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Structuring Corporations for Long-Term Employee Ownership

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Goals of the Presentation

- We will review the notion of governance in employee-owned companies and ask "Is there a better way?"
- We will spend some time on history and legalities
- We will hear examples from Carris Reels and King Arthur Flour
- We will contemplate the question - - Can we make a better employee-owned corporate structure? What does the law allow today? What should the law allow?

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Setting the Table

- ESOP performance advantage
- ESOP companies represent a “new capitalism”
- The old capitalist forms appear to be tumbling apart - - We cannot divorce finance from underlying success
- Just having an ESOP is not enough to create performance advantage
- To revise and revive capitalism, also need to focus on underlying corporate assumptions of governance

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The Corporate Form - History

- Arose as a creature of statute
- States approached the creation of corporate law in many different ways
- Common to all approaches is a democratic concept - - Shareholders would vote for directors who would oversee the shareholders' interests in the day to day operations of the corporation
- Corporations are "mini-democracies"

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What Governs Board Conduct?

- State statutory law governing corporations (look to the state of incorporation)
- Corporation’s articles of incorporation
- Corporation’s bylaws
- State’s case law concerning board fiduciary matters such as the duty of care, the duty of loyalty, and the business judgment rule

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Statutory Law

- Corporate powers are exercised by or under the authority of a board of directors
- Also three key rules:
  - Can act without meeting
  - Can create committees to do certain functions
  - Articles can contain any legally allowed rules

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Standards of Conduct

- Statutory law holds the director to a prudent person standard (not “prudent expert”)
- Director can rely on reports of others, i.e., lawyers, accountants, engineers, etc., but, if the director has some expertise, he or she is expected to use it

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Articles and Bylaws

- Statutory law is only the basic framework
- A company's articles and bylaws can fill in the gaps

Duties of the Board

- State case law provides much of the meat of corporate governance through decisions discussing:
  - Duty of Care
  - Duty of Loyalty
  - Business Judgment Rule

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Duty of Care

- Directors have to exercise their duties in a way that avoids harm to the corporation
- The duty of care requires that board members be attentive to the operations of the company
- Courts tend to describe the duty of care as the duty to act as a reasonably prudent person would act under similar circumstances

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Duty of Care – Basic Principles

- "Know your company."
- "Know your company's operations."
- "Know you company's finances."

Duty – Does the ESOP Change Anything?

- A board member's duty with an ESOP shareholder in the mix may, or perhaps should change. Why?
  - Under general negligence rules, if a fiduciary (i.e., director) knows that a person to who it owes duties has a particular trait that makes it possible that he or she can be harmed more easily or in a different way, then the fiduciary's duty is enhanced to take into account the special trait
  - So, it is at least arguable that the board's duty of care changes with an ESOP present

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Duty – Does the ESOP Change Anything? (2)

- Also, in any corporation, common sense tells us that the board of directors must be responsive to the needs of significant shareholders
- If an ESOP owns, say, a 25% or larger equity stake and has provided the method through which the corporation's founder has had a liquidity event, then it seems logical that the board should be paying special attention to that ESOP's needs
- They certainly would if a private equity firm has supplied that money

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Duty – ESOP's Reasonable Expectations?

- Under the reasonable expectations doctrine, a minority shareholder's reasonable expectation that is formed when it invested in the corporation are to be protected from improper or abusive exercises of majority control
- Thus, although a majority shareholder may by virtue of his or her majority position have the power to do what he or she wants with the corporation, his or her actions are limited by a fiduciary relationship to the minority shareholder, and the scope of that relationship is measured by the reasonable expectations of the minority shareholder.
- Thus, the director's (and majority shareholders') duty to the ESOP would specifically relate to the ESOP's expectation when it invested in the company, for example, in connection with a leveraged ESOP transaction

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Duty of Loyalty

- Duty of loyalty is designed to make sure that directors do not act greedily and do not put their own interests above those of the shareholders
- The duty of loyalty is implicated whenever directors are also executives if they are approving compensation matters for themselves, leasing or purchasing real estate from an executive (typically the former majority shareholder), or establishing special executive bonus programs like stock appreciation rights plans
- If the duty of loyalty is implicated, then the business judgment rule does not apply
- Instead, the board decision must pass a fairness test

Business Judgment Rule

- Judicial statement that courts should not second-guess the business judgments of directors that have resulted nevertheless in poor results or with which reasonable minds might differ
- Sounds good, but does it provide that much protection?

Business Judgment Rule (2)

- Case law demonstrates that the particular strengths of a board are disregarded
- The key to get the business judgment rule to apply is to have good processes in place for all matters

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Basic Principles

- With this general backdrop, let’s now discuss some basic ways corporate governance and corporate governance documents might be adapted to:
  - Enhance the ESOP benefit
  - Help keep the company independent
  - Create a new common capitalism

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Carris Reels

Dave Fitz-Gerald

Brief Introduction

Carris Reels

- Founded in 1951
- Manufactures packaging for wire and cable
- About 400 employee-owners
- ESOP founded in 1995
- 100% in 2008
- Vision of Bill Carris, COB, second generation President

Articles and Bylaws

- "Employee ownership is a valued aspect of the Corporation's culture which is expected to contribute to its success by assuring that the profits achieved by the work, creativity and loyalty of its employees are used for the benefit of the employee owners. Therefore, this Corporation intends to remain entirely employee owned by limiting the ownership of its stock to the CFC ESOP and current employees… and may not be sold or transferred to any other party."
- In the articles in 1995
- Moved to the bylaws in 2005

One vote per employee-owner

- "Each Participant … shall be entitled to one vote with respect to any issue on which the Participant is entitled to vote"
  - From the ESOP's Plan Document

Annual Allocation

- 90% based on salary
- 10% based on years of service
- Salary cap appx $40,000
- President is NOT the largest ESOP holder

What would a potential buyer likely do?

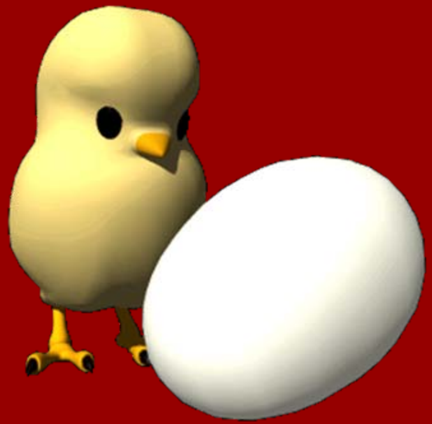
- Pay fair market value?
- Want to catch a deal?
- Want to pay a premium?
- Such a "strategic buyer" would likely combine us with other operations and close several of our facilities.

Participation

- Which comes first?
- A high sense of ownership

OR

- A high degree of participation



Committees

- Safety Committees
- Plant Wide Meetings
- Strategic Planning Committees
- Charitable Giving Committee
- Green Committee
- ESOP Committees
- Special purpose committees from time to time

"Corporate Steering Committee"

- Three day meetings
- Twice per year
- Discuss state of the company
- Reports from each site
- Direct involvement in <u>policies and procedures</u>
- Allocation of benefits
- Involvement in other issues/case by case basis
- <u>Direct the vote of the internal trustees committee</u>
- Trustees committee includes 3 self selected employee representatives.

Trustees

- CFO
- HR Director
- 3 elected representatives from the Corporate Steering Committee
  - James Brooks
  - Brian Payne
  - Frank Coursey

Former trustee Dave Porter

Communication & Education

Keys to remaining employee owned

- In the documents
- Equality
  - Equal votes
  - Similar account sizes
- In the culture
  - Participation
  - Education
  - Communication
  - Teaching employee-owners the business

King Arthur Flour - -
The B Corporation and Other Ideas

- **B Corporations**
- A new kind of company which uses the power of business to solve social and environmental problems.

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B Corporations:

- Build collective voice for good companies
- Meet high performance and legal standards
- Make good easy for consumers, employees, investors

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A Little History

King Arthur Flour:

- **About**: King Arthur Flour is America's oldest flour company, operating for over two hundred years and continuing its promise to create the best flour available to bakers and consumers across the country.
- **Goal**: We seek to inspire companionship among people worldwide through the creative joy of baking.

Certified B Corporation:

- **Why:** King Arthur Flour Company's two centuries of history has been shaped (and made possible) by our strongly and broadly held values. We gladly lend our support to advocate for businesses run on like principles: our fellow B Corporations.

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Why does this matter?

We need a new sector of the economy

- Government and nonprofit sector are necessary, but insufficient
- Business drives everything (77% US GDP)

Vision

- C Corps, S Corps . . . B Corps (AB2944)

• Tax incentives
• Procurement preferences
• Investment preferences (B Corp Capital Partners)
• Public stock exchange for B Corps

- A sector as large as the nonprofit sector today

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How do you become a Certified B Corp?

- **Performance Standards:** Achieve a passing score (80 out of 200) on the B Ratings System

- **Legal Standards:** Amend your Articles of Incorporation to include consideration of stakeholder interests

- **Make it Official:** Sign Term Sheet agreeing to random audit and annual fee

More on Legal…

Flexibility:
Give legal permission and protection to officers and directors to consider all stakeholders, not just shareholders

Accountability:
Create additional rights for shareholders to hold directors and officers accountable to consider the interests of employees, consumers, the community, and the environment, while also serving the best interests of shareholders

Limitations:
Limit these expanded rights to shareholders exclusively; non-shareholders are not empowered with a new right of action

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But, what's in it for me?

- **Differentiate your business**
- **Maintain mission**
- **Access B Corp Service Partnerships**
- **Influence the market beyond the success of your individual company**

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Additional Ideas

Board Policies re ESOP

- The board should adopt written policies to reflect its concern for and need to work with the ESOP.
- The policies could set forth the items set forth on the next slides

Board Policies re ESOP (2)

- The board should understand the ESOP and so will meet at least annually to get an ESOP review and will attend meetings like this regularly
- The board should learn how the ESOP became a shareholder. What were the terms of the transaction? What were the forecasts that supported the valuation? How was the business described to the trustee/buyer? Has that business changed? Have the forecasts been met?
- The board should learn about the intersection between their duties as directors and the ESOP trustee's duties under ERISA.

Board Policies re ESOP (3)

- The board should understand how choices made by executives of the company can affect the value of the shares held by the ESOP and actively take part in helping to structure those decisions. For example, if an executive knows that he or she is retiring soon and that the company has a lump-sum cash-out provision under its ESOP, then that executive may take risks to pump up the share value

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Board Policies re ESOP (4)

- The board must develop a balanced approach between protecting assets and committing capital to the company’s growth
- The board needs to understand the trustee’s valuation process and it should meet at least annually with the trustee

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Board Committees

- If the board is of a significant size, say more than five people, the board should establish committees in the bylaws to allow for a more efficient direction of corporate policies
- The most typical board committees are (1) the audit/finance committee; (2) the compensation committee; (3) the ESOP committee; (4) the board succession committee; and (5) the management succession committee

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Outside Board Members

- Bringing in outside board members when an ESOP becomes a shareholder is a <u>good</u> idea
- Under ERISA and state corporate law there is an unbroken circle—the board appoints the trustee, and the ESOP appoints the board. If there is too tight a confluence between the board members and the trustee, there is simply no way of introducing new ideas into the management of the corporation.
- Without the introduction of outside board members, every decision made by the board is subject to conflict of interest analysis and therefore overturns the defense of the business judgment rule for the board.

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Staying ESOP Owned - - What is a Board to do?

- Many companies want to stay ESOP owned, but directors and trustees get nervous about policies that "just say no" to bids from the outside
- Policies adopted well in advance of an outside suitor's approach should be in place

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Staying ESOP Owned - - Practical Ideas

- Amend the articles of incorporation to provide that in addition to the corporation having the purpose of conducting general legal business, it also has a purpose of becoming or being employee-owned, or even perhaps, ESOP-owned. This could be further refined by providing that the directors are entitled to reject offers for the company in acknowledgement of this provision in the articles

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Staying ESOP Owned - - Practical Ideas (2)

- Amend articles to provide for a certain number of "outside" directors who have experience in ESOP companies

Staying ESOP Owned - - Practical Ideas (4)

- Amend the articles to provide that the board shall look to long-term rather than short-term growth and shall consider the needs of multiple constituencies

Staying ESOP Owned - - Practical Ideas (5)

- If state law permits, adopt a provision that allows current shareholders to have a vote about whether a purchaser can vote its shares and also adopt a provision to pass this vote through to ESOP participants

Staying ESOP Owned - - Practical Ideas (6)

- Allow participants to vote for the board of directors
  - The current board would sponsor, and the ESOP trustee could comment on whether they could properly serve (i.e., they have the expertise)
  - But have the candidates make their case to the participants

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Staying ESOP Owned - - Practical Ideas (6B)

- Allow participants to vote for the board of directors
  - This may seem radical
  - But we “allow” folks to vote for president, for governor, for city council and county boards
  - Corporations were founded on the basis of a democratic vote for directors
  - Perhaps restoring this vote to its rightful place will reinvigorate our shared capitalism

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Questions?

VEOC
Vermont Employee Ownership Center

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