

Vermont Employee Ownership Center

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ESOP Sustainability:

What is it?

and

How is it achieved?

Today's session

- This presentation will be divided into three parts
 - Some general comments about ESOPs.
 - A definition of ESOP sustainability.
 - How is ESOP sustainability achieved?

Part 1

Some general comments

ESOPs are variously described as:

- A benefit plan
- A scam
- A complicated unknown for my accountant/lawyer
- A retirement plan
- A tax dodge
- A capital structure
- A succession plan
- A cash out/exit strategy for the current owner(s)
- A giant pain in the _____
- A transitional stage to something else
- A (the) way of economic life

ESOPs occupy a different space than other capital structures such as:

- Family owned businesses
- Sole proprietorships
- Partnerships (whether general or limited)
- Foreign owned businesses
- Private equity funds/hedge funds
- Public companies
- Consumer / producer coops
- Non-profits
- Non-governmental agencies

An ESOP is a self-contained stock market

- Plan document contains specific rules for:
 - Accumulating shares
 - Selling shares
- This process is aided by:
 - The valuation process
 - The administration process
- Rules promulgated by:
 - The Department of Labor (DOL)
 - Implementing ERISA
 - The Internal Revenue Service
- Important point: unlike most other private companies, ESOPs have a structured cash out event
 - The ESOP is a type of buy / sell agreement

Shared equity and empowerment

- ESOPs are about shared equity (wealth)
 - Generally, employees of ESOPs are capitalists (markets, investment risk, profits, a piece of the pie)
 - Populist outcome (equity/wealth is structurally spread around)
- Employees viewed as critical to long term success rather than simply a cost to be minimized
- The combination of ownership and empowerment critical to long term success
 - Research shows that the former without the latter does not result in superior performance

ESOPs are about appropriate management of conflicts of interest

- Board of Directors / Trustee(s) / Senior Manager / Non-Trust owner
- Employee / beneficial participant / corporate creditor
- Older employees versus younger employees
- Newer employees versus more senior employees
- Terminated vested employees versus current employees

Part 2

Definition of ESOP sustainability

Definition

ESOP sustainability means:
being employee owned
through an ESOP
in perpetuity.

Is this a reasonable definition?

- Why should we care about ESOP sustainability?
 - Proposition: ESOPs generate better overall outcomes for stakeholders as a whole
 - Justification for public policies supporting ESOPs

Part 3

How is ESOP sustainability achieved?

Maybe two aspects to this question

How is ESOP sustainability achieved?

What prevents ESOP sustainability?

Some potential answers:

1. Supporting legislation eliminated
2. Business model fails
3. Repurchase obligation is too great
4. No consensus view of shareholder value
5. Succession discontinuity
6. Business is not run like an ESOP
7. Plan design time bombs go off
8. Purchase offer is “too good to pass up”

1. Supporting legislation eliminated

- ESOPs are creatures of the federal tax code and ERISA
- Potential efforts to curtail ESOPs
 - 2008: Rangel bill
 - 2009: Tax reform
- Advocacy efforts

2a. Business model fails

- ESOPs can not overcome a flawed business model, e.g., Polaroid
- ESOPs cannot overcome a poor implementation, e.g., United Airlines
- ESOPs cannot overcome management fraud, e.g., Enron

2b. Business model fails

- Sustainability of the ESOP, as previously defined, must be a strategic imperative
 - If not, sustainability is a matter of luck rather than design / purpose

3. Repurchase obligation is too great

- The problem is not repurchase obligation per se, but repurchase obligation in excess of normal benefits levels
- Valuation issue: current valuation standards for ESOPs incompatible with “ESOP in perpetuity”
 - Current standard: willing buyer/willing seller from IRS Revenue Ruling 59-60
 - Written in 1959, before ERISA law of 1974
 - This standard does not consider repurchase obligation in excess of normal benefits levels as a claim against cash for valuation purposes
- Management issue: may mean a fluctuating share price
 - Communication, communication, communication

4a. No consensus definition of shareholder value

- Different views / lack of definitional alignment of shareholder value among the following:
 - Trustee(s) of the ESOP Trust
 - Non-trust shareholders
 - Board of Directors of the company
 - Maybe influenced by state of incorporation
 - Senior leadership
 - Middle/front line management
 - Non management employees
 - ESOP committee
 - Employees not in trust (seasonal, part time, foreign)
 - Terminated employees

4b. No consensus definition of shareholder value

- **What is shareholder value in an ESOP company?**
 - Proposition 1: Shareholder value in an employee owned (ESOP) company is solely share price, and all the organization's energy should be directed towards maximizing the share price.
 - Proposition 2: Shareholder value in an employee owned (ESOP) company is something other than solely share price, and all the organization's energy should be directed towards maximizing that value proposition.

4c. No consensus definition of shareholder value

- Proposition 1
 - Standard “wall street” definition
 - Shareholder value = share price
- Proposition 2
 - Terms shareholder value and share price are not identical – must be careful when using these terms
 - Each ESOP must spend time defining what is its shareholder value proposition
 - Must be buy in from the different stakeholders
 - Must be buy in from the Board of Directors
 - Each ESOP must communicate its definition of shareholder value to the employees

4d. No consensus definition of shareholder value

- The employment dividend
 - Those cultural norms, work place rules, benefits, etc. that your company implements only because it is an ESOP. (Some examples.)
- The employment dividend generally depresses the current share price
 - But may support longevity of the company, and a create a higher share price in the long run

4e. No consensus definition of shareholder value

- Is proposition 2. legal?
- Does it conform to the fiduciary duties of the Trustee(s)?

5a. Succession discontinuity

- Talk about three areas
 - Board of Directors
 - Senior Leadership
 - Employee selection

5b. Succession discontinuity

- Board of Directors
 - Challenge: implementing “best practice” of outside dominated Board while getting real Board buy-in to the ESOP ownership form (refer to the “Shareholder Value” discussion)
 - Selection
 - Define what your company wants
 - Number of insiders versus outsiders
 - Specific technical or industry knowledge
 - Is ESOP knowledge a pre-requisite?
 - Recruitment
 - How to find
 - Not a large pool of ESOP knowledgeable directors

5c. Succession discontinuity

- Senior leadership:
 - Generally, many private company ESOPs are started by an owner/CEO who believes in employee ownership, or who does an ESOP to keep the company independent and comes to believe in ESOPs more broadly through that experience.
 - In most cases, the owner has a ready successor in either a family member or a long term, trusted and proven employee, who is the designated successor CEO.
 - The problem generally comes with the third CEO. (Recruit or develop.)

5d. Succession discontinuity

- Senior leadership con't:
 - Recruiting from outside—some problems
 - Limited pool of talent to become a senior leader/manager (CEO, CFO, etc.)
 - Limited pool of philosophically oriented leaders outside of other ESOP companies
 - In addition, most senior managers at ESOP companies like their company and are reluctant to move
 - S Corps have almost no ability to give a recruited senior leader capital gains treated gain sharing, i.e., 15% tax rate
 - Rangel bill: Paragraph 3701

5e. Succession discontinuity

- Senior leadership con't:
 - Developing next generation of senior leadership from within
 - In a bigger ESOP company, this should be a central focus of the BoD and current senior leadership
 - Issue: ESOP company maybe too small to have successors on staff
 - Now what?
 - Are the required leadership competencies in a sustainable ESOP different from other capital / cultural structures?

5f. Succession discontinuity

- Employee selection:
 - New employees
 - Selection / recruitment criteria consistent with ESOP in perpetuity
 - Current employees
 - Retention criteria consistent with ESOP in perpetuity
 - Why should the company retain philosophical cynics or those that do not believe in shared equity?

6a. Business is not run like an ESOP

- Is a mixed capital structure sustainable?
 - ESOP and public company
 - Which definition of shareholder value prevails
 - ESOP and private company
 - Minority ESOP
 - Majority ESOP

6b. Business is not run like an ESOP

- Lack of conviction that ESOP should be sustainable (some examples)
 - A financial ESOP where sustainability of the ESOP is unimportant; looking for the next exit strategy
 - Or, there is no perceived value in shared equity / ownership; selling shareholder continues to run the business as before the ESOP transaction
 - Or, a union buyout where the union does not want ownership, just want to own it long enough to turn it around and sell, and then go back to being employees
- Failure of conviction that ESOP should be sustainable
 - Senior leadership and/or the BoD losses its belief in ESOPs
 - Business model is failing
 - Repurchase obligation overwhelming
 - Definition of shareholder value defaults to share price
 - Successor leadership has no empathy with ESOPs
 - ESOP model is overwhelmed with cynics
- Failure to appropriately manage the inherent conflicts of interest

7. Plan design time bombs go off

- The bank run waiting to happen
- Plan design assumes a constantly increasing share price

8a. The offer that is “too good to pass on”

- Evaluating the offer:
 - Share price is merely the beginning
 - The add backs
 - The employment dividend
 - The S Corp tax shield
 - The repurchase obligation in excess of normal benefits levels
 - The potential salary/wage premium
 - Above market salary / wage structure
 - Disintermediation

8b. The offer that is “too good to pass on”

- Do I have to sell?
 - Board of Directors – state law for BoD members
 - Trustees
 - DOL statement of 1989
- What can we do to slow down the need to sell process
 - Adopting a “not for sale unless” statement

Back to the beginning

- Are ESOPs sustainable?
- The answer, I believe, is yes.
 - Not entirely clear as to all the pieces but includes
 - Unshakable belief in employee ownership through ESOPs
 - Sustainability of the ESOP is a strategic imperative
 - Proper governance (balancing inherent conflicts of interest)
 - Appropriate level of repurchase obligation (and a plan to fund it)
 - ESOP philosophy is passed from generation to generation
 - The ability to say no to the offer that appears “too good”