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EsopCentre

spreading the wages of capital

Employee Ownership & The Future Of Capitalism

Webinar

Monday 07 Sep 2020

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A Word From Today's Chairman

Professor Michael Mainelli

Executive Chairman

Z/Yen Group

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Agenda

17:00 – 17:05	Chairman's Introduction
17:05 – 17:30	Keynote Address – Corey Rosen
17:30 – 17:45	Questions & Answers

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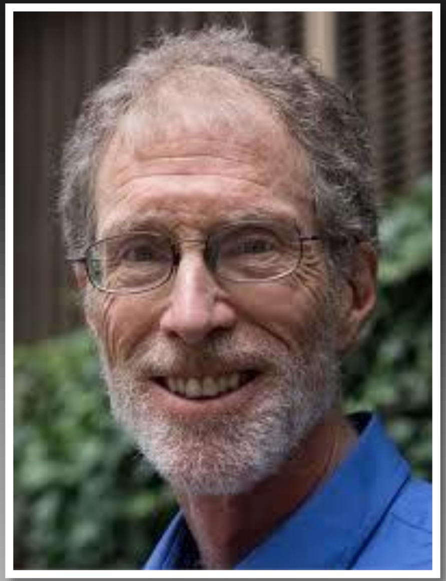
Employee Ownership & The Future Of Capitalism



Corey Rosen

Founder

National Center for Employee Ownership

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NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP

Employee Ownership and the Future of Capitalism

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Why Employee Ownership is Essential

- Just over 20% of all Americans have no wealth at all.
- Forty percent of Americans cannot cover a financial emergency with available cash.
- Only about half the working age population has retirement savings of any kind.
- The net worth of a typical white family is nearly ten times greater than that of a black family.
- About 60% of white families have retirement accounts; 30% of black families do.
- The median ownership of stock by white families is nearly eight times as high as black families.
- Housing equity is about 2.5 times greater among white than black families.
- While the differences are less stark for Hispanic families, the disparities remain very large.

Wealth Insecurity is Debilitating

This lack of access to wealth is economically, socially, and psychologically devastating. Wealth means options; wealth means security; wealth means we can plan for the future. With wealth, we can send our kids to college, take a chance on a new job or starting a business, handle an emergency, and much more.

While this is now widely recognized by all political sides, there is little agreement on what to do about it – except employee ownership.

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Capitalism for the left and the Right

Broad-based employee ownership plans, primarily through Employee Stock Ownership Plan, have bene embraced by both parties, resulting in a long services of laws.

Most recently, different dramatic proposals have been introduced by Ron Johnson (R-WI), a very conservative Senator, and Alexandria Ocasio-Cortez, (D-NY), one of the most liberal members of the House.

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Employee Ownership Works

Most common form of employee ownership in the U.S. is the Employee Stock Ownership Plan (ESOP).

ESOPs are almost always add-ons to other retirement plans. Participants in these plans accumulate 2.2 times the retirement assets of employees in other retirement plans and literally infinitely more than the roughly half the non-government working population that has no retirement plan at all.

In 2017, Nancy Wiefek of the National Center for Employee Ownership, using data on millennials from the National Longitudinal Survey of the Bureaus of the Census, found that the median household net wealth among respondents in employee ownership plans was 92% higher for employee-owners than for non-employee-owners; employee-owners of color have 79% greater net household wealth.

Employees in these plans are one-third to one-fourth as likely to be laid off, depending on the survey year.

ESOP companies default loans taken out to buy company stock at a rate of 2 per thousand per year.

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Granting Equity Broadly Works Too

Companies with broad-based plans saw productivity rise 20% to 33% above comparable firms after plans were implemented, with medium-sized firms at the higher end of the scale.

Looking at companies before and after they set up a plan, indexing out industry effects, shows that productivity went up 14.8% and return on assets 2.5% in the three –year period after they set up their plans.

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To see a summary of all major studies, see this link.

ESOPs

Started in 1974

7,000 companies in 2020; 14 million participants

$1.4 trillion in assets (estimated 2020)

Used for

- ✓ **Succession Planning**
- ✓ **Financing Growth**
- ✓ **Employee Rewards**
- ✓ **Matching 401(k) Deferrals**

Tax Benefits for

- ✓ **Selling Shareholders**
- ✓ **Company**
- ✓ **Employees**

Why an ESOP?

Creates a way for owners of closely held companies to provide for ownership transition in the most tax effective way available.

Allows companies to be transferred to employees using corporate profits, not employee after-tax dollars, on a schedule comfortable to the owner(s).

ESOPs can buy some or all of the stock, from one owner or more

Properly structured ESOPs can improve competitiveness.

S ESOP companies can avoid taxation on profits attributable to the ESOP's ownership percentage.

ESOP Basics

- Defined contribution plan under ERISA
- Company sponsored and paid; employees very rarely buy shares
- Funded instead by company contributions to an ESOP trust; contributions allocated among plan participants based on relative pay or more level formula
- All full-time employees are usually covered by the plan, subject to service and vesting rules
- Paid out in flexible terms on termination

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How An ESOP Buys Out an Owner (details follow)

- Company sets up an employee benefit trust.
- Contributes cash to buy shares or
- Borrows money through the plan to buy shares.
- Employees do not buy the stock.
- Contributions are tax deductible, even when used to repay a loan (principal and interest), up to 25% of eligible pay.

How Much Will the ESOP Pay?

Price must not be higher than fair market value on a financial basis as determined by an independent, outside appraisal firm.

The ESOP cannot pay synergistic value.

Minority ownership sales are valued at less per share than control sales.

Elements of Valuation

Most important is some multiple of future free cash flow or, similarly, discounted future cash flow over an appropriate number of years.

Comparable company sale data and, if applicable, public company comparison data will be factored in.

Asset value is usually the least important factor, but valuable non-performing assets may add to value.

Benefits to Seller

- If ESOP owns 30% or more of the company after the sale in a C corporation, seller can defer tax on gain on the sale if reinvested in qualifying stocks and bonds (see slide later). If this is not possible, sale still qualifies as capital gain.
- If the company is an S corporation, deferral is not possible, but capital gains deferral is not available, but other tax benefits are.
- ESOP can buy some stock now, some later.
- Sale accomplished in pre-tax dollars.

Sales in a S Corporation

- The tax deferral is not available.
- The profits attributable to the ESOP, however, are not subject to federal, and usually state, income tax.
- Subject to the anti-abuse rules, the seller, 25% owners, and family members can get ESOP allocations.
- Distributions made to other owners must be made pro-rata to the ESOP, but can be used to buy additional shares.

Funding Options

- Banks can loan money to the company, which reloans to the ESOP (the internal loan), which uses the cash to buy the owner's shares.
- Company repays the bank, not the ESOP. Payment usually over 5-7 years.
- Covenants on loans are typical.
- Internal loan often for much longer term to smooth out annual additions to employee accounts.
- Sellers can finance the transaction with a note, but can only get a tax deferral on what they reinvest in first 12 months (see more in next slide).
- Company can contribute cash each year to the plan, either to buy shares that year or to build a cash reserve to make a larger purchase later on, perhaps in combination with debt.
- In limited circumstances, some portion of funds in existing defined contribution plans may be used to help fund the ESOP (but fiduciary issues arise).

Seller Financed Sale to Employees

- Seller takes a note for the shares from the company.
- Company reloans to the ESOP. Terms do not need to match.
- Principal and interest deductible.
- Interest rates and terms must be arms length equivalent and fair to the ESOP trust.
- Seller notes often used in combination with bank loans and may have warrants attached.

Leveraged ESOPs

- Plan can borrow money to buy existing shares or new shares to fund growth.
- Company contributes cash to the ESOP to repay the loan and takes a tax deduction.
- Shares go into a “suspense account” and as they are paid for get released to employee accounts.

Step 1

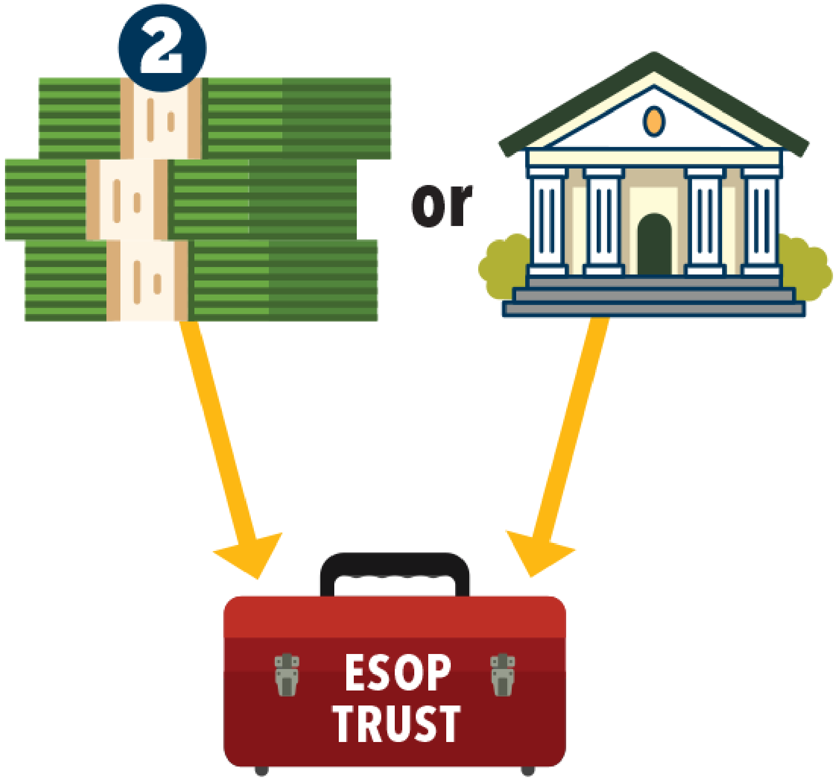
ESOP Nuts and Bolts

An ESOP enables employees to own part or all of the company they work for. Individual employees accumulate shares in their retirement accounts over time, and they cash in those shares when they retire or leave. Yet the stock they own never costs them a nickel. To see how this works, let's imagine that Pat, a company owner, decides to sell shares to an ESOP.

1

The first step is to set up an ESOP trust. The trust is a legal entity that will hold shares of stock on behalf of the employees. It is governed by many of the same rules as 401(k) plans, but it is funded entirely by the company.

Step 2



Next, the company contributes money to the trust, or else the trust borrows money from a bank, the seller, or both. If it borrows the money, as is common, the arrangement is called a leveraged ESOP.

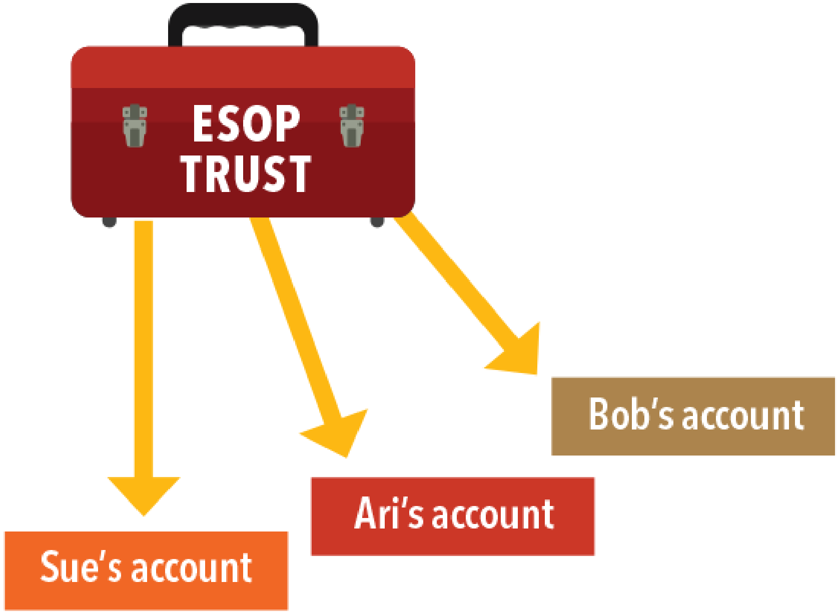
Step 3

Using that money, the trust buys some or all of the company's shares from the owner or owners (Pat in this case). The price of the shares is determined by an independent appraiser.

Step 4

4

Then the trust begins allocating shares to the retirement accounts of employees. In a leveraged ESOP—the kind with borrowed money—it allocates the shares as it pays back the loan. By law, shares must be distributed according to relative pay or by some formula that results in a more equal distribution.

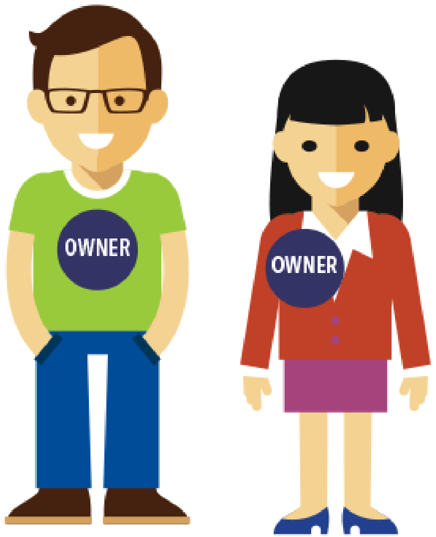


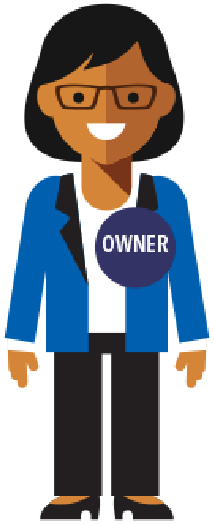
See what happened? The employees' accounts now have stock, and they are the owners—without having made any cash outlay.

Step 5

5

When employees leave the company, they are cashed out. The ESOP provides them with a significant retirement benefit. Beyond individual employees, the ESOP protects jobs by providing ownership continuity and keeping the company as a going concern.





And Pat not only found a buyer for her business while keeping it going, but she can keep working there and ease out in stages if that's the right thing for her and the company.

Key Points to Remember

- The company, not the employees, fund the plan.
- The acquisition of shares is a non-productive expense, so the company must have the earnings to absorb it.
- ESOPs are the only way a company can use pre-tax dollars to buy out an owner.

Participation, Vesting, and Allocation

- Employees have individual accounts.
- Company contributes cash to buy stock, contributes stock, or has plan borrow to buy shares.
- Accounts are subject to vesting over not more than 6 years.
- Generally, at least all-full-time employees with 1,000 hours in a year must be included in the plan.
- Allocations can be based on relative pay or a more level formula. They cannot be discretionary or merit based.

Distribution

- Employees start getting distributions not later than one year after death disability, or retirement, or
- Five years after the end of the plan year for other terminations.
- Can be paid out in installments up to five years.
- Employees with 10 years in the plan who are 55 or older can diversify part of their stock accounts.

Governance

- Limited employee voting rights.
- Plans governed by a trustee appointed by the board.
- Often an ESOP committee to assist in the process.

Costs

- First year costs typically $80,000 and up.
- Ongoing costs can be as low as $15,000 or so, depending on size of the company, changes in the law, and other factors.
- ESOPs more expensive than other plans, but much less expensive than selling a business in other ways.

Making It Work

Just sharing ownership is not enough.

The most effective companies share information at both the overall company level and through work-level metrics.

Employees then use this information to identify problems and make decisions about issues affecting their jobs.

More and more companies are going beyond this to involve employees in strategic planning.

The MSA Idea Card

Idea	
Name	Date
What is the problem/waste?	
Why is it happening?	
Idea:	
Date implemented:	

Create a Responsibility Chart

<table>
<tr><th colspan="7">MSA Idea Board</th></tr>
<tr><td rowspan="2">Huddle day and time</td><td></td><td colspan="2"></td><td colspan="2"></td><td></td></tr>
<tr><td colspan="6">Ideas and Progress</td></tr>
<tr><td rowspan="8">Huddle steps:
1. Review metrics
2. Ideas in progress
3. New ideas
4. Celebrate!</td><td>Idea</td><td colspan="2">Owner</td><td colspan="2">Task</td><td>Due Date</td></tr>
<tr><td></td><td colspan="2"></td><td colspan="2"></td><td></td></tr>
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<tr><td colspan="6">Follow Up</td></tr>
<tr><td colspan="2">Parking lot ideas</td><td colspan="3">Needs help that need help

Review every three months and move to in progress when a task is assigned.</td><td>Completed ideas</td></tr>
</table>

Additional Resources from the NCEO

Understanding ESOPs

Beyond Engagement: How to Turn Your Company into an Idea Factory

www.nceo.org

Fall Forum

crosen@nceo.org

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QUESTIONS & DISCUSSION, ANSWERS?

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The Esop Centre's *newspad*, edited by Fred Hackworth, is a monthly publication providing in-depth coverage of the main international news in the employee share ownership field.

NB Reminder: The email address of Fred Hackworth, editor of *newspad*, has now changed to: fred_hackworth@zyen.com (please note the under-score). Please send all press releases, company bulletins and news items for *newspad* to the above address. Thank you.

September 2020

In this month's edition:

- Employee equity values slashed in pandemic job cuts
- Discretionary employee stock award for sex – claim
- Roadchef: efforts to secure tax-free compensation fail
- Executive reward under pressure
- Reports on five Centre-FS Club webinars
- Covid pushes SMEs towards share plans, report claims
- Share plans in a Covid world
- Last orders for Centre-STEP Jersey seminar September 25
- British Isles share plans symposium London, March 24
- Pandemic news: employees turn Bolshie

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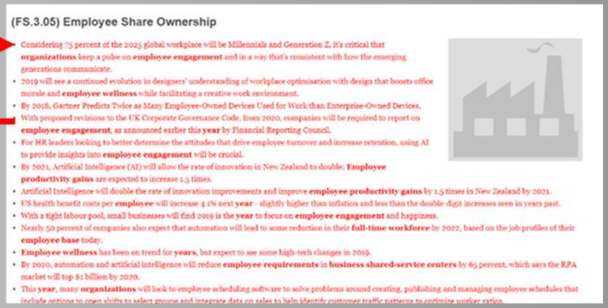

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- 10 September 2020 (10:00) Regulation & Recovery: EU Financial Services In The Wake Of Covid-19 & Brexit
- 14 September 2020 (11:00) Can I Really Be An Inventor If I Work in Finance? How & When To Obtain Patent Protection For Financial Innovations
- 15 September 2020 (16:00) Leadership Of Self - An Introduction To Mindfulness & Inner Resilience For New Modes Of Working

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