



Transitioning to an ESOP

Vermont Employee Ownership Center
Sixth Annual Employee Ownership Conference
Burlington, VT
June 6, 2008

Steve Magowan, Steiker, Fischer Edwards & Greenapple, P.C.
Alex Moss, Praxis Consulting Group, Inc.



Presentation Goals

- We're going to discuss the ten or eleven key issues you must consider when you design an ESOP
- We're going to offer ideas of how to create employee involvement in the plan design process
- We will go over your questions



The ESOP Performance Advantage

- Before getting into design issues it is important to recognize that there is a documented ESOP performance advantage
- ESOP companies do better than their peers - - they last longer, provide better benefits, have tax advantages
- BUT

The ESOP Performance Advantage (2)

- The performance advantage only arises when employees are empowered and informed in connection with the existence of the ESOP
- So, this leads to our discussion
 - Can the ESOP be designed in a way to foster employee involvement in order to enhance the possibility that the adoption of the ESOP will lead to the ESOP performance advantage?
 - We think the answer is “Yes!” – both the substantive ESOP rules and the decision-making process itself



Building the “Perfect” ESOP

- Before turning to the dry requirements of ERISA and the Internal Revenue Code, let’s ask ourselves, why do we do employee ownership?
- There are in fact many competing reasons - - owners seeking diversification, managers needing a tax efficient vehicle for a buyout, owners wanting to benefit employees, etc.
- But what drives the “movement?” Aside from desiring to obtain knowledge, why do people come to these programs and why are they so charged up after they leave?



Building the “Perfect” ESOP (2)

- We would say that the reason is because they care. Employee ownership is an idea that captures peoples’ attention. It is in a sense a form of “common capitalism,” a collective striving for commercial success that recognizes the intrinsic value of hard work and the external rewards that come with hard work.

Building the “Perfect” ESOP (3)

- To build the perfect ESOP, we need to recognize these aspirational aspects of employee ownership
- If we do recognize these aspirational aspects in the context of the business studies demonstrating the ESOP Performance Advantage, we must come to the following conclusion: Building the perfect ESOP requires not only a discussion of the principal legal rules, but also a description of the optimal processes used to make choices under these legal rules
- The process of determining the design of the ESOP thus becomes as important as the ultimate results of the design discussion

Building the “Perfect” ESOP (4)

- Outcomes, if we do it right
 - Better plan design decisions
 - Better employee buy-in – understanding and acceptance – due to better engagement up front
 - Clarity around decision making principals: we are modeling the opportunities (and limits) of employee input

Building the Perfect ESOP Company

- The consideration of how to build the perfect ESOP will of necessity lead to the more complex problem of how to build the perfect ESOP company
- As we work through the problem of the perfect ESOP, let's also think about what the perfect ESOP company would look like. How would it reflect our individual goals and values? How would it run in order to be competitive in the marketplace? How would the views of employee/stakeholders be reflected in the day to day operations of the company? What are the legal constraints in designing the perfect ESOP company?

Outline of a Sample Inclusive Plan Design Process

- Leadership identifies
 - Overall objectives
 - Specific ESOP issues for consideration
 - Constraints – what's not on the table
 - Decision-making parameters – recommendation vs. final authority
 - Team member criteria
 - Team member selections

Outline of a Sample Inclusive Plan Design Process (2)

- Employee Team studies alternatives
 - Series of meetings – often several meetings, several hours each
 - Reading / research – legal issues, and benchmarking
- Employee Team presents recommendations
 - Issues considered
 - Alternatives
 - Recommended plan design features
- Leadership reviews and makes final decisions
- Periodic review

ESOP Design: Eligibility, Participation and Vesting

- “Eligibility” concerns who will be permitted to become a “participant” in the ESOP.
- “Participation” refers to which participants will receive stock and/or other benefit allocations to account balances under the ESOP.
- “Vesting” is a term that means ownership, and refers to how much of a participant’s account (including interest and earnings) a participant is entitled to at any point in time - even though those benefits are not payable to the participant until he or she retires or otherwise terminates employment with the Company.



ESOP Design: Eligibility, Participation and Vesting

- Eligibility, participation and vesting together perform a gate keeping function for the ESOP by setting the minimum criteria employees must meet to obtain benefits through the ESOP.

ESOP Design: Eligibility, Participation and Vesting

- There are no Company dollars directly at stake initially in decisions concerning vesting, participation and eligibility. Company contributions to the ESOP will be based upon ESOP debt service and/or Company discretion.

ESOP Design: Eligibility, Participation and Vesting

- Nevertheless, there are several important concerns at stake in determining eligibility, participation and vesting, including:
 - maintaining a covered base of employees with payroll high enough to avoid IRC contribution limits (i.e., contributions cannot, generally, exceed 25% of payroll);
 - addressing personnel concerns related to using ESOP incentives to motivate management and other employees and achieve higher productivity/levels of service; and
 - ensuring that the vesting schedule does not create future liquidity problems based upon the Company's obligation to repurchase Company stock from departing employees with vested balances.

ESOP Design: Eligibility, Participation and Vesting

- The Company must determine: (i) which employees are permitted to participate, (ii) the period of service required before eligible employees can participate, (iii) the period of service for vesting, and (iv) whether there will be credit for vesting purposes for years of service prior to adoption of the ESOP.

Considerations

- How much wiggle room do you have on each issue?
- What are the underlying values and goals that should drive these decisions?
 - Incentive theory: who can drive value in your business?
 - Broad-based vs. narrowly held ownership
 - Inclusion vs. centralized decision-making
 - Perceived fairness / sense of ownership
 - Perceived importance to participants
 - Give more, ask for more in return
 - Cost / administrative burden
 - Other considerations?

ESOP Design: Eligibility, Participation and Vesting

- There are two primary types of minimum participation standards:
 - *Coverage* -- an ESOP must cover a broad group of employees to ensure that the ESOP does not disproportionately benefit higher paid employees.
 - *Eligibility* -- an ESOP may not impose onerous age or minimum service requirements as a condition for employees to participate in the plan.

ESOP Design: Eligibility, Participation and Vesting

- Coverage - - An ESOP must cover either: (1) at least 70 percent of Company non-highly compensated employees; or (2) a percentage of Company non-highly compensated employees that is at least 70 percent of the percentage of Company highly compensated employees who are covered by the plan. HCE equals employees making more than \$105,000 (in 2008; adjusted annually for inflation)

ESOP Design: Eligibility, Participation and Vesting

- Age and Service - - An ESOP may require, as a condition of participation in the ESOP that: (1) an employee be at least 21 years old and (2) an employee complete one year of service for the employer. An ESOP may require two years of service as a condition of participation if the participants are thereafter immediately vested. “Year of service” is no more than 1,000 hours. Employer can lessen the amount of hours

ESOP Design: Eligibility, Participation and Vesting

- Coverage and Age & Service - - The Employer also has to figure out when the employee enters the ESOP after completing the age and service requirements - - Right away? On the one year anniversary? On a set entry date?
- A set entry date (January 1 or two to four other set dates) make it easier to administer the plan
- Ease of administration is an important consideration



ESOP Design: Eligibility, Participation and Vesting

- Coverage and Age & Service - - How should you go about making these decisions?
- Considerations

ESOP Design: Eligibility, Participation and Vesting

- Participation - - Each participant in the ESOP must perform a certain amount of service for the Company in order to receive an allocation of a portion of the Company's contribution to the ESOP for a given plan year. Typically, a participant must complete 1,000 hours of service during the plan year and be employed by the Company as of the last day of the plan year in order to participate in the plan for that plan year.

ESOP Design: Eligibility, Participation and Vesting

- Participation - - Last Day rule:
 - Some companies with a seasonal workforce eliminate the “last day” requirement.
 - Some companies that receive substantial reimbursement of ESOP “costs” by a governmental agency reduce the hour requirement and eliminate the “last day” rule to increase participation and thereby increase the governmental reimbursement.

ESOP Design: Eligibility, Participation and Vesting

- Participation - - How should you go about making these decisions?
- Considerations

ESOP Design: Eligibility, Participation and Vesting

- Vesting - - Vesting refers to the period of time that a participant must work for the Company before he or she has a nonforfeitable right to the account balance under the ESOP. When an individual terminates employment with the Company and has a sufficient “break in service,” the non-vested portion of his or her individual ESOP account balance is forfeited and the forfeited amounts are reallocated to the individual accounts of other plan participants. The vested portion of a departing employee’s individual account balance is non-forfeitable and is used to pay benefits to the departing employee according to the terms of the ESOP.

ESOP Design: Eligibility, Participation and Vesting

- Vesting - - “scaled” vesting and “cliff” vesting. A scaled vesting schedule provides that a portion of a participant’s individual account under an ESOP becomes progressively vested each year until the entire account is vested. The maximum permitted scaled vesting schedule is a six-year schedule by which 20 percent of an individual’s account balance under an ESOP is vested after two years of service and increasingly vested in twenty percent increments so that a participant’s entire account balance is fully vested after six years of service. Cliff vesting maximum term is three years

ESOP Design: Eligibility, Participation and Vesting

- Vesting - - How should you go about making these decisions? A significant vesting requirement places an obligation upon participants to demonstrate commitment to the Company before becoming entitled to a benefit from beneficial ownership through the ESOP. The Company must balance concerns about the vesting period in a manner that is best calculated to motivate employees and make the Company more productive and profitable.

ESOP Design: Eligibility, Participation and Vesting


- Vesting - - The Company should identify the “foreseeability” of vesting to entry-level employees to determine which vesting period will best encourage employees to continue with the Company. If the period is too long, vesting is not foreseeable and employees remain unmotivated. If the vesting period is too short, the ability to become vested will not by itself encourage employees to remain with the Company.
- If eligibility and participation requirements are more liberal, vesting is the key gatekeeper

ESOP Design: Eligibility, Participation and Vesting

- Vesting - - Employees at different levels will have different concerns regarding vesting. The “foreseeability” period for employees at different levels may vary significantly. Longer term management employees, who generally have more years of service for the Company, will be most concerned that prior years of service be credited in determining vesting. The Company will need to balance its desire to reward its existing long-term employees by crediting prior service with its ability to use a vesting period to motivate employees to continue to work for the Company.
- Considerations

ESOP Design: Eligibility, Participation and Vesting

- If prior service is totally or partially credited, a long vesting period will be positive for managers as there will be more forfeitures by shorter term employees. Lower and mid-level employees will desire a shorter vesting period. A shorter vesting period will make the benefit of the ESOP more tangible to them.
- Considerations




ESOP Design: Contributions

- ESOP contributions are subject to tax deduction limits, individual allocation limits, special allocation rules, and timing rules. The ESOP must also provide for a formula for allocation of ESOP contributions. The Company must carefully consider plan design and transaction design alternatives in light of these rules.

ESOP Design: Contributions

■ Key rules:

- 25% of payroll
- 100% of compensation or \$46,000
- “Considered compensation” of \$230,000 in 2008




ESOP Design: Contributions

- Compensation can be defined in a way that is different from all compensation. The Company could for example not include bonuses or the amount of compensation could be capped in order to spread the ESOP benefits more broadly.
- Query, would an ESOP company be better served with a flat compensation definition model (say by ignoring compensation over \$100,000) and a non-qualified stock rights plan for executives?

ESOP Design: Contributions

- Contribution formula - - The contribution formula is usually based on payroll. Most ESOPs provide for allocations of contributions (including employer securities) in proportion to the eligible compensation of all employees who have 1,000 hours of service during the plan year and who are employed as of the last day of the plan year.
- Other formula
 - Seniority / service based
 - Hybrid: balancing compensation and service using a points system



ESOP Design: Contributions

- Contribution formula - - How to go about making this decision? Need to bear in mind the administrative complexity.
- Considerations

ESOP Design: Voting of Stock

- It is now time to go down to the Piraeus, as it were, and discuss voting of stock
- ERISA only requires participant voting of stock in very limited instances, as we shall discuss
- Perhaps, though, the perfect ESOP requires something more than these limited rules

ESOP Design: Voting of Stock

- ESOPs must grant participants the right to vote stock allocated to their individual ESOP accounts on certain key corporate issues such as merger, recapitalization and dissolution. The ESOP trustee need not, however, consult plan participants when voting company stock on other matters (such as the election of directors), unless required by the ESOP plan document.

ESOP Design: Voting of Stock

- Pass through voting for the Board is permitted
- Conventional voting complexities still apply
 - Voting for a pre-determined slate, who nominates the slate, plurality vs. majority voting, etc.
 - Generally state law issues, not ESOP issues...but deeply affect perceived fairness of voting process
- ESOPs can also permit voting on a one person – one vote basis (the “Democratic ESOP”)



ESOP Design: Voting of Stock

- One important reason for using an ESOP is to motivate employees and to create a sense of employee ownership as well as the fact of employee ownership in a company.

ESOP Design: Voting of Stock

- There is ample data to suggest that ESOP companies that adopt participative management styles outperform both other non-participative ESOP companies and conventional companies. ESOP participants also tend to vote their stock more conservatively than outside owners.
- Participation, whether through voting or through other means (including greater information to, and feedback from, employees) will be important for the ESOP transaction to achieve legitimacy and appear beneficial to the average Company employee.



ESOP Design: Voting of Stock

- Participation, whether through voting or through other means (including greater information to, and feedback from, employees) will be important for the ESOP transaction to achieve legitimacy and appear beneficial to the average Company employee.



ESOP Design: Voting of Stock

- Can there be a model of gradual broadening of voting rights while employees learn how to be owners?
- What about using advisory votes?



ESOP Design: Distributions

- All qualified plans, including ESOPs, must commence distribution of a participant's benefit by the beginning of the plan year following the plan year in which the participant retires at normal retirement age.



ESOP Design: Distributions

- An ESOP also must commence distribution of benefits to a participant within one year after the plan year in which a participant terminates employment because of retirement at normal retirement age, disability or death, or by the close of the fifth plan year following the plan year in which a participant terminates employment for any other reason.

ESOP Design: Distributions

- An ESOP is not, however, required to commence distribution of any benefit attributable to securities acquired with a stock acquisition loan (as long as the company was a C corporation at the time of the incurrence of the loan) until the loan is repaid in full, except if a participant dies, becomes permanently disabled, reaches normal retirement age with at least five years of service under the ESOP, or reaches age $70 \frac{1}{2}$.

ESOP Design: Distributions

- ESOPs are also subject to a special “diversification” requirement. Participants 55 years or older and with more than 10 years of service *under the ESOP* must be permitted to direct the trustee of the ESOP as to the investment of 25 percent of their ESOP stock account balance. The percentage of a participant’s account subject to direction increases to 50 percent if the participant is 60 years or older and has more than 15 years of service under the plan.



ESOP Design: Distributions

- *Form of Distribution:* Participants generally may choose to receive benefits attributable to Company stock in stock or in cash. The ESOP may require that participants accept their benefit in cash if the bylaws of the Company provide that employees must own substantially all of the stock in the Company or if the Company has elected Subchapter S status.

ESOP Design: Distributions

- *Form of Distribution:* The Company is required to offer to repurchase stock distributed to employees by the ESOP at the stock's fair market value price as determined by an independent appraiser. This "put option" may be exercised by participants either upon receipt of the Company stock or during a period one year after the receipt of the Company stock. The Company may choose to have the ESOP repurchase stock rather than the Company as the ESOP may be funded with pre-tax income.

ESOP Design: Distributions

- *Timing of Distribution:* An ESOP can distribute benefits in Company stock in a lump sum (e.g., all of the stock is distributed to the participant at once) or in equal installments over five years. A Company required to repurchase stock distributed in a lump-sum distribution may pay for the repurchased stock over five years, provided that the Company pays “reasonable” interest and provides “adequate security” for repayment.
- If the distribution is in stock, the repurchase obligation for each installment distribution will be different based upon each year’s appraisal.

ESOP Design: Distributions

- Distribution decisions can have a big impact on the ESOP. Do you wish to have departed employees still partake in the value of the ESOP? What can you do if you do not have a choice?
- Might there be good reasons to increase diversification rights?
- What impact does the desire to smooth out distributions have?
- Considerations



Questions?

Speaker Contact Information

Alex Moss

Praxis Consulting
Group, Inc.

www.praxiscg.com

alex@praxiscg.com

215.753.0303

Steve Magowan

Steiker, Fischer,
Edwards, &
Greenapple, P.C.

www.sfeglaw.com

smagowan@sfeglaw.com

802.860.4077