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A Stakeholder System

Employee stock ownership plans give workers a voice and bring corporate benefits

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Some employee benefits might seem like perks only for employees, but companies that turn their workers into owners can reap incentives, too.

Employee stock ownership programs enable employees to become shareholders in the companies where they work, while at the same time aiding in employee recruitment and retention, as well as reducing corporate tax liabilities in some cases.

According to The ESOP Association, a Washington, D.C.-based group that represents ESOP companies, there are approximately 11,500 ESOPs in place in the U.S., covering 10 million employees, or 10 percent of the private work force.

Employees who work for an ESOP company draw approximately 3 percent of their total compensation from ESOP contributions.

While the association reports that more than 20 percent of U.S. ESOPs are in the manufacturing sector, the programs can be implemented in any industry, said Rich Armstrong, president of Great Game of Business, a subsidiary of SRC Holdings Corp., which has been employee-owned for 27 years. Great Game works with companies to institute an ownership culture – not necessarily through ESOPs – and encourages open-book management and making employees responsible for monitoring, and changing, the numbers. Armstrong serves on the ownership culture committee of the ESOP Association's Heartland Council and on the board of directors of the National Center for Employee Ownership.

Springfield-based Penmac Personnel Services Inc. launched its ESOP in October, in part because founder Patti Penny wanted to slow down, said Paula Adams, Penny's daughter and president of the company.

Rich Armstrong: ESOPs are applicable to any industry.

Paula Adams: ESOP paved the way for founder Patti Penny to slow down.

James McLeod: Many companies back out of ESOPs after valuation.

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Gillian Hamm, an employee of Penmac Personnel Services, works with a job applicant. Hamm is among employees who have benefited from Penmac's ESOP.

"We found it was a very nice way for her to transition out of the company and she also liked the idea of giving back to our employees," Adams said.

While Penmac leaders had considered other succession plans, Adams said retaining the company's principles and preventing job losses led them to choose an ESOP.

"Nothing has changed at the company," she said.

How they work

ESOPs buy a company's stock from the owners and provide that stock to employees. The percentage of employee ownership is determined by the company, but 3,000 of the ESOPS in place in the U.S. are 100 percent employee owned, as is Penmac.

Stock allocated to each employee is based on the individual's rank in the payroll pool. If, for example, an employee's salary equals 4 percent of payroll, that employee would receive 4 percent of stock allocated in a year.

New York-based CSG Partners has helped about 80 companies, including Penmac, transition to ESOP ownership, said Managing Director George Thacker.

While ESOPs have broad industry appeal, Thacker said they're not ideal for all companies.

"ESOPs are not designed for the mom and pop shops, but for more mature businesses that have a net income before taxes of $1 million or more," Thacker said, noting that one of the first steps is to evaluate a company's eligibility for an ESOP.

While some companies seek outside financing to pay the owners for the company stock, Penmac enacted its ESOP with what is known as friendly debt, which gave Penny and other owners promissory notes.

Thacker said that while Penmac's ESOP didn't result in an immediate payout for the owners, it will free up cash for the company in tax savings.

"With the increased cash flow, the company can pay the note off over time," he said.

While Adams declined to disclose the terms of Penmac's ESOP transaction, Chief Financial Officer Leah Ann Iaguessa said tax savings will be substantial.

Iaguessa said the process, which took about a year, was challenging.

"There were a lot of legal documents," she said.

All 15,000 of Penmac's internal and contract, or temporary, employees are eligible for the plan, but there is a three year vesting schedule for the plan.

Weighing costs, concerns and outcomes

Attorney James McLeod, partner with Lathrop & Gage LLP in Springfield, said the total cost of instituting an ESOP can range from $20,000 to $100,000. McLeod's firm has helped more than a dozen companies, including Springfield-based RPCS Inc. – now operating as Pyramid Foods, put ESOPs in place. He said more than half of companies that come to the firm don't get past the early step of obtaining a business valuation.

"A company has to do all of the transactions at fair market value, and a lot of times the process ends because the owner is not willing to sell for the price the business valuation comes in at," he said.

If a company does choose the ESOP route, they must select a trustee, which can be a member of management or an independent trustee party outside the company. Penmac chose Reliance Trust Co. as its trustee.

While giving employees ownership and saving company tax dollars can be positive, McLeod said there is a potential downside for employee owners.

"The employees are more at risk and have more of their eggs in one basket," Armstrong said. "If the company doesn't perform, their retirement can decline or can evaporate."

He said the ESOPs that are successful are those at companies that have fully communicated the benefits of the program, and Armstrong agreed.

“If owners take the time to invest in training and getting employees more involved to grow the business, it has a better chance of succeeding,” he said. “If they do it only for the financial benefits, they will get frustrated, because they won’t feel the employees appreciate it.”

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