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THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Benefit Capital Companies
(ESOP-Assisted Buyout Specialists)

ROBERT W. SMILEY JR. is the Founder, Chairman of the Board and a Managing Director of The Benefit Capital Companies, a national group of merchant banking and financial advisory firms headquartered in southeastern Nevada, with offices in Irvine, Los Angeles, New York, Dallas and Honolulu. His principal functions include the implementation of management and employee buyouts using employee stock ownership plans (ESOPs) and other tax advantaged financing techniques. Mr. Smiley has been involved as a principal, consultant or advisor to over $5 billion in successful transactions in diverse industries over the past 25 years. He is a member of the management team of Benefit Capital Partners, which provides equity financing for management, employee and other buyouts, and brings substantial experience to these transactions. Mr. Smiley is a Founder and past President of The ESOP Association, a nonprofit trade association for ESOP companies with over 2,000 current members and a full-time Washington, DC, staff. The Association promotes cooperation among government, industry and the professions involved with ESOPs. Mr. Smiley continues as a lifetime honorary member of the Board of Governors, and is a member of the Advisory Committee on Legislation and Regulatory Issues. He is also a director of the National Center for Employee Ownership and a founding editor of and contributing author to its flagship publication, *The Journal of Employee Ownership Law and Finance*. He is also a former Trustee of The Employee Ownership Foundation. Mr. Smiley was invited to testify before the Committee on Finance of the United States Senate in regard to pension legislation subsequently adopted by the U.S. Congress. He has also been invited to testify before state legislatures on pension matters. In recognition of his contribution to pension policy in the United States, he received the President's Special Achievement Award from the President's Commission on Pension Policy. Mr. Smiley is a frequent speaker and author on topics of corporate finance involving management and employee buyouts using tax advantaged financing techniques. He is the senior editor and a co-author of *Employee Stock Ownership Plans: ESOP Planning, Financing, Implementation, Law and Taxation* published since 1989; the latest edition to be published mid-2005. Mr. Smiley has served on the faculty of the University of California, Los Angeles (UCLA) Extension. He served as a Trustee of the Reason Foundation, a free-market think tank, for nine years. Mr. Smiley received his AB in Economics from Stanford University and an LLB from LaSalle University, Chicago. Prior to entering Stanford he served a tour of duty in the United States Navy. He is a current member of the State Bar of California and the American Bar Association. He is listed in *Who's Who in America*. He has served as a director for a number of companies, both public and private.

(ZAX614) TWST: Would you begin with a brief historical sketch of Benefit Capital, and give us a picture of the business at the present time?

Mr. Smiley: We completed our first employee stock ownership plan (ESOP) in 1973, well before the major enabling legislation in 1984, and before ERISA (Employee Retirement Income Security Act). We founded our current company in 1984 when Congress passed some very favorable legislation affecting employee stock ownership plans, and we've been incredibly successful since then. We've been principals, consultants and advisors to over $5 billion worth of successful transactions involving employee stock ownership plans and other types of buyouts.

As to the current picture, I'll refer you to our Website, www.benefitcapital.com. We are one of the foremost experts in ESOPs, ESOP-assisted buyouts, employee stock ownership plan financing and ESOP implementation. Our senior people have testified before Congress, written major articles, books, given keynote speeches; they're pretty much everywhere. Some ESOPs are set up as employee benefit plans and don't use many of the incredible tax and financial benefits available. Some ESOPs are partial buyouts and use a few of the benefits. But the full power of the ESOP is only gained when the ESOP and employees' ownership approaches 100%.

"With an ESOP-assisted buyout, over 100% of the transaction value is available in additional financial benefits to the buyers and the sellers. But the biggest benefit is that with an ESOP-assisted buyout the company gets to deduct principal, interest and dividends on the payments that are made to buy the company."

TWST: Could you explain what the 1984 and subsequent legislation did for everybody and sketch out how you've managed to use it to everybody's advantage over the years?

Mr. Smiley: In 1984 several major benefits were added to the Internal Revenue Code for employee stock ownership plans. One, sellers are allowed to sell their entire company (or part of it) to an employee stock ownership plan and, as long as certain thresholds for ownership are met, the sellers can defer their capital gains tax by reinvesting into certain types of investments. That's a very, very important benefit for two reasons.

The sellers have deferred the capital gains tax, and if they hold the reinvested amounts until they die, the tax may be deferred forever.

Two, the millions of dollars that would have gone to capital gains tax are available to the sellers and will be earning interest and other income over the period of time that they hold the qualified replacement property. So there are really two major benefits: the benefit of saving the capital gains tax and the benefit of all the income they will earn by reinvesting those millions they saved in taxes.

In some cases, $10 million or more in extra benefits can accrue to the sellers and their families. That gives the sellers about 50% of the additional financial benefits that are only available if they use an ESOP-assisted buyout. All together, with an ESOP-assisted buyout, over 100% of the transaction value is available in additional financial benefits to the buyers and the sellers. But the biggest benefit is that with an ESOP-assisted buyout the company gets to deduct principal, interest and dividends on the payments that are made to buy the company. Imagine, for example, that you could buy your house and deduct the principal, wouldn't that be great? Employees get to do that when they buy a business through an ESOP-assisted buyout. They're the only entity our tax code favors in this way. Given all these benefits, that's why employee ownership works so well.

Dividends weren't deductible before the enabling legislation. This was the first time that dividends had ever been made deductible. As you know, Congress has recently reduced the tax on certain qualified dividends to 15%. But because of favorable ESOP legislation, companies can deduct 100% of dividends that go into the ESOP and are used to repay debt or are passed through to employees. It's simple, proven and it's a nice benefit many companies have been able to enjoy.

In recent legislation (1998), Congress passed a law that allows a company, once it's ESOP-owned, to elect to pay no federal income taxes. If you think about it, say you've got a company that's making $10 million a year. It's paying $4 million in taxes. By selling to the employees as opposed to a third-party buyer, the employees end up with a company and then the company can elect to be an S corporation and pay no federal income taxes on the ESOP-owned portion. In many cases, they will pay little or no state income taxes.

This benefit is very substantial. Using that company with the $10 million of pre-tax income that I just mentioned, if you assume it continues at $10 million of pre-tax income, over 10 years that's $40 million in tax savings. Do you believe that would give a company a competitive advantage? Many companies have found that it does.

It also makes local communities more stable. ESOPs keep jobs in local communities. And employees can provide productivity increases that benefit all.

TWST: Tell us about your book.

Mr. Smiley: I am the senior editor and co-author of the leading reference work on ESOPs called *Employee Stock Ownership Plans: ESOP Planning, Financing, Implementation, Law and Taxation* that was first published by Warren Gorham Lamont. The book was sold out. It is being completely updated and the new version will be published by the University of California at San Diego and the Beyster Institute sometime in the late summer of 2005. Through that book we have been able to get the message out to many, many people about the unique benefits, challenges and solutions in using ESOPs and ESOP-assisted buyouts.

There have been thousands of ESOP companies formed since the 1984 legislation and there are more being formed every week. In addition to writing books and articles, we work hard to bring the message to all business owners and the employees and managers of the companies that we believe would be good candidates for an ESOP.

Typically, a good candidate is someone who has a business valued at $5 million or more, has a material interest in wanting to keep the company locally owned and controlled, and is interested in enjoying significant tax savings. The candidate generally wants to keep his or her legacy going and keep the company alive as opposed to liquidating it or selling out to a conglomerate, a third party, someone who's going to disrupt the business (or the community), and probably fire most of the employees, etc. Why sell to a stranger when your employees are often the ideal buyer?

TWST: In general, you're talking about smaller companies?

Mr. Smiley: No. Many of your readers, I think, will love the fact that they can sell a $50 million business and defer all normal taxes, sometimes forever. The majority of the companies are probably small to midsize. They're probably less than $50 million in sales. However, there are no upper limits. Multi-billion dollar ESOP-assisted buyouts have been done, and more will be done.

There are some very fine major companies that have used ESOPs successfully. I don't know if you've heard the MCI Communications story? Back in the days when it was first founded, it had a very successful employee stock ownership plan that we helped to design, implement and administer. The employees made over $500 million. We're proud of that. Sullair Corporation, the company that makes the compressors, did a very successful ESOP, as did T. Rowe Price, the large mutual fund company. Lowe's Companies, the large national home improvement chain, used an ESOP to grow exponentially. Bob Strickland, the former Chairman, would be the first to tell you that.

There have only been a few that didn't make it, but those are the exceptions. We call those rescue ESOPs. United Airlines was a rescue ESOP. Weirton Steel was a rescue ESOP, and they did very well for many years. However, the norm is success, not failure. There have been over 20,000 successful ESOPs. There are many, many companies that are over 50% or more employee-owned. There is a list of the top 100 of these companies that we'd be happy to provide your readers. E-mail us.

TWST: What's your role when a company does an ESOP?

Mr. Smiley: We put everything together. We make it happen. We are the investment bankers, consultants and advisors. We typically represent the company and/or the sellers throughout the entire process. We are the quarterbacks and coaches of the ESOP team.

TWST: How much competition do you have?

Mr. Smiley: In our market, not a lot. The good news is that since ESOPs have become a very important part of the business succession and financing landscape over the last several years, many new firms across the country have sprung up. They are new at it, but they've learned a lot from us and we hope that they will continue to learn.

TWST: Do you have a distinct competitive advantage?

Mr. Smiley: Yes, we do. We probably know more about employee stock ownership plans and ESOP-assisted buyouts and have more experience with real companies in real situations over many, many years than anyone. We have that kind of experience with the full cycle of the ESOP company. Most of these new firms don't.

For example, if you start out with an ESOP, you could sell 30%-40% or more initially. You wait a while, pay off the debt and then you'll do another tranche in a few years of maybe another 30%. Then at some point you'll sell the balance. There are a number of critical issues at each step that will make the next step work properly. We know those issues.

"There are many, many companies that are over 50% or more employee-owned. We put everything together. We make it happen. We are the investment bankers, consultants and advisors. We typically represent the company and/or the sellers throughout the entire process. We are the quarterbacks and coaches of the ESOP team."

TWST: Is there any opposition to this at all?

Mr. Smiley: There is a little from the folks who are concerned about the possible loss of current tax revenue. The IRS wants to insure, because of the taxes that are being saved, that you're doing it right. They engage in a lot of oversight and we have a lot of successful experience in working with them. Do it right and there are seldom any problems. We think their standards are helpful, and that's to the good.

We think that a number of business brokers don't like ESOPs because they can't compete with a well-designed ESOP-assisted buyout. An ESOP effectively doubles the transaction value, and that's difficult for them to compete with. In fact it is impossible for a business broker to double the tax and financial benefits the buyers and sellers receive with an ESOP-assisted buyout.

The support for ESOPs has been bipartisan. I mean ESOPs are up there with apple pie, motherhood and the American flag. There have been over 25 pieces of legislation that favorably affect ESOPs over the last couple of decades and very few pieces of legislation that have hurt ESOPs.

The big benefit, the one we were concerned that might not last, was the privilege allowing a company to elect to no longer pay federal income taxes. That one we thought was going to go away. To be perfectly candid, when the law was passed with an effective date of January 1, 1998, it had some holes in it and even when they corrected the holes, I still was concerned that it wasn't going to last. This was the only circumstance in America where a company that is not already a non-profit can elect to pay no federal income taxes. We were not sure that the generous support of Congress would continue and we are still not certain how much longer it will last.

The good news so far is that the Office of Management and Budget has studied this carefully, and they have come out several times saying that this benefit is certainly worth the small cost. We were very, very pleased with their logic.

There were some abuses in the past. You can imagine that being able to elect to pay no federal income tax would attract somebody who wanted to drive a truck through that loophole. What was happening was that a number of the professional firms were setting up ESOPs that were inappropriate, abusive and not within the spirit of the law. For example, with these 10 or fewer person ESOPs, the benefits went almost exclusively to a few owners. The government didn't like that. Congress quickly passed legislation to give the Internal Revenue Service incredible powers to stop it. The Internal Revenue Service has since issued a series of regulations and revenue rulings, the most recent of which came out in December 2004. We fully support these regulations and rulings and know how to skillfully work with them.

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TWST: Has it been demonstrated that ESOPs benefit the general economy?

Mr. Smiley: Rutgers University did a study and there have been several other studies, all of which will be covered in the ESOP book. Bottom line, companies that have employee stock ownership plans as compared to their peers do significantly better in almost all categories.

TWST: What about the overall economy, since less tax revenue is coming in for the moment when an ESOP is set up?

Mr. Smiley: The economy benefits in many other ways. The taxes saved are often reinvested and used to grow the business. ESOP companies are using their extra cash for all kinds of business opportunities and purposes, so that cash is being recycled in the economy. As I learned at Stanford, I would say that the money is essentially being recycled until the employees pay taxes when they receive their distributions.

TWST: Is that parallel to the Laffer curve?

Mr. Smiley: I don't know if Art Laffer would agree with this, but he always liked employee stock ownership plans, yes. The tax savings are reinvested, which significantly benefits our national economy.

TWST: What is the future of ESOPs and what is your strategy for the near future or longer term?

Mr. Smiley: The future is very bright. I have one more thought I'd like to share first. ESOP-assisted buyouts also work well with publicly traded companies. They may be an alternative to continued compliance with Sarbanes-Oxley. In terms of the future, there will be a broader and wider acceptance of ESOP-assisted buyouts by folks who are currently not knowledgeable about this. We spend a lot of time educating the CPAs, lawyers, investment bankers, lenders, valuation experts, and other professionals so that they can educate their clients and prospects.

TWST: Can you explain the relationship to Sarbanes-Oxley?

Mr. Smiley: If you're a small public company, you have additional expenses and additional costs to remain a public company. The costs of Sarbanes-Oxley have been estimated from $500,000 to over $1 million per company.

TWST: It falls heavily on the smaller companies.

Mr. Smiley: Yes. So instead of being public, why not migrate to a third form of ownership? We've got public companies and we've got private companies. There is a third major form of ownership — employee-owned companies. If there were more employee-owned companies coming from the public sector, they would no longer have to be reporting companies for Sarbanes-Oxley. This is especially true if the benefits of being a public company no longer apply to them.

Some companies clearly need the capital markets and some don't. Some have gone public and their market makers have abandoned them, deserted them, etc. And so, if they think about it, they may be good candidates to go private through an employee stock ownership plan approach. They need to analyze the ESOP alternative carefully to fully understand its many benefits.

Companies are now sometimes going private to escape the burdens of Sarbanes-Oxley. Some are going private through the normal, conventional ways of going private. They team up with their investment banking groups and they go do it. We are talking with public companies right now that are looking at employee ownership as a way to escape the burdens of Sarbanes-Oxley.

TWST: At this point, why aren't ESOPs better known or more widespread?

Mr. Smiley: Because people don't really know about the unique benefits of ESOPs. There were a number of myths that started with ESOPs many years ago. Some of those myths are still prevalent. Frankly, it is misperceptions, myths, and a lack of knowledge.

TWST: Can you give me an example of one myth regarding ESOPs?

Mr. Smiley: The most prevalent myth would be, "The employees can't pay me what my company is worth." If you talk to a business owner and you ask them if their employees can pay what they think the company is really worth, the business owner will almost always say, "No." The reason they say no is for the very reason that their employees are employees. Employees have to work and they're not perceived as having money.

By putting together a properly structured ESOP-assisted buyout in a well-managed company, the money for the purchase price is readily available. Lenders are happy to loan if they're properly structured. We're experts in finding this money.

Another myth is that ESOP-assisted buyouts take years to do. We can frequently do them in as little as three to five months.

There are several more myths. Anyone wanting a list, please e-mail us.

TWST: Could you give us one or two of the elements that are involved in an ESOP-assisted buyout being properly structured?

Mr. Smiley: First, the ESOP buyout needs to be designed so that it does not overburden the company. We've seen other folks very aggressively trying to get all of their money out in a very short period of time. That can work, but sometimes it's better to give it more time. It's like over-leveraging the company in a leveraged buyout, which is not a good thing to do.

And since employees do not have to be rich to buy a company, there are also the considerations of which banks or other institutional lenders are going to want to loan to a particular transaction. You have to be sure (absolutely certain) that the terms, conditions and covenants, representations and warranties, are all something that can be lived with for a long period of time. Remember, businesses have ups and downs. Lenders don't like it when the companies have downs, so it's important to have a good relationship with a good lender so that they'll be there and they'll stick around and not pull the plug when times get tough.

TWST: 2001 and 2002 weren't such great years for a lot of people. How well did ESOPs fare in general, and how well did your company fare?

Mr. Smiley: We did very well. The ESOP companies that we were involved with did very, very well. Frankly, after September 11, everyone felt some kind of effect at some level someplace. For example, there was one transaction for about $810 million where the employees decided to buy the company and the deal almost didn't get closed. It almost didn't close because of September 11. Fortunately, it did close. The employees are now very happy and their stock price has more than doubled between the time they bought it in late 2001 and now.

The issue of that period of time when the cycle was down meant, at a minimum, flat earnings, flat profits and industry specific mini-recessions. But remember, those companies that were 100% employee owned weren't paying any income taxes. That gave them a competitive edge because they had additional cash to weather the financial storms. It gave them time to develop R&D, to develop new products, new concepts and new ways of delivering their products and services.

TWST: Are there ways you can be innovative at this stage?

Mr. Smiley: Yes. We get copied all the time. We have some very, very innovative techniques that allow an owner who would normally take a five- to 15-year time frame to sell their business to the employees to structure it so that they can sell 100% right now. By doing so they do not have to worry about the potential legislative and tax-change risk.

There's nothing like agreeing to sell your business to the employees and not being able to because the laws changed. Let's say it's worth $100 million. If you do an ESOP-assisted buyout, and you sell 30% now, you sell $30 million worth of stock. You pay no current capital gains tax on the sale of that stock. The company is going to be able to deduct that $30 million in principal payments, which is going to save them at least $12 million, plus they get to deduct the interest which will save millions more. They're going to be able to pay off any debt relatively rapidly.

You then expect to sell, say, another 30%. If Congress decides to change the rules in between the first step and the second step, guess who's out of luck?

TWST: I guess it's the employees.

Mr. Smiley: Plus the sellers. Plus the company. Plus the local economy. If you had elected to sell 100% when you could, and then elected to pay no federal income taxes (all prior to the time that the law changed), it is unlikely that they would make the changes retroactive to you. It is much more likely they would grandfather you in as they have done in past years. You get to keep all of today's benefits if you do an ESOP-assisted buyout today.

> *"If a company qualifies for an ESOP (and that's part of what we can help determine pretty quickly), they should try to do the ESOP as soon as possible, before these incredibly generous tax benefits are cut back. Now is the time to take action. It's a risky strategy to wait because Congress makes changes to the tax laws almost every year under both Republican and Democratic administrations."*

TWST: Do ESOPs incentivize employees more?

Mr. Smiley: Yes. Few people truly understand the substantial productivity increases possible. ESOP companies also did relatively well in the period of time that you were mentioning earlier because it's hard for the non-ESOP companies to compete with them. The ESOP companies have a bunch of excited, dedicated employees.

I can give you a great example. A very successful printing company with several thousand employees has an employee stock ownership plan to which it has devoted much time, money and energy to properly using. Shortly after the ESOP was formed, I understand that the founder and former owner was in a meeting with the employees and someone at this employee meeting said, "Our trucks go out of our plants full of our products but our trucks come back empty."

He looked at them and he said, "Yes."

They said, "Shouldn't we do something about that?"

He looked at them and he said, "Yes."

They said, "What are <u>you</u> going to do."

He looked at them and, after a moment, said, "It's your company now. <u>You</u> figure it out."

Within two weeks, they had come back to him to tell him they had a solution. That they'd set up a system that, when the trucks went out, someone would be on the phone looking for partial shipments and partial lots (the normally unprofitable partial shipments nobody else usually wanted to ship at a reasonable cost) to bring back in the empty trucks. The employees turned what was a loss into a substantial profit center. That's just one example of many, many employee innovations in the real world.

In terms of the productivity, research shows that a 2% increase in productivity in some companies can lead to a 10%-30% increase in profitability. Remember, an increase in productivity is getting more work with the same costs, except for your cost of goods sold. If in fact, with the same employee base, they are making more money, with everything else being equal except for the cost of goods sold for the additional product, they've got additional profitability.

And what happens with the additional profitability? For example, at a multiple of 10 (most stocks trade at a p/e ratio above 10) times earnings, it translates into a fairly substantial increase in the stock price.

"Any business owner who wants to maximize his/her wealth should strongly consider doing a 100% ESOP-assisted buyout now while the law is crystal clear and while sellers are able to gain these exclusive benefits for themselves, their companies and their employees."

TWST: Is an ESOP compatible with a union shop? How well can that work?

Mr. Smiley: ESOPs can be designed with and without union employees in the ESOP. Collectively bargained employees can be excluded. Where they have been included, it has worked relatively well. ESOPs help lower absenteeism. Employees are very excited to own their own company. They often put in extra hours because that profit goes in their pockets.

The truth is that the unions have been slow, over the years, to accept this concept of employee ownership. This is partially because they're concerned that it means that they won't be as necessary as they would have been without the employee stock ownership plan.

Mr. Kelso, the founder of ESOPs, explained this fact, during his lifetime, in very clear terms to the unions. He often said, "You are not as critical as you were, but you are still very important to the employees to negotiate their benefits, to negotiate their hours, to negotiate their rules, etc. There is a place for the unions in ESOP companies." Some of the unions have in fact endorsed employee ownership in a relatively big way over the years. We certainly encourage their participation and cooperation. Again, ESOPs can be designed with and without union employees.

TWST: Among those who think and write about it, are there any grumblings from the left or the right?

Mr. Smiley: Yes. When Enron, WorldCom and those other companies went in the tank because of the fraud at the top, the employees lost money, primarily in their 401(k) qualified plans. In addition to its other many benefits, an ESOP is also a qualified plan that provides retirement benefits. At the time of their failure, Enron and WorldCom were not considered ESOP companies. Most companies that get into trouble are not ESOP companies and most ESOP companies do not get into trouble.

When the employees' qualified plans lost money, Congress expressed concern that maybe it wasn't such a good idea to allow employees to invest too many of their eggs in one basket. After thousands of employees voiced their opinions that they didn't want their ability to choose to invest in company stock curtailed, Congress decided to let them decide. The correct concept is that you put as many of your eggs in one basket as you would like, and then you watch the basket very, very carefully, which is how entrepreneurs do well. Note that employees are not required to invest their own money in an ESOP-assisted buyout transaction. It may be a good idea, but it should be studied very carefully.

There is another small group that believes that employee ownership should be limited and restricted; that the safest thing for an employee is a defined benefit pension plan and that the employees are not smart enough or capable enough to be able to decide where they want to invest their money. That group, fortunately, is a very small minority.

In fact, with a properly designed ESOP, the risk to employees is very limited, and potential rewards are great. The happy part is that employees are <u>not</u> personally liable when these bank loans are taken out to buy the company. If you bought the company yourself, can you imagine trying to get a bank loan without personally guaranteeing it? It's not likely. Employees are not required to make those guarantees, so that when they buy the company, they have much less risk than the average buyer. Plus, the bank loans can be paid back very quickly with the pre-tax dollars and the employees working harder, faster and smarter.

As far as grumbling, some individuals in the Department of Labor will occasionally speak out negatively on the issue of the concentration of stock in the employees' accounts. There's still an old guard there. Their attitude is, "We don't know why employees would want to own employer securities in a privately held company." However, the attitude is slowly changing as people become better educated about the many benefits of ESOPs.

I think there's also grumbling from the people who think employees should not be investing in their own companies — period. Their philosophy is that employees should work hard, make elective 401(k) or profit sharing contributions, and then invest those contributions in somebody else's company and not their own. Too much risk, they say. Perhaps, but that's for the individuals and their advisors to determine in their own situations, isn't it?

People on the left favor employee ownership. They like the workers getting cut in on the action, and like the whole concept of employee ownership. Frankly, we're getting support from both the left and the right. The people on the right love the lower taxes and also like the whole concept of employee ownership. There's much support for ESOPs on both sides, but for any idea in the world, if you graph it on a bell shaped curve, there are people who are going to be against it. There are also grumblings from people who were involved in ESOP companies where the ESOP was not appropriate, or the company didn't make it for business reasons unrelated to the ESOP. United's business and industry-wide problems were not the result of their ESOP. Again, this speaks to the skill in selecting and designing the ESOP in the first place. That's one of the valuable skills and services we offer. Should and can an ESOP-assisted buyout be done?

By using the search feature on *The Wall Street Transcript Website*, and typing in "employee ownership" you will find that a number of the companies you have profiled have some form of employee ownership. Some are our clients. These companies have learned from their own experience that employee ownership is a viable, healthy and powerful form of ownership.

I will tell you in all candor that in all the years we've been doing this, only two of the several hundred ESOPs we've done have had problems that were inherent in the design, which we worked out to everyone's satisfaction, and that was many years ago. We're very proud of our track record. We are not afraid to tell a company that employee ownership won't work for them at the present time.

TWST: What about ESOPs that were done without your help? Is your success percentage higher?

Mr. Smiley: Yes. Substantially higher. Some other consultants and advisors in this industry tell people that the ESOP, all by itself, will magically create an employee culture leading to increased productivity and profitability. They believe that once they put the ESOP in, they'll see an automatic connection between employee ownership and productivity. Not a chance. It's not automatic. It takes a lot of work, and some money, often over an extended period of time, and some managers are not willing to invest the money, the time and the effort (or to modify their management styles). In other words, if the ESOP is looked at just as a "tax shelter," it isn't going to be as successful as it could be.

TWST: As far as changing management style, what do they have to do?

Mr. Smiley: They have to begin to be more sharing, and this is tough. Can't you see them bristling as we speak? The autocratic, shove-it-down-your-throat approach is not as successful as employee ownership management methods. But they also have to get over the image of the janitor leaning on the broom trying to run the company. They have to teach the employees that with ownership comes responsibility. With responsibility there may be needed changes in their actions and their performance and attitudes. We've learned that employees don't care much about the voting rights. What they care about is having an effect on their jobs within their sphere of influence, being listened to and being understood, and enjoying the results.

ESOPs are getting more sophisticated and they're getting better and better over time. Why are they getting more sophisticated? Because the design of the ESOPs in the current capital markets and with the structure where no income taxes are paid currently is material to the direction that the company goes over time. If I know I'm not going to pay any income taxes for the next 10 years, I will make different decisions.

Many of the newcomers to the ESOP profession are using real companies as guinea pigs. They haven't even read our 1,500-page book. They don't go to the employee stock ownership plan meetings. They are amateurs and they make grave mistakes. They get hired because they are not very expensive up front. However, when the problems show up these inexperienced advisors end up being the most expensive of all. Unfortunately, most people and their advisors can't tell the difference until it is too late.

> *"More and more medium sized and large companies see ESOP-assisted buyouts as a superior alternative to leveraged buyouts. Leveraged buyouts are risky because they often involve a huge amount of debt and offer very few tax benefits. More companies are learning that the ESOP alternative can meet their needs better than a leveraged buyout."*

TWST: What are the possibilities in Europe?

Mr. Smiley: International ESOPs are tough to do because the countries are trying to keep the money within their country, and collect local taxes, and if the stock is of a company that's US-based and it's private and employee owned, that makes it tough. They don't have the same trust or benefit plan laws that we have. They don't have the same private property laws that we have. We should keep ESOPs at home. They make America strong.

TWST: It sounds like a classic American way of doing things.

Mr. Smiley: Senator Russell Long was a good friend. While he was Chairman of the Senate Finance Committee, he was very much pro employee ownership. He said to me one day, "We can look at employee ownership from the left and from the right. We get support from both."

TWST: It's a populist idea.

Mr. Smiley: It's a populist idea, but it doesn't require that you rob from somebody else. And that's the part everyone loves about ESOPs. You don't have to raise taxes or take money from people or extort from them in order to help both employees and owners of American businesses.

TWST: What would you like to see a few years from now for yourself and the ESOPs in general?

Mr. Smiley: I would like to see several changes to the law made, which were proposed last year and will probably be re-introduced. They are important to do. We're hoping that they can happen. ESOPs contribute to a higher tax base because as employee owners make more money, they pay more personal taxes. And when they get the money out of the plan at some time in the future, which is what it's all about, they're going to pay taxes on that. I think it was Senator Long's father, Huey Long, who said, "I'd like to see a chicken in every pot." Senator Long was heard to say, "I'd like to see an ESOP in every pot."

I'd also like to see an ESOP in every employee's future. Of course it's optimistic and unrealistic to think an ESOP can be in every employee's future. But for the companies that qualify for employee ownership, we would like to see them take advantage of these unique benefits while they are still available.

"Employees must be taught the employee ownership message or the ESOP will not realize anything like its full potential. If you don't explain to them their rights and responsibilities, how it works, what's in it for them, what they get, when they get it and what they have to do to make it better, it won't be as effective as it could be."

TWST: You mentioned that not all ESOPs are functioning as well as yours are. Is there any legislation coming along that would stiffen things up so that the incompetent ESOPs wouldn't be allowed to be so incompetent?

Mr. Smiley: The good news is that has happened. In December 2004, regulations issued by the IRS make it even more likely. That's the good news. With the last legislative changes, at this moment in history, we think owners have a wide-open highway to implement an ESOP-assisted buyout. There are no roadblocks. There are no obstructions. There are no problems other than finding competent professionals to help you fully explore the ESOP alternative.

We have an informative free report that many of your readers may want. It's called "Wealth Creation for Business Owners." It's a 19-page report. I've been told that it's probably the clearest explanation of ESOP-assisted buyout benefits that people have ever seen. Your readers could learn how to sell their businesses and defer millions of dollars in taxes, sometimes forever. Readers who are interested in receiving a copy should e-mail me at rsmiley@benefitcapital.com, and put "Wealth Creation for Business Owners" in the subject line when they send their contact information. (Or send a fax.)

TWST: Could you tell us about your background?

Mr. Smiley: My background is ideal for designing and implementing ESOP-assisted buyouts because I'm well versed in law, economics, in corporate finance, in lending and the employee benefit area. I am an expert in the productivity aspects of ESOPs. I'm the senior editor and co-author of the leading reference work on employee stock ownership plans *Employee Stock Ownership Plans: ESOP Planning, Financing, Implementation, Law and Taxation*. (Advance copies can be ordered at http://www.benefitcapital.com/esopbook.htm). I speak at many conferences each year. I'm on the Board of Editors of the National Center of Employee Ownership's *Journal of Employee Ownership Law and Finance*. I think that over the years I've been helpful in the lobbying efforts and the educational efforts at the congressional and regulatory levels.

I was a co-founder of The ESOP Association. I helped found The ESOP Association in 1977 because I could see that the Internal Revenue Service and the Department of Labor were not looking favorably on ESOPs and I realized that the hostility stemmed from pure ignorance (lack of knowledge) and misperception. Congress was behind ESOPs, but the agencies were not. I figured that if we got them together in one place and under a forum that had enough objectivity that they would attend, they could learn that, in fact, ESOPs were good for them and good for America and good for the employees and that the only losers were going to be those that weren't set up correctly. In 1984 I received the President's Special Achievement Award from the President's Commission on Pension Policy. I am the only lifetime member of the Board of Governors of The ESOP Association. I am a director of the National Center for Employee Ownership, and former Trustee of the Employee Ownership Foundation.

TWST: Where did you go to school? And can you tell us about the backgrounds of a couple of your colleagues?

Mr. Smiley: I graduated from Stanford. I have a law degree from LaSalle University, Chicago. I was very interested in implementing my dreams so I wanted to get out in the real world.

We have many key people. I will mention a few in our limited time. Our Website has the bios of our senior people. We have been principals, consultants and advisors to well over $5 billion in transactions. Kenneth Winslow, who runs our Dallas office, used to head all of Chemical Bank's ESOP lending. He's a Harvard MBA and is an extremely knowledgeable speaker, writer, educator and is a wonderful fellow. Been with us since 1988.

Steven J. Levine runs our New York office. As you can imagine, we have done successful ESOPs all over the United States. He has an actuarial background, which has provided him with very strong skills in math and other complex areas of qualified plans. He works primarily with those companies that have overfunded and underfunded pension plans, as you can see on our sister Website, www.overfunded-pensionplans.com. He assists shareholders wishing to realize value for the overfunding in their defined benefit pension plans. There is nearly confiscatory taxation of over 90% of the overfunding in defined benefit pension plans. Typically, this leaves less than a dime on the dollar. We have unique and proven solutions for this overfunding dilemma. Conversely, if the company has an underfunded defined benefit pension plan, our proven financial solutions can discount the underfunded pension obligation by as much as 30% and eliminate the ongoing liability of the sponsoring company. Steve Levine is a frequent speaker on how ESOPs combined with fully funded pension plans can truly contribute to the productivity of employees and companies.

Dick Morris runs our Hawaii office. He has been a big factor in the development of employee ownership on the Islands for over 15 years.

Our Benefit Capital Companies include a number of affiliated companies and offices around the country. Richard F. Sandifer, Roland G. Thon, Ronald J. Gilbert and Edward M. Bixler are all key principals. Again, we refer your readers to our Website for the backgrounds of our senior people. I wish we had more time to tell you about all of the highly skilled professionals on our team.

Over the past 30 years, for each of the disciplines and areas of expertise that are necessary to successfully complete an ESOP-assisted buyout (feasibility, design, implementation, finance, valuation and fairness work, post-transaction services and productivity enhancement consulting), I and other key principals of our group have been involved in these areas. Our work is hands-on in real companies. We have substantial experience in helping companies become more productive and therefore more profitable. Our innovative structures have enabled sellers and buyers to realize results, in time-tested ways. Our track record speaks for itself.

By the way, did you know that people love to hear about ESOP-assisted buyouts? This is one of the most popular topics at some conferences. If any of your readers organize symposiums or conferences, if we have the time, we may be able to speak at one or two of them.

TWST: Is your own company an ESOP company?

Mr. Smiley: Yes.

TWST: What are some of your opinions on the Social Security situation?

Mr. Smiley: It's a system that many people believe needs to be improved. I don't believe that a pay-as-you-go system is appropriate. I don't think that Congress should be allowed to spend the money or to reinvest it or do the things with it that the government is currently able to do. I think it should be a stand-alone, fully funded system, but it isn't.

I believe that ESOPs are a wonderful supplement to the base that Social Security could provide, but I think that the future of Social Security is not viable under its current system. It's underfunded. It's a pay-as-you-go system.

There's a repurchase obligation that all companies that have an ESOP are required to honor, and that requires that when an employee retires, dies, becomes disabled or otherwise terminates service, the company must buy back the stock from the employee at fair market value. There is also a requirement allowing an employee to elect to diversify at certain ages.

But it's like anything else. Some companies don't preplan for the obligation. I believe that Social Security would be far safer for all of us if it were funded. And the assets were safely set aside and diversified, like pension plans are required to do. We make sure every ESOP we do is headed toward being fully funded so that no one ever has to worry about the repurchase obligation.

TWST: In the beginning, the pay-as-you-go approach was all right because there were plenty of people to pay in and not that many to collect.

Mr. Smiley: Yes, in the beginning, it was the reverse of what we have today. You had five or six workers for every retiree. Now you've got, as I understand it, one retiree and one-and-a-half people to support him or her. But if people have other benefits, including ESOPs, then the amount of Social Security that they need is going to be less, which means that we have less of a social problem. That's how I would see ESOPs relating to Social Security.

One final thought. If a company qualifies for an ESOP (and that's part of what we can help determine pretty quickly), they should try to do the ESOP as soon as possible, before these incredibly generous tax benefits are cut back. Now is the time to take action.

"We should leave the ESOP benefits alone. Let the companies continue to be successful and create jobs that will employ Americans. Let them be as profitable as they can be. It will multiply the tax revenues in future years."

TWST: They could be cut back?

Mr. Smiley: Absolutely. It's a risky strategy to wait because Congress makes changes to the tax laws almost every year under both Republican and Democratic administrations. Historically, some of these changes hurt ESOPs. If you can't sell out tax-free and if you can't elect to pay no federal income taxes and the principal, interest and dividends are not deductible, that would be a major setback for employee stock ownership plan growth.

Procrastination can cost business owners dearly. I've seen business owners delay making a decision and while they were analyzing and re-analyzing the many benefits of ESOPs and ESOP-assisted buyouts, the tax laws changed. So those poor folks were no longer able to use these generous provisions that were in force when they first started contemplating it.

Typically, and this has always been the case with ESOPs, if you've got an ESOP, you're in and you're grandfathered if the tax laws change. Based on my 30 years of experience in this area, our advice is that any business owner who wants to maximize his/her wealth should strongly consider doing a 100% ESOP-assisted buyout now while the law is crystal clear and while sellers are able to gain these exclusive benefits for themselves, their companies and their employees.

From 1986-1989, Congress persistently cut back on ESOP benefits. Senator Long and President Reagan had gotten eight distinct, beautiful benefits in by the end of 1986. Then in 1987, 1988 and 1989 and on through 1995, Congress searched for ways to raise revenues to close the budget deficit. (Do you see the parallels today?)

They decided to eliminate tax benefits for certain taxpayers and took away major parts of some of the ESOP benefits. Hear this: within a decade, only three of the eight benefits were left standing. Fortunately, those are the three that are still critical today, including the tax deferral for sellers, the deduction for dividends and the deduction for principal and interest on loans. All of the others are gone.

The point I'm making is that ESOP law and ESOP tax benefits change rapidly. The benefits available currently are unprecedented. I ask you: do you know of any other way that you can own a profitable business and pay no income tax? I don't. And we have no guarantee that these unique benefits will last.

TWST: I think you mentioned earlier that you can't do an ESOP with just one or two people.

Mr. Smiley: Most have a minimum of 25 people. There are ESOPs in smaller companies. They can work. They are sometimes more difficult to design and harder to do.

By the way, under President Bush, ESOP benefits have been expanded. He is a supporter. Leading Democratic and Republican Senators and Congressmen also support employee ownership. Most of Congress is pro-employee ownership. Their voting records over the years are pretty clear and are very encouraging.

TWST: Looking into the future, what do you think would be the outer limit for ESOPs? You had mentioned $50 million.

Mr. Smiley: ESOPs have been done in the several hundred million dollar range and up.

More and more medium sized and large companies see ESOP-assisted buyouts as a superior alternative to leveraged buyouts. Leveraged buyouts are risky because they often involve a huge amount of debt and offer very few tax benefits. More companies are learning that the ESOP alternative can meet their needs better than a leveraged buyout.

Employees can afford to buy the business. We can structure them, finance them, and get them done. More business owners need to learn how ESOP-assisted buyouts can be a powerful alternative to leveraged buyouts and other third party sales.

TWST: Have you ever met with strong opposition when you're out speaking about ESOPs? Why are there not more ESOPs that work as well as they could?

Mr. Smiley: Not since 1975. We had a guy on a panel who was a union organizer. He could not accept or understand that it was possible to cooperate, that employees could cooperate with management, become owners and create a more effective company. He was old school. But that's the last time I've been attacked.

Employees must be taught the employee ownership message or the ESOP will not realize anything like its full potential. If you don't explain to them their rights and responsibilities, how it works, what's in it for them, what they get, when they get it and what they have to do to make it better, it won't be as effective as it could be. The company may go along fine and it may still survive and even prosper, but it's not going to be the company it could have been. We show companies how to realize those new heights.

ESOPs won't work well if the sellers and other advisors and professionals get sloppy and greedy. There has been some limited litigation involving employee stock ownership plans and it has almost always centered around the valuation. You cannot sell a $10 million company to the employees for $12 million. That is simply not allowed. However, remember that if you're selling a company that you think is worth $12 million but everyone else realistically and objectively agrees that the fair market value is really $10 million, you're still going to make out better. You can sell for the $10 million, rather than holding out for what may be years to find that one and only buyer willing to offer you the $12 million.

Why? Assume you get lucky, and someone pays you the $12 million. You're going to pay 25% in capital gains tax. You will send $3 million on a one-way trip to Washington, DC, if you do a traditional sale to outsiders. If you sell for $10 million through an ESOP-assisted buyout, you're going to have $10 million instead of $8 million, so you're $2 million or 25% ahead with an ESOP. You might feel as a seller that your company is really worth $12 million, but you've got to find that buyer. That means you've got to go through the process, you've got to do the disclosure, you've got to go through due diligence, you've got to spend the minimum of 18 months or more it will probably take, and you may or may not get a financed offer for $12 million on your terms. In the meantime, some of your key employees may have deserted you. Who wants to work for some new unknown buyer, when they can go somewhere else where they can probably get a piece of the action?

TWST: In working on an ESOP with a company have you ever had to just step out of the way?

Mr. Smiley: Yes. We tell them it will not work. But we've saved companies a lot of time and a lot of money because we can do this analysis in the beginning and we pretty much get through all of the problems and challenges that could occur. We're very, very good at this. Also, we work with the top valuation experts in the nation, so our valuations have never gotten into trouble.

TWST: Is there anything you want to add, particularly with regard to your vision or long-term objectives?

Mr. Smiley: In terms of vision, if we could quadruple or quintuple the number of professionals that truly understood the challenges and benefits of an ESOP, we would be clearly better off as a country. ESOP-assisted buyouts require a team approach. No one law firm or accounting firm can do these alone. Congress should leave alone and not tinker with the ESOP benefits.

I have repeatedly watched Congress introduce legislation to repeal these hard-earned benefits. For example, we had six transactions worth over $1 billion on the table in 1989, fully funded and ready to close, when every critical ESOP benefit was slated for repeal. Some politicians thought it was too much of a good thing. The "revenue costs" and "tax expenditures" were too high, they said. Some politicians think the same thing today. So legislative risk should concern everyone. That's why any seller who wants to maximize gains and minimize taxes should try to do an ESOP-assisted buyout as soon as possible. In fact, it would be counterproductive to reduce ESOP benefits. We should leave the ESOP benefits alone. They were established by the leaders of both political parties to benefit American businesses, employees and communities. These decisions were carefully made over many years, and after numerous hearings and studies. Short-term thinking and adjustments are neither necessary nor desirable. The country can have the results of these ESOP tax incentives if Congress and the regulatory agencies will just let the ESOPs work their magic and do what they have proven they can do. Let the companies continue to be successful and create jobs that will employ Americans. Let them be as profitable as they can be. It will multiply the tax revenues in future years. Those tax revenues will then be there when we need them the most. Those employees are going to end up paying lots and lots of taxes back into the system, and that will benefit us all.

If any of your readers would like to get a jump-start before the tax laws change, they can send an e-mail to rsmiley@benefitcapital.com, with their contact information, and we will send them our free 19-page white paper titled: "Wealth Creation for Business Owners."

TWST: Thank you.

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Corporate Business Description

Founded in 1984, Benefit Capital is widely known as the premier firm in America providing a full range of employee stock ownership plan (ESOP) and related services. Benefit Capital helps companies quickly and effectively form ESOPs and assists owners in selling their stock to ESOPs. By doing so, owners can defer all taxes on the sale, sometimes forever.

Benefit Capital has served as a trusted advisor on more than $5 billion in transactions all across the United States in a variety of industries. In addition, Benefit Capital has six offices across several states and Hawaii providing a variety of services related to ESOPs, ESOP-assisted buyouts, business brokerage, pension plans and related services.

Investment Banking

Benefit Capital provides a variety of services to companies valued at between $10 million and $900 million and has been a primary advisor on more than one billion dollars worth of investment banking transactions. The investment banking services that Benefit Capital provides to middle-market companies include mergers and acquisitions, private placement of debt and equity, fairness opinions, structuring and financing leveraged transactions and corporate partnering.

Merchant Banking

Benefit Capital has a highly regarded track record as a principal in originating and sponsoring private equity and debt investments in middle-market companies. Transactions in which Benefit Capital and its affiliates have provided investment capital include buyouts, recapitalizations, growth equity and ESOPs.

Overfunded Defined Benefit Pension Plans

Benefit Capital has a unique and proven solution to the 90% taxation of overfunded defined benefit pension plans and has been successfully providing these solutions for more than 15 years. Benefit Capital uses its financial engineering expertise to enable shareholders to monetize the value of the overfunding (often by millions) in defined benefit pension plans.

Benefit Capital works with some of the top actuaries and pension lawyers in the country to deliver these services. The firm also acts as a principal in transactions monetizing the value of overfunded pension plans for shareholders. The beneficiaries of the pension plans are always protected in these transactions and receive all promised benefits.

Underfunded Defined Benefit Pension Plans

Almost all Americans are aware of the crisis with underfunded defined benefit pension plans. Benefit Capital has been an industry leader and pioneer in delivering innovative solutions in this area for more than 10 years. Benefit Capital's solutions can discount the underfunded pension obligations by as much as 30% and eliminate the ongoing liability of the company.

Employee Stock Ownership Plans (ESOPs)

Benefit Capital's principals have more than 25 years of successful experience in providing services in the Employee Stock Ownership Plan arena as principals, consultants or advisors to over $5 billion worth of transactions in diverse industries. ESOPs enable a unique class of buyers (the employees) to buy a company and write off (deduct) not just the interest on any loan but also the principal. ESOPs are the only buyer that is so favored by the tax code and this provision has enabled hundreds of thousands of employees to significantly increase their personal wealth.

Benefit Capital can provide turnkey ESOP services encompassing every aspect of ESOP planning, design, formation, implementation and monitoring. Benefit Capital can also provide equity financing for management and employees and can bring in additional financing sources on the largest transactions. The principals of Benefit Capital are co-authors and editors of the definitive book on ESOPs, which is used as a reference by many ESOP companies and professionals nationwide. Due to his expertise in this area, one of Benefit Capital's principals was asked to testify before Congress and also received an award for his contributions to public pension policy.

ESOP-Assisted Buyouts

As the large baby-boom generation retires, owners of businesses are finding that the smaller succeeding generation does not have enough people to buy all the businesses being put up for sale. Many businesses for sale are not finding buyers. In many cases, the employees are the ideal built-in buyers.

With a properly structured ESOP, owners can sell their businesses and defer all capital gains taxes (sometimes forever). Owners can save millions to tens of millions of dollars in taxes. Employees can buy the business and write off all interest and principal on the loans. Benefit Capital is a top expert in the USA on ESOP-assisted buyouts and has successfully completed more than $2 billion of these win-win transactions.

Solutions to Sarbanes-Oxley

Compliance with Sarbanes-Oxley rules and regulations costs many public companies from $500,000 to more than $3 million per year. While large public companies can afford these fees and expenses, they can be crippling to smaller companies. In some companies, the costs of complying with Sarbanes-Oxley uses up most or all of corporate profits. In other companies, the costs of Sarbanes-Oxley has significantly reduced or eliminated the advantages of being a publicly traded company.

Benefit Capital has a unique set of solutions to the Sarbanes-Oxley challenge. In many cases, Benefit Capital can help smaller publicly traded companies escape the burden of Sarbanes-Oxley compliance and thereby save $500,000 to more than $3 million per year.