

## **COMPENSATION AND BENEFITS REVIEW**

### **ESOPs: SEVEN MYTHS DISPELLED**

Employee stock ownership plans (ESOPs) are attracting considerable attention for their capacity to both satisfy a variety of corporate and shareholder needs and benefit employees. Companies have found that the plans are an inexpensive source of capital and provide a ready market for the owner's stock. ESOPs can also motivate employees, resulting in dramatic increases in productivity, sales and profitability.

#### **THE MYTHS**

Yet many benefit plan administrators and boards of directors have heard horror stories that have destroyed their interest in establishing ESOPs are commonly heard these days; each is addressed and dispelled in the following sections.

#### **MYTH #1: "ESOPs are a giveaway."**

One could argue that because employees do not actually pay for the stock of the company maintaining the ESOP, its transfer is mere charity, but this conclusion fails to account for the full picture. In fact, the value of ESOP stock at the time of transfer is typically only a fraction of its value at vesting.

The increase in value results from an increase in employee productivity. ESOP-related productivity gains are well documented. A 1986 study published by the National Center for Employee Ownership found that "ESOP companies grew 5% per year faster than [comparable firms in their industry] after their ESOPs were established." This is particularly significant for companies operating on a 5% margin, because a 5% increase in productivity without a corresponding increase in overhead means a 100% increase in profitability.

The reduced cost of raising capital is another attraction of the ESOP. Consider that a firm requiring capital for expansion or an acquisition can choose the traditional route and pay a lending institution one or more percentage points above the prime rate in after-tax dollars, or, on the other hand, it can sell sufficient company shares to the ESOP to fund the capital need. The ESOP, in turn, borrows funds for the purchase from a lending institution at typically 80% to 90% of the prime rate. The company repays the debt (including principal and interest) in pretax contributions to the ESOP.

Individual business owners, too, benefit from the ESOP by gaining liquidity for their stock at current fair market value. (This advantage alone seems to belie the notion of ESOPs as a 'giveaway'; in fact, ESOPs can use their substantial borrowing power to *purchase* company stock.) In addition, under Internal Revenue Code Section 1042, business owners can defer the payment of taxes on capital gains from the sale of stock to an ESOP, often permanently, by reinvesting the proceeds in other qualifying securities.

The ESOP legislation also contains significant estate-planning benefits for business owners, which were intended to prevent the liquidation of a company upon the death of its owner. Specifically:

Under Internal Revenue Code Section 2210, a business owner's estate may donate shares to an existing ESOP, in exchange for which the ESOP assumes liability for payment of the decedent's estate tax in an amount equal to the value of the donated shares. The ESOP has as long as 14 years to pay this tax, which accrues interest at 4% on the first \$1 million, and current rates above that amount. (No principal payments are due in the first four years.) Payments are made by the company in pretax future dollars through contributions to the ESOP.

ESOPs are clearly not a "giveaway", as employees do earn ownership, and share in the success of the company. To the extent that their efforts result in increased value of the company, their stock increases in value. In many cases, employees receive regular dividends. Should they leave the company, they receive current fair market value for their shares and are entitled to "roll over" the proceeds tax-free into another qualified retirement plan or an Individual Retirement Account. Should they not roll over these funds, they may be eligible to receive five- or ten-year forward averaging tax treatment.

#### **MYTH #2: "I'll lose control of my company."**

Taking into account the need of business owners to maintain control over their companies, the framers of the ESOP legislation restricted participation in the decision-making process by employees who participate in the ESOP. Management's operating control is specifically protected under Internal Revenue Code Section 409(e) (3), which grants ESOP participants voting rights on only six specific issues: (1) merger or consolidation, (2) recapitalization, (3) reclassification, (4) liquidation, (5) dissolution, and (6) sale of substantially all the assets of the company. These rules apply regardless of percentage of the company owned by the ESOP. By limiting ESOP purchases to 49% of the outstanding stock of the company, the owners outside of the ESOP retain a majority vote on all issues. The most successful ESOPs however, are in those companies that encourage employee participation. It makes sense for employees to be responsible for areas (that is, their jobs) about which they know more than management does. In most cases, though, employee expertise does not extend to policy-making and strategy issues. In a December 1986 study, the General Accounting Office (GAO) found that "only 4% of ESOP firms with boards of directors had union or non-managerial representatives on boards." Moreover, a 1987 survey by the ESOP Association of America revealed that "only 13% of the firms passed through full voting rights on ESOP stock, [and] 82% of the firms passed through full voting except those required to pass through to employees by law."

ESOPs do furnish employees with an incentive to make their workstations more efficient and improve their job performance. A well-conceived ESOP creates a structure for such efforts and encourages employee input. Employees'

knowledge of their own jobs and resourcefulness in discovering ways to perform their tasks more effectively and/or more efficiently are major company resources. For example, a company's janitors may know better than any other employees of significant company wastefulness. Their suggestions for reducing waste could be of great value. They will be likely to share those suggestions if they know the company is interested in their suggestions where appropriate. Management's willingness to take time to listen and follow up on employee suggestions creates an atmosphere in which employees begin to identify more deeply with the company and ultimately make valuable contributions.

A 1986 study at the National Center for Employee Ownership addresses the issue of control squarely: "[ESOP] characteristics such as ... percent of the company owned by the ESOP ... voting rights, [and] board representation were not related to corporate performance in the employee-owned companies." On the other hand, "Employee participation was 'strongly and significantly related' to corporate performance in [such] companies." The study concludes: "ESOP companies should find ways to involve employees in decision making in order to improve corporate performance, [though] overcoming management's fear of such participation 'may actually be quite formidable.'" (*Managing Beyond Taxes*, 1986, published by the National Center for Employee Ownership).

Is the issue of control an ESOP issue? Yes and No. On one hand, management control within an ESOP company is protected in the legislation. Yet studies show that employee participation is essential to the success of an ESOP. These seemingly contradictory priorities – management control and employee participation – peacefully coexist in most successful ESOP companies. In fact, a well-conceived program of participation reinforces management control by enhancing employee interest in the success of the enterprise.

**MYTH #3: "You must disclose financial data to employees."**

It is not necessary to disclose normal operating and financial data, executive compensation, or the value of the company to ESOP participants. Many companies, however, encourage employee interest and involvement in significant company achievements. The sharing of limited financial data may boost such interest. For example, employees may become interested in reducing the amount of time it takes to perform a specific task or increasing the efficiency of a particular process. Allowing them to see how their efforts filter down to the bottom line may instill in them a feeling of genuine participation.

One detail executives often neglect is to present company growth in a way that is meaningful to employees who support their families on, say \$25,000 per year. Bottom-line improvements mean little to the employees who have worked to generate the profit for anonymous shareholders; however, direct relationships between the increased efficiency of a particular process and the increased value of their stock provides employees with a financial reward and a high degree of personal satisfaction – both of which they will work to enjoy again.

In the event that sensitive financial or operational information is presented in a group meeting, it should be discussed in the context of the success of the company. Though studies show that employee-owners greatly respect the confidentiality of such information, it is generally not advisable to provide it in writing, but rather in the form of slides or overhead transparencies. In addition, information regarding executive compensation is best kept confidential.

In making such presentations, another consideration is that it may be difficult to stretch the typically short-term financial perspective of the employees to accommodate long-term goals. The value of a typical employee's stock at vesting under various productivity scenarios may be a powerful tool for this effort. Visual illustrations and simple arithmetic explanations can bring the notion of compounding (which can produce dramatic gains from small increments of increased productivity over time) to life.

The best-run ESOP companies are eager to grasp the opportunity to help employees gain a long-term perspective, to build employee identification with the company's products and profitability, and to convey caring for the employees' well-being.

**MYTH #4: "My employees can't pay me what my business is worth."**

In fact, under the provisions of the ESOP legislation, ESOPs can pay full market value for the interest purchased.

ESOPs are enabled to purchase company shares through a variety of funding mechanisms, the most common of which is the borrowing of funds in the marketplace at normally preferred rates.

The price at which the ESOP purchases company shares is determined by an independent appraisal, which uses the standard criteria for determining market value: "the price at which the interest would change hands between a willing buyer and a willing seller, both being adequately informed of the relevant facts and neither being under any compulsion to buy or sell" (*IRS Ruling 59-60*). It is unlikely that a buyer would pay more than market value, pretax, for company shares. (Pretax refers to the proceeds to the selling shareholders. When taking the pretax proceeds of a transaction into account, the ESOP can pay the full price for the interest purchased that any other economic buyer would generally be equal. When looking at the after-tax proceeds of the transaction, however, the seller is generally much better off by selling to the ESOP than selling to another buyer. This is due to the generous tax benefits of IRS Code Section 1042 enabling the tax-deferred and often tax-free sale of the securities to the ESOP). Furthermore, since the owner has the option to "roll over" the proceeds into a qualifying security under Internal Revenue Code Section 1042, he or she typically cannot do better, after tax, than selling to an ESOP.

The facts belie the myth, as it is likely that ESOP purchases of company stock are the only reliable means by which to achieve a fair price for a business, with

fairness being defined as a value determined by an objective third party, not by adversaries in the heat of negotiations.

**MYTH #5: “My employees are not interested in an ESOP.”**

It might help to look at the issue in another way: How many employees would prefer to retire with more resources, benefiting from the increased value their productivity brings to the business? The answer is self-evident, and to the extent that one's employees are not interested in an ESOP, it is likely that the concept has not been communicated to them effectively.

Most employees can easily understand the basic ESOP concept. In fact, a recent survey by the Bureau of National Affairs determined that 57% of workers would be willing to trade their next pay increase for an ownership interest in the company for which they work. Common sense dictates that people take pride in possessing things of value, and the figures obviously support this conclusion.

**MYTH #6: “ESOPs are for failing firms.”**

A number of failing firms have used ESOPs successfully to save jobs and rescue otherwise hopeless situations. One of the most remarkable ESOP turnarounds occurred at Weirton Steel. In March 1982 National Steel of Pittsburgh decided to divest itself of its Weirton plant. Two years later the employees formed the nation's largest ESOP and became 100% owners. Today, Weirton is the nation's eighth largest steel company.

But the use of ESOPs by failing firms is the exception. Some 98% of companies maintaining ESOPs are health, thriving enterprises using the plan to drive their prosperity. They implement ESOPs for a number of reasons. Chief among them are these:

- 1) *To shelter profits.* Company contributions to an ESOP are tax deductible, and the extent that they exceed taxable income in a given year, they can be used to recapture previously paid federal taxes.
- 2) *To maintain continuity.* ESOPs lay the groundwork for an orderly transition after the owner's exit. ESOP companies are more profitable than other companies, so they have a better chance for survival; and the act of setting up an ESOP places management in a planning mode and often leads to long-term succession planning.
- 3) *To finance acquisitions.* Through the purchase of company stock, ESOPs provide cash to finance the acquisition of assets and/or other companies.
- 4) *To facilitate a cash out.* Owners can sell some or all of their stock to the ESOP and thereby convert equity in their business into cash.

- 5) *To facilitate estate planning.* ESOPs provide liquidity for a business owner's estate and a significant tax advantage to the estate for the sale and/or contribution of stock to an ESOP.

Business owners may fear the decline of their enterprises once they leave the company. They may perceive their businesses as an extension of themselves. ESOPs, however, are an effective vehicle for institutionalizing continuity. They create an atmosphere in which the company readies itself for a transition, thereby providing for the long-term success of the business. In fact, studies have shown that ESOP companies, after receiving control from the selling shareholders grow 30% faster than before.

**MYTH #7: "ESOPs are forever."**

Because they are important in helping a company achieve its goals, ESOPs are rarely discontinued. A company that wishes to discontinue its ESOP, however, can do so by discontinuing contributions to the ESOP and buying back company stock as employees retire or depart. It can collapse the ESOP immediately by fully vesting all participants and repurchasing their stock.

On the other hand, many companies that are considering implementing an ESOP worry that the plan may *not* be forever. Is the legislation that created this program subject to the budget-cutting ax?

In fact, through the enactment of ESOP legislation, Congress intended to encourage broader ownership of capital. Whereas only a minority of citizens would otherwise own stock, ESOPs give the majority of Americans an opportunity to participate in capital ownership. A report by the General Accounting Office to then-Senator Russell Long (D., Louisiana) indicated that ESOPs have helped Congress achieve this objective. It said, "A median of 71% of employees informs sponsoring ESOPs own stock through their plans; in contrast, only 19% of all U.S. families owned stock directly or through mutual funds in 1983."

ESOP provisions, which offer benefits to business owners, may be considered sacrosanct because they protect workers from company liquidation's, enable them to participate in the economy in the dual role of capitalist and laborer, and enhance their productivity and that of the nation.