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EMPLOYEE BENEFITS

The Perfect Perk
By Bridget McCrea
Illustration by Umberto Peña
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In today's competitive business environment, no company can afford uninterested, unproductive workers. Among the variety of incentives that firms blandish to keep employees motivated, one with unrivaled win-win appeal is the innovative Employee Stock-Ownership Plan, or ESOP. When employees have the chance to buy into the company where they work via ESOPs, they automatically acquire a direct tie to the organization's financial future. When the company wins, they win too. Instead of just punching a clock day in and day out, workers know that their productivity will end up increasing their own individual wealth. Which explains why ESOPs have proved such an effective management tool: They create a corporate culture that ties the firm's future to that of each and every employee.

And vice versa. Research shows that ESOPs lead directly to greater sharing of information, better communication and a decision-making role for employee-owners.

Ownership Society

In simple terms, ESOP is a retirement savings plan that makes employees of a firm the owners of its stock. But how exactly does an ESOP work? An ESOP is operated through a trust that the company funds with tax-deductible contributions, which are then used to buy company shares that are distributed to individual employee accounts.

In general, employees may cash out after vesting in the program or when they leave the company. Employees or their beneficiaries receive the vested portion of their accounts either at termination, disability, death or retirement. Recent numbers from the Employee Ownership Foundation and The ESOP Association prove what a boon this perk really is. In a report they released earlier this year, 82 percent of companies surveyed found motivation and productivity among employees improved as a direct result of implementing ESOPs. “These results consistently demonstrate that employee ownership through an ESOP is good business,” says J. Michael Keeling, president of The ESOP Association. “As we’ve stated time and time again, more ownership through employee stock ownership should be part of an ownership society in this nation.”

What's in it for the company?

Besides improving productivity and motivation, companies that opt to establish an ESOP do so because:
*45% of ESOPs are established to enable companies to purchase the stock of an exiting shareholder—cited as the top motivator behind the establishment of ESOPs for more than a decade.
* 18% of companies create their ESOPs to provide additional employee benefits.
*17% establish ESOPs because they like the employee ownership concept.

Sharing The Wealth
Around the United States, about 10 million employees, or almost 10 percent of the private-sector workforce, are beneficiaries of the Employee Stock-Ownership Plan.

How much of a company do the workers end up owning? According to statistics from The ESOP Association, which represents some 1,400 companies, approximately 75 percent of its member firms are more than 50 percent owned by employee shareholders under the plan. These workers earn over 3 percent of their total compensation from ESOP contributions.

According to the association, 7 percent of companies using the plan are publicly traded; some 25 percent are in the manufacturing sector, followed closely by construction and distribution.

Interestingly, an ESOP is the only corporate entity that U.S. tax and labor laws say must invest primarily in the securities of the sponsoring employer. It is also the only employee retirement savings plan that may legally use borrowed funds to acquire its assets: securities of the employing firm.

Some companies leverage ESOPs as a technique of corporate funding to help finance expansion, make an acquisition, spin off a division, or buy back publicly traded shares. About 2 percent of ESOPs have been used to buy out an existing firm that would otherwise have closed.

While ESOPs represent a highly motivating benefit for employees, it is generally not the only one being offered. The ESOP Association reports that 87 percent of member firms offer a supplemental benefit plan in addition to the ESOP, including 401(k) plans, pension plans and profit sharing.

Starting An ESOP

Employee shareholders meeting

To set up an ESOP, The National Center for Employee Ownership (NCEO) says companies need to take several key steps.

Once the current owners of the company agree to create an ESOP, the first step they need to carry out is a feasibility study to assess factors like cash flow, payroll and financial projections. On that basis, a valuation to check whether a sale of stock to employees is practical or not must be carried out.

If the value is too low, the partners may not want to sell. But if they do decide to go ahead with the plan, somebody has to pick up a phone and call a lawyer.

The attorney will set up the plan and submit it to the IRS. When approved by the tax agency (a process that can take several months), companies will obtain funding for the plan. This can mean borrowing money from a bank or other lender, or even through the company's existing benefit plans.

Lastly, companies must establish an operating plan, according to the NCEO, which suggests using a trustee for this task. In most private companies, this will be someone from inside the firm, but some private and most public companies hire an outside trustee.

An ESOP committee (typically made up of managers, nonmanagers or a combination of the two) will direct the trustee, and will also establish a process for telling employees how the plan works—to get them genuinely involved as owners of the business.

Interested companies should also take into account the costs involved.

According to Keeling, companies with ESOPs typically pay about $15,000 to $75,000 in annual overheads for the plans, depending on the size of the firm.

Employee-benefits lawyer Bill Whitehurst of the North Car-olina-based law firm Womble, Carlyle, Sandridge & Rice, PLLC, breaks the cost down further by saying that "transaction costs" (fees incurred when the actual stock sale takes place) associated with the ESOP typically run 2 to 3 percent of the sold stock's value, while the valuation costs $3,000 to $20,000, depending on company size.

Getting Your Money's Worth

While ESOPs may go a long way in motivating the workforce, they also pose the challenge to management of getting them to work as they should. One of the biggest problems comes when the initial steps aren't taken to educate and inform employees of the shift in ownership.

“In an ESOP where management isn’t interested in engaging the employees as co-owners,” says Keeling, “there won’t be any productivity boosts, profit gains or increased employee loyalty.”

Companies should also be aware that such loyalties and gains may fluctuate with the firm’s performance. It’s fairly easy to manage an ESOP firm when “times are good and employee profit statements are going up,” says Keeling, but keeping that motivation intact when shares start to slide may not be as simple.

“During the lifespan of a company, you’re bound to have some share decline or stagnation,” Keeling says. “If you haven’t engaged your employees and educated your workforce on the fine points of ownership, the ‘team’ environment can break down quickly.”

Knowing this, Carl Grassi, chairman of the business department at Cleveland-based law firm McDonald Hopkins Co., LPA, says the most successful ESOPs are those centered on a corporate culture that embraces and emphasizes the benefits of ownership.

“Employees need to understand that, unlike investing for retirement through public stocks, they’re investing in their company,” says Grassi, “a place where they have the opportunity to make an impact.”