NCEO
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EMPLOYEE OWNERSHIP REPORT

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ISSUE HIGHLIGHTS

- Employee ownership is a pro-business, pro-worker policy. Can it be a cure for the divisiveness of U.S. politics? *See page 2 for comments and page 13 for highlights.*
- Download documents and checklists you can use to simplify plan administration, corporate governance, and responding to acquisition offers. *A guide is on page 3.*
- What happens if ESOP participants want to refuse an outside offer to purchase the company? *Page 4* describes why the answer may be less clear than you think.
- If you want to avoid the possibility of an unwelcome sale entirely, the case study of Metis Construction on *page 6* outlines one strategy.
- You have been doing lots of things to help employees think and act like owners, but what if you are not really doing what you think you are doing? *Pages 8 and 9* have ideas for eliminating the "ownership culture blind spot."
- What's the single most common use of money from equity compensation plans? *New research on page 12.*
- Courts ruled on cases on issues including stock valuation in private-company ESOPs. *See pages 10 and 11.*
- Being employee-owned means your company is not owned by an outsider. *Page 15* discusses why that matters.

RESOURCES CONTACT SHARE
CASE STUDY OWNERS' PAGE

NEW RESEARCH

ESOPs Stable in New 2014 Data

According to the latest data available from the Department of Labor, there were 6,717 ESOPs covering close to 14.1 million participants and holding more than $1.3 trillion in plan assets as of the end of 2014. The count of ESOPs is down slightly from 6,795 as of the end of 2013, but the number of participants was essentially unchanged (a 1% decline).

Among the 6,717 ESOPs, 82% are standalone ESOPs and 18% are KSOPs (ESOPs that also have 401(k) features).

The tables on page 5 look at the new data in several ways. Table 1 separates public companies from privately held ones, and shows that public companies represent 8% of ESOPs, 79% of ESOP participants, and 59% of employer securities. Table 2 shows that most public company ESOPs are KSOPs. Table 3 shows that small privately held ESOPs tend to be nonleveraged, and table 4 breaks out the age of ESOPs by their plan's effective date as reported in the Form 5500. Older ESOPs as a category hold more than $1.2 trillion in plan assets. Twenty-one percent of ESOPs have been established since 2008. Among them, 395, or 6%, were newly established in 2014.

The March-April *Employee Ownership Report* will focus on the characteristics of these new ESOPs.

—Continues on page 5

POLICY CHANGE

USDA Supports Worker Ownership

In a December 12 blog post, the U.S. Department of Agriculture announced a new program to support the conversion of businesses to worker-cooperatives and ESOPs. As of August, the Business & Industry (B&I) Guaranteed Loan Program can provide financing for a transaction.

The blog post describes a major aspect of this policy change: "Under the previous B&I rules, loans for purchasing businesses with a B&I guarantee required complete ownership transfer so that the selling owner retains no financial or ownership interest. This requirement made it difficult for the employees to take on such large loans and did not permit the selling owners to stay involved for transferring the know-how for running the business."

—"Ownership News" continues on page 12

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VOTING ON OFFERS TO BUY THE COMPANY

Can ESOP Participants Say No to a Takeover Offer?

If an ESOP company receives an offer to purchase substantially all its assets or stock and the directors are in favor of accepting the offer, then the ESOP trustee is required under ERISA to exercise its fiduciary duty in deciding whether to vote the ESOP shares in favor of or against the proposed transaction. In certain circumstances, ESOP participants have a right to vote on the transaction. Can they vote "no" and force the trustee to vote "no" as well? Under current law and practice, the answer is unclear.

Do Trustees Need to Follow the Participants' Vote?

The answer depends on the circumstances. If there are unallocated shares, the trustee will vote those shares. If the plan document requires mirror voting of unallocated shares based on participants' votes of allocated shares, the trustee does not necessarily have to follow this direction. Even if the ESOP participants are allowed to vote a controlling number of shares on a proposed offer, the trustee may need to override the participants' vote if the trustee believes it would be a breach of fiduciary duty under ERISA to follow the participants' vote. That could happen, for instance, if the participants voted "no" on an offer with a very large premium from a buyer that would lay off employees, relocate operations, or offer continued employment but for lower compensation. Employees could be put in the difficult situation of losing their jobs or working for less pay, in return for a relatively small amount of money for their stock.

In *Herman v. NationsBank of Georgia, N.A.*, a case concerning a hostile takeover bid for Polaroid, the Department of Labor took the position that the ESOP trustee must essentially ignore participant directions if it concludes that the offer would substantially increase the value of plan assets. In a 1995 letter to the AFL-CIO, Olena Berg, the Assistant Secretary of Labor at the time, said that trustees cannot "automatically assume that following plan provisions [providing for participant voting] in every case will come out with a result that is prudent under ERISA." But in those cases where a trustee does not follow the participants' vote, the trustee needs to show in writing why it followed its own course. Trustees ordinarily should give deference to the participants' vote, but can still override it if the trustee believes the participants' decision is inconsistent with ERISA requirements. This effectively expands the range of acceptable offers. Some offers that the trustee normally might accept could be rejected, but higher offers could not be rejected if doing so would be a breach of fiduciary duty. In the absence of clear guidance, however, trustees may be more likely to err on the side of caution.

Providing the Vote

If the offer is structured as an asset purchase, the law entitles ESOP participants to pass-through voting. If the offer is to purchase stock, however, pass-through is not required by ERISA, but a company can choose to include pass-through voting in its plan documents. If a company does so, participants must be given adequate disclosure materials to make their choice. The trustee (not the company) should hire an advisory firm to prepare detailed material on the offer, explaining the risks and considerations in language ordinary participants can understand. Company management needs to be exceptionally cautious to play a neutral role in this process. Management should, however, make sure that employees understand how ERISA works in acquisitions, ideally by bringing in an independent third party. Acquirers need to be told in advance, in detail, what this process will involve and how much it might cost in dollars and time.

Employee Voting Still Makes a Difference

Requiring a pass-through vote by ESOP participants may, in itself, discourage potential buyers who are not comfortable with the prospect of going through a long, expensive process of making an offer in the face of an uncertain election. Even the possibility of a "no" vote could be perceived by a potential buyer as making the acquisition of an ESOP company more expensive than a company without an ESOP.

Should You Allow Employees to Vote?

Most ESOPs do not provide more than the mandatory minimum voting rights on acquisition offers, presumably because management and boards want to have more control over that decision. In practice, however, we know of only a few cases where employees and management have gone different ways on a vote, and these cases sometimes presented unusual scenarios, such as feuding family members serving on boards and ESOP trust committees. ■

The NCEO thanks Theodore Becker of Drinker Biddle & Reath LLP for his input on this article. Any conclusions and errors are the NCEO's, not his.

The NCEO is launching a project to explore the desirability and viability of regulatory changes on this issue. We very much welcome your comments, which should be sent to Corey Rosen at CRosen@nceo.org or Loren Rodgers at LRodgers@nceo.org.

CASE STUDY

Employee Ownership through Perpetual Trusts

Most conversation about employee ownership in the United States focuses on three vehicles: ESOPs, equity compensation plans, and worker cooperatives. Recently a few company owners have been considering a perpetual trust, an employee ownership model imported from the United Kingdom. The March-April 2016 issue of this newsletter covered the design firm WATG, a U.S. company whose shares are owned by a U.K.-based trust on behalf of employees. This article explores a related approach.

In 2008, Mattias Scheiblehner founded Metis Construction, which does commercial and residential construction. In February 2016, he sold all of the shares to a trust. The sale price was calculated to reflect the time and direct expenses Scheiblehner had invested to establish the company. Metis is based in Seattle, and the trust is a noncharitable purpose trust, a form of trust that exists in many but not all states. The trust is intended to be the permanent owner of the company shares, but state law only allows it to exist for 150 years after the death of the settlor or the final beneficiary. Scheiblehner hopes that when that time comes, the laws of the state of Washington will have changed, but otherwise, the founding documents of the trust instruct it to move to a state with laws that do allow actual perpetuity.

Trust Ownership at Metis Construction

Of the 34 current employees, 18 are employee-owners, or more precisely, beneficiaries of the trust. Another 16 employees are not yet owners, but they are on track to become owners over time if they remain at the company. People who were Metis employees as of six months before the transaction had the chance to become owners immediately. All employees who joined later are automatically given the option of becoming members if they are still employed by Metis at the conclusion of a five-year probationary period.

The trustees of the Metis trust are a subset of Metis employee-owners. Prospective trustees put their names forward and then all employee-owners vote on who will be trustees. In addition, the company has one independent outside trustee.

Scheiblehner sees this structure as simply the right thing to do because "any other organization misses the point of who is doing the work and who is making the profit." He also sees a transformation in the increased responsibility employee-owners are taking on themselves.

Contrast with ESOPs and Co-ops

In an ESOP, participants receive shares or the cash value of shares, generally at retirement, but the financial benefit to Metis employee-owners is that they annually receive a share of company profits. By default, Metis pays 70% of each year's profits as profit sharing, which goes to employees based on hours worked.

Company shares, both at Metis and at ESOP companies, are held by trusts, but the trust that owns Metis shares is dramatically different from an ESOP trust.

- Since the Metis trust does not pay retirement benefits to employees, it is not subject to ERISA. By contrast, ESOPs have requirements for participation, allocation of benefits, fairness to non-highly-compensated employees, distribution, and more.
- The Metis trust is intended to be the owner of the company in perpetuity, but the trustee of an ESOP, by contrast, may find it difficult to resist an offer to buy the shares if the terms are sufficiently favorable. *(See the article on page 4.)*
- ERISA provides standards for the valuation of shares in transactions involving ESOPs, but shares held by the Metis trust are intended never to circulate, so once they enter the trust, the shares do not need to be valued. The valuation standards for determining the price for the sale of shares to the trust depends on state trust law, not on federal ERISA rules.

The tax treatment of ESOP companies, especially S corporation ESOPs, does not apply to Metis. The Metis model has some similarities with worker cooperatives, such as democratic governance and egalitarian treatment of profits. Scheiblehner himself describes the company as a cooperative, although in a traditional cooperative, members own their shares directly, rather than through a trust.

Other Approaches

Metis was an ongoing business that converted to trust ownership, but other models are possible. Equity Atlas, for example, is a mortgage and financial services company that was founded by Brad Hippert in 2016, and its shares have been owned by a perpetual trust since its founding.

Chris Michael of the ICA Group, who worked with both Metis and Equity Atlas, says that two main reasons might lead a business owner to choose employee ownership via perpetual trust. First, the model may be especially attractive to business owners who want to ensure that employee ownership lasts in perpetuity without the risk of an unwanted buyer. Second, the lower cost and increased simplicity of perpetual trusts can make trust ownership a good approach for companies that are too small for ESOPs or that want to avoid the cost and complexity of an ESOP transaction and the ongoing costs of complying with ESOP requirements. ■

Learn more about perpetual trusts at the NCEO annual conference. Chris Michael also has an article about U.S. perpetual trusts in the October 12, 2015, issue of *Tax Notes.*