues Be Covered?

If a partner leaves the firm or practice, do you want her to hang out her new shingle right across the street? Probably not. Most conventional partnership agreements include noncompete clauses to keep departing partners from immediately setting up a competing business that would be detrimental to the former practice or partnership.

Many of these agreements force the departing partner out of their market for a certain length of time, meaning that they may be forced to practice in another state before coming back home. After all, it's all about saving the originating practice.

Chapter 24

Ten Things to Consider Before Transforming Your Company Into an ESOP

In This Chapter

- ▶ Getting a handle on ESOPs and how they work
 - ▶ Examining the details that make up an ESOP
-

An *employee stock ownership plan* (ESOP) is a trust established by a company for the allocation of shares to employees. It sounds almost altruistic: A business owner works hard; builds a profitable, successful company; and then, out of the goodness of her heart, creates shares that she allocates to all her wonderful workers.

Okay, we're being a bit snide here. In truth, ESOPs can work out very well for a business's founder and her workers, and some owners really do want their employees to share in their success. But make no mistake: In nearly every case, ESOPs are created in the best interests of those who create them. In most cases, the creator is the business owner or the company's top management, but sometimes the workers propose ESOPs.

Why are ESOPs a valuation issue? Getting an ESOP off the ground means establishing that the company is a valuable asset in its own right, which requires expertise and planning. This chapter names ten things to do before creating an ESOP.

Research How ESOPs Are Created

In the conventional model for creating an ESOP, a business owner sets up a trust to which he makes annual contributions of stock, and that stock goes into individual employee accounts within the trust. Workers own stock based on their salary levels or years of service.

Printing stock certificates on your computer doesn't make your company an ESOP. You need to fund the stock offering. Some companies use their own resources, get employees to contribute, or borrow money from banks, insurance companies, or private parties.

ESOP shares must vest before employees are entitled to receive them. Under rules set in 2006, vesting must be completed after three years (for *cliff vesting* — employees remain unvested during an initial period of service but become fully vested after that) or six years (for *graded vesting* — employees become vested in 20 percent of their accrued benefits after an initial period of service; they become vested in an additional 20 percent in each subsequent year, with full vesting four years later).

We're not going to get into the minutiae of the ESOP creation process because this book isn't about ESOPs. But it's safe to say that you're going to need a variety of experts — attorneys who have specific knowledge of ESOP creation, as well as your private attorneys, accountants, and financial planners.



ESOPs, like most major business transitions, aren't born in a day. At least, they shouldn't be. In a family business, you may need months or years to sell this idea to other family members, because the idea is all about sharing the wealth.

Understand Why ESOPs Are Attractive in Certain Situations

According to the ESOP Association (www.esopassociation.org), the two most common uses of an ESOP are to buy the stock of a retiring owner of a closely held company (probably a big issue for people reading this book) and to create an additional employee benefit or incentive plan to ensure the company's growth. But ESOPs have other purposes as well, such as to finance a company's expansion, spin off an operation into a separate company, or take a public company private.

In very few cases (about 2 percent), the ESOP Association says, ESOPs are formed as a last-ditch effort to bail out a company that's dying — you see both employees and owners attempting to save companies in this way. This process isn't for the squeamish.

You also hear about companies that create ESOPs to prevent unwanted takeovers. If a substantial amount of stock is in the hands of founders or employees, a company may be able to provide a united front against unwanted suitors.

Know How the Tax Advantages Work

Congress has provided certain tax incentives that make ESOPs a good deal for the owners of the business as well as for the new owners created by the ESOP:

✔ **Deduction for ESOP contributions:** ESOP contributions (in cash or securities) are tax deductible to the sponsoring corporation based on certain limits. When employers contribute their securities directly, they may take a deduction for the full value of the stock contributed. That deduction may allow an employer to increase her profits thanks to the taxes saved.

If the ESOP is *leveraged* — that is, financed by a loan from a bank or other source — the tax advantages can be sweeter. Because contributions to a tax-qualified employee benefit plan are tax deductible, thereafter the employer may deduct contributions to the ESOP that are used to repay not only the interest on the loan but principal as well.

✔ **ESOP rollover:** Keep in mind that an ESOP allows a shareholder or group of shareholders of a closely held company to sell stock in the company to the firm's ESOP and defer federal income taxes on the gain from the sale. The ESOP must own at least 30 percent of the company's stock immediately after the sale, and the seller(s) must reinvest the proceeds from the sale in the securities of domestic operating corporations within 15 months (3 months before or 12 months after the sale). This tax break isn't always available to current or retiring owners.

✔ **Deduction for dividends:** Employers who create an ESOP also get a tax deduction for cash dividends paid on stock purchased with a loan for those ESOP securities. A deduction is also available for dividends paid on ESOP leveraged stock to the extent that the dividends are used to reduce the principal or to pay interest on a loan incurred to buy that stock.

Examine How Valuation Comes In

We start this section by saying that the U.S. Department of Labor — which puts out most of the rules and regulations for ESOPs — demands that you get an appraiser trained in ESOP work to do a valuation of the company to determine what the ESOP will actually pay for all or part of the company. Remember that the ESOP represents the employees who have a majority or minority ownership stake in the company.

This process gets pretty complicated. For full details, you can consult plenty of books on ESOPs. But valuation experts in an ESOP situation do the same thing that valuation experts do in other situations: They value the assets of the company and apply certain discounts to their price based on certain facts about the way the company will be owned and how marketable it would be to new buyers if an ESOP were in place.

Bottom line: Setting up an ESOP for your company isn't like giving yourself a hammer to break a piggy bank with. An ESOP is a complicated strategic transaction that has consequences for the value of the company based on the way you structure it. The appraiser or valuation professional isn't the only expert you involve in this process; you also need to work with estate and tax attorneys, as well as financial advisors.

Get a Handle on Your Launch Steps

Setting up an ESOP involves not only time but also a fairly considerable paper trail. Here are just a few of the tasks involved over the time it takes to form an ESOP:

- ✓ Hire attorneys to design, draft, and implement ESOP plan documents and various trust agreements.
- ✓ Work with these attorneys to obtain favorable determination letters from the Internal Revenue Service.
- ✓ Create ESOP feasibility and business succession studies.
- ✓ Start your business succession plans.
- ✓ Consider and put into place the financing options to launch the ESOP.
- ✓ Structure and record ESOP and related transactions.
- ✓ Advise fiduciaries on the status of the transition.

- ✓ Inform clients and customers.
- ✓ Settle all legal matters that could threaten the transition.
- ✓ Change over all tax-reporting structures to fit the ESOP structure.



You always need a valuation professional who understands your industry and the particular objective for which you're doing the valuation. Anyone who does your valuation work on an ESOP should have verifiable experience in valuing ESOPs.

Prepare for Preparation Costs

No one-size-fits-all cost applies to doing an ESOP, but fees are the only really easy thing to quantify in this process. Attorneys and tax/valuation experts may cost anywhere from \$10,000 to \$20,000, but you can vary those amounts based on how much preparation and study you bring to the process.

The tougher part to quantify is your time, especially the time you need to spend educating your officers and employees about the process. An ESOP isn't something that you can do — or should do — in a couple of months. The best-laid ESOPs are planned well in advance, with firm ideas about how that ownership structure will serve the growth of the company going forward.

Get Ready to Train Next-Generation Leadership

Training next-generation leaders is the succession-planning component of the ESOP process. If the ESOP enables a primary owner or a founder to retire with a sizable cash payment, it doesn't signal the end of that person's interest in the company. Family and friends will remain, and it's in everyone's best interest that the value of the company be maintained over the long term.

Many owners plan an ESOP well before their retirement — sometimes, 10 to 15 years before. The advantage is that not only do you get to review and assemble management talent for the next generation, but you also get to oversee the cultural change that ESOPs should bring. If you're making owners out of your officers and staff members, they should start acting like owners, setting and reaching performance targets that should guide all their actions going forward.

Plan Ongoing Training for Employees

You can't stop looking for talent on the lower rungs of top management. In an ownership culture, you need to train and educate employees at all levels about what's going on with the company so they know exactly what their responsibilities are in continuing to build value at the company they will own.

This process is important because a company stops being a paternalistic organization the minute it becomes an ESOP. The organization still has leaders and employees, but tremendous advantages exist when you make employees at all levels aware of what it takes to keep the company growing.

Estimate ESOP Costs after Launch

According to the National Center for Employee Ownership, a company with 20 employees might spend \$2,000 a year for plan administration costs, such as filing reports, keeping records, and sending account statements, plus an additional \$30 to \$60 per employee for special situations such as retirement or plan asset allocations.

Also keep in mind that if a company has to borrow to launch the ESOP and the loan comes at a high rate, it's particularly important to think carefully about how that debt will be managed and eventually extinguished — which brings us to the last and most important item, which follows.

Realize That ESOPs Can Fail

The idea that ESOPs can fail is an important one. In fact, while we were editing this book, one of the biggest ESOPs in history came dangerously close to failing. The Tribune Company, parent of the *Chicago Tribune* newspaper, was transformed into an ESOP as a way for real estate investor Sam Zell to take over the company in mid-2008. Thanks to factors including the failing economy and the rapid decline of the newspaper industry, the company filed for bankruptcy protection by the end of 2008. Reports circulated that the company's employees were particularly vulnerable because their accounts were 100 percent invested in company stock, which can be decimated by bankruptcy.

When considering bankruptcy, owners and all their experts need to be particularly vigilant about the prospects of the company's industry and all the possible disasters that may happen.