

# Why RIA Leaders Shouldn't Overlook ESOPs as a Succession Strategy

**Employee stock ownership plans let business owners take their chips off the table while staying deeply involved in their firms.**

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Employee stock ownership plans (ESOPs) are emerging as a popular transition strategy for owners of registered investment advisory firms, especially in cases where business independence, continuity, and legacy preservation are paramount concerns.



ESOPs are a business succession vehicle that allows owners to take their chips off the table while staying deeply involved in their companies. PHOTO: DREAMSTIME

Some background: ESOPs are the legislative cousins of 401(k)s. Instead of offering third-party investments, these Erisa-authorized retirement plans provide employee participants with [stock in their own company](#). Plan sponsors can either contribute shares to an employee stock ownership trust or sell equity to a trust at a fair market valuation.

The latter strategy, known as a [leveraged ESOP](#) , can help business owners gradually divest from their companies or exit altogether. As a result, ESOPs can function as a business succession vehicle that allows owners to take their chips off the table while staying deeply involved in their companies.

**Liquidity and legacy.** The graying of middle-market company ownership—part of the ongoing “silver tsunami” of baby boomers reaching retirement age—has driven increased consideration of ESOP strategies. But there’s another factor at play: a growing disenchantment with private equity-backed M&A. In recent years, advisors have seen competitors [accept robust private equity acquisition offers](#) with significant cash at closing, only to find they weren’t prepared to surrender their businesses and their legacies.

One alternative to this scenario is a partial ESOP transaction. Here, a business owner initially sells a minority stake to an employee trust, allowing them to get capital out of their company without sacrificing their involvement. Selling shareholders can defer capital-gains taxes on their proceeds, and their companies can earn corporate deductions equivalent to the ESOP sale price. This strategy offers the best of both worlds: liquidity and continued leadership of a more efficient, still-independent company.

A partial ESOP sale can also serve as a catalyst for estate planning strategies to preserve wealth. An example would be a sole business owner selling a 49% stake to an employee stock ownership trust. To acquire those shares, the employee trust effectively borrows money from the company. The added leverage reduces the enterprise value of the transaction immediately post-transaction. That depressed valuation (along standard discounts) creates tax-advantaged opportunities for the owner to sell or gift their retained equity to family members or trusts.

Grantor retained annuity trusts ([GRATs](#)) and intentionally defective grantor trusts (IDGTs) are often incorporated in these strategies. If and when the outstanding equity is sold to the ESOP, the business owner’s children and grandchildren will be the beneficiaries.

**Family concerns.** Broadly owned companies can also leverage ESOP strategies. In a [family-owned business](#) with shareholders across multiple generations, an

employee stock ownership plan can buy out retiring or nonperforming family members on an individual basis. These targeted transactions create liquidity opportunities without inviting investment by outside third parties or necessitating highly taxable internal sales.

Taking a long view of this example, employee ownership of a family business isn't necessarily permanent. A company can opt to buy back its employee trust's entire stake, or it can choose to gradually wind down the ESOP. When vested employee owners depart or retire, the business will repurchase their shares at fair market value. Afterward, the company can choose to retire those shares to its treasury account rather than recirculate the ESOP stock. Over time, a repetition of this redemption process will enable the family to regain a 100% stake in the business.



**ESOPs for RIAs.** The [consolidation trend in wealth management](#) has impaired the independence and entrepreneurship of many talented advisory groups. Many RIAs would actually prefer to sell their practices to rising team members, but internal sales are often inefficient and virtually impossible [without sizable seller financing](#).

ESOPs offer a potential remedy. In a transaction model widely used by other multipartner professional services companies, shareholders in an RIA can sell stock to an employee trust, secure third-party debt to finance these transactions, and create additional equity opportunities for rising leadership. In addition to preserving a firm's unique culture, the strategy can even be utilized as a growth and acquisition platform—how's that for stealing a page from private equity?

Employee ownership isn't always the obvious choice. Business owners who simply want to maximize their upfront liquidity, exit their businesses, and never look back may be better served by a third-party sale. But if an ESOP transaction reflects a company's needs, and financial analysis reaffirms the potential benefits, it might be the right strategy for RIA owners as well as their employees, families, and clients.



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**Larry Kaplan** founded and is managing director of [CSG Partners](#) , where he built the ESOP investment banking practice that has guided hundreds of middle-market companies through the building and financing of [leveraged ESOPs](#) . Prior to starting CSG in 2000, he co-founded, developed, and sold two growth companies.

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