

# Ohio Employee Ownership Center Conference

April 17, 2009

Panel discussion on ESOP sustainability by:

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# ESOP Sustainability Topics

- **Enabling Legislation**
- **Business Model Failure**
- **Valuation / Repurchase Obligation**
- **Discontinuities in ESOP Philosophy of Succeeding Generation of Senior Management and/or Board of Directors**
- **Compensation**
- **Recruitment/Retention**
- **Plan Design Results in “run on the bank”**
- **Offer to Purchase**

# Enabling Legislation

- ESOPs created in the ERISA law of 1974, with additional enabling legislation in subsequent laws (e.g., S-Corp laws of 1996 and 1997)
- ESOPs combine a capitalist ownership structure concerning productive assets with a populist outcome concerning wealth distribution
- Emerging problem: whose ox is to be gored in the upcoming legislative battle concerning tax reform?
  - ESOP supporters must be prepared to respond

# Business Model Fails

- ESOPs are not sustainable when:
  - Share price growth/repurchase obligation is out of balance with underlying growth/capacity to satisfy repurchase obligation
  - ESOP implementation is flawed
  - Product offering is obviated
  - Fraud is present
  - Excessive risk is embraced
  - Company acts against its own interests

# Valuation / Repurchase Obligation

- Valuation standard is from Revenue Ruling 59-60 which defines fair market value:
  - as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

# Valuation / Repurchase Obligation

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- Lack of relevance of this valuation standard to ESOPs:
  - Issue 1:
    - Revenue Ruling 59-60 states:
      - In valuing the stock of closely held corporations, or the stock of corporations where market quotations are not available, all other available financial data, as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes.
  - Issue2:
    - Does not describe the circumstances of an ESOP
  - Issue 3:
    - Many in the ESOP valuation community maintain that the standard of valuation embodied in 59-60 specifically excludes repurchase obligation in excess of normal benefits levels and the S-Corp tax shield from the valuation

# Valuation / Repurchase Obligation

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- Potential new standard of valuation, i.e., the new language:
  - A private company with an employee stock ownership plan shall be valued as an ESOP in perpetuity. Such valuation shall address those cash flow issues which are unique to ESOPs, including those created by statute.

# Discontinuities in Philosophy

- ESOP Boards of Directors and Senior Managers turn over every 10 – 15 years (more true after the founder retires and the company is more mature)
  - Thus during the 40 year career of an employee, that employee will experience at least 3 – 4 Board of Directors and/or senior management teams, maybe more
- Each change in the Board of Directors or the senior management team introduces the opportunity to change the philosophical orientation towards the ESOP
  - Only one change in personnel which results in a pervasive attitude that the ESOP is more problem than benefit is needed to unravel the sustainability of the ESOP as defined this morning

# Compensation

- Some issues that have to be addressed to conform compensation to the previously discussed definition of ESOP sustainability
  - Does your company believe that it is a proposition 2 company, but uses a proposition 1 compensation structure, especially for the non-ESOP equity portion of the compensation package, e.g., stock options, SARs?
  - Does the cash out provision of the equity portion of the compensation structure advantage the beneficiaries of the compensation structure over the beneficiaries of the ESOP Trust?
  - Does the compensation structure contain provisions for change of control?
  - Is the equity portion of the compensation structure so rich as to result in the attitude that “risk mitigation is a drag on performance”?
  - Does the compensation structure change the culture from one of shared wealth creation to one of personal wealth creation?

# Recruitment / Retention

- Recruitment questions:
  - Is your shareholder value proposition used to screen and hire:
    - Members of the Board of Directors?
    - Management, especially the CEO?
    - Non-management employees?
- Retention question:
  - Is your shareholder value proposition used to evaluate the performance of members of the Board of Directors, management, and non-management employees, and to make termination decisions?
    - Problem: Identify “situational cynics” from “philosophical cynics”

# Plan Design results in the “run on the Bank”

- Cash out provision(s) of the ESOP Trust plan document create the possibility of a run on the bank which results in an unrecoverable liquidity crisis for the company.
  - One example: Terminated employees are distributed 100% of their vested benefits 30 days after termination, regardless of the reason for termination.

# Offer to Purchase

- Position of the State of Ohio
- Position of the DOL
- Concept of “Add Backs”