Topics in Corporate Governance: Techniques in Equity Compensation

Class 1: Introduction to Equity as a Currency – Overview of Techniques: Qualified Plans

July 30, 2018
6:30 to 9:30 PM

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Our Agenda for Today

Today Let’s:

- Get to know each other
- Clarify the Course “Objectives” (Yours and Mine) and go over the “Mechanics” of how the course will work and what will be required of you
- Explore the notion of equity as a currency of business
- Explore the most “tax favored” techniques, qualified plans

My Overall Agenda for this Course

You will:

- Understand the potential of equity as a currency
- Discover the differences (and overlap) between equity compensation and employee ownership
- Explore the universe of techniques to achieve each
- Learn the strengths and weaknesses of various programs
- Master basic legal and accounting issues related to using equity as a currency
- Confront and deal with shareholder and investor concerns related to using equity as a currency
- Design a program of equity compensation to meet the needs of a typical strategic situation

Your Agenda – The Parade of Grails

- What skill, information, notion, fact, or idea did you come here to find?
- What will be your measure of the success of this class?
- What problems or special needs do you think will affect your success in this class?
- If you could be any person (living or dead; real or imagined) for 1 day, who, what would you do and why?

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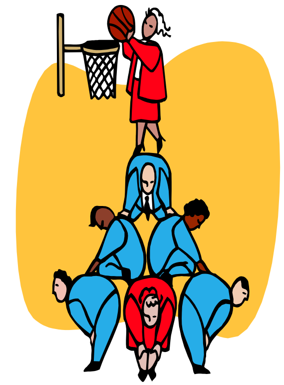
Let's Get Started…

Tax and Cash Benefits

A Culture of Ownership





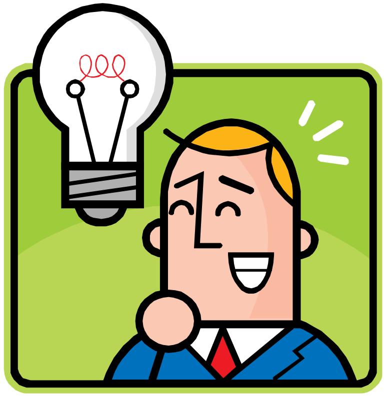



Compensation Substitute | **Executive Compensation** | **Management Equity Incentives** | **Profit Sharing Stock Bonus Plans** | **Gain Sharing Value Plans** | **Employee Ownership**



What's the Difference?

- Equity Compensation is a business tactic



- Employee Ownership is a business value

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Equity Accumulation Tactics:

Equity Compensation:

- Stock Options
- Restricted Stock
- Synthetic Equity
- Performance Units

Employee Ownership

- Worker Cooperative
- Stock Purchase Plans
- Broad Based Stock Options
- Employee Stock Ownership Plan

On the Nature of Corporate Ownership…

- Ownership generally includes two equal parts (but with very different benefits):
  - If you own a corporation, you have the right to all the value that it creates
  - If you own a corporation, you will have the right to tell everyone what to do
- In most cases, those two features go together
- How much you own can have an effect on both features.
  - Minority stakes are not worth as much as majority (or controlling) stakes are
  - Minority shareholders will have a lot less power individually than a single majority shareholder

Employee Ownership…

- Employee Ownership generally separates the two features of ownership:
  - The value of ownership is transferred to employees through some vehicle: direct issue to the employee (espp, options etc.) or a trust fund on their behalf (ESOP, Profit Sharing, etc.)
  - The control feature of ownership is generally vested elsewhere (and is generally not intended to be transferred with employee equity ownership)
  - In ESOPs the “Owner of Record” is the ESOP Trustee
- Governance change is not generally the goal.

Other Forms Value Control:
COOP STRUCTURE OF THE POWER

	POWER	**FACTOR OF PRODUCTION** (Resource/Tool)
Conventional Companies	CAPITAL	LABOR
Cooperatives	**LABOR**	**CAPITAL**

THE MONDRAGON CO-OPERATIVE

- Over 60 Years old
- Over 100,000 members (employees)
- 120 Related Companies
  - Very Diverse Industries
- In 2007 about 16 Billion Euros in Revenues

"Humanity at Work"

Ownership is Powerful Stuff!

(And Experts Come From Surprising Places)

On why a marauding prince ought to kill quickly but be very careful about confiscation

- "…because men sooner forget the death of the father than the loss of their patrimony."

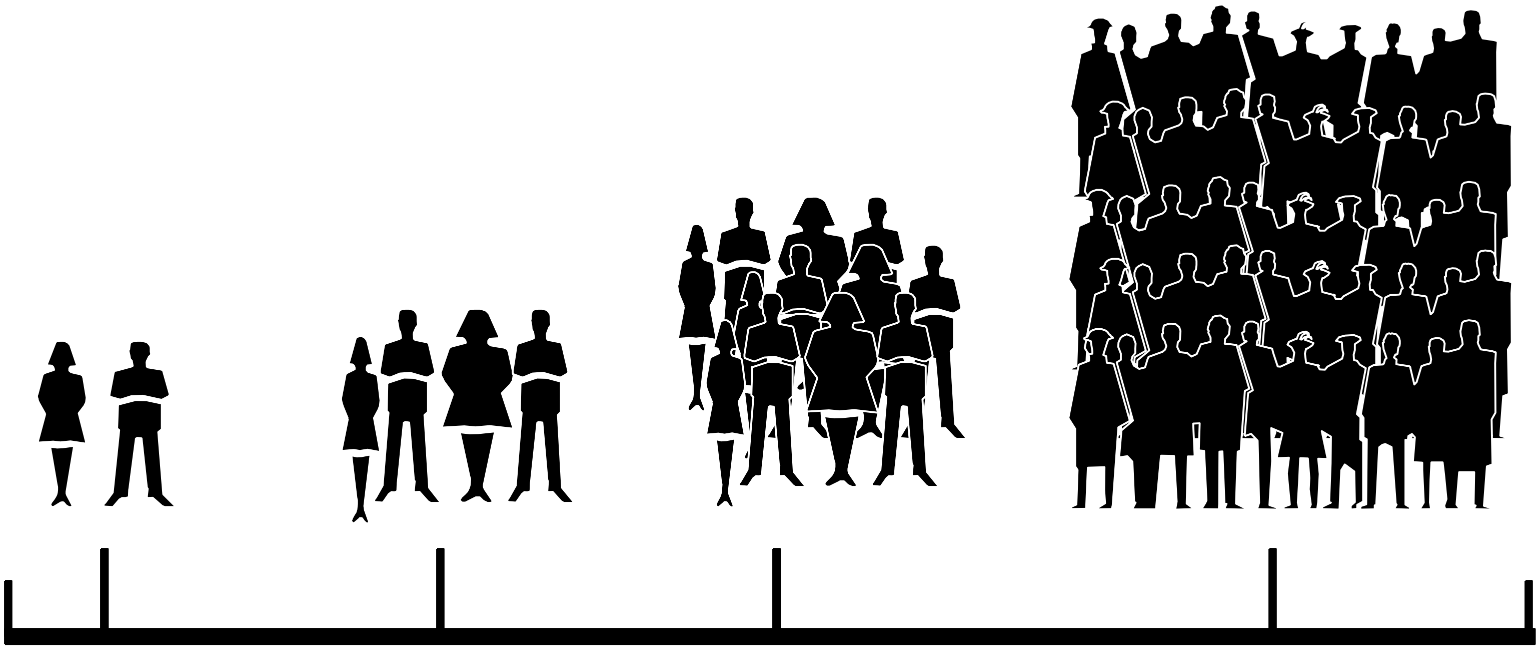
  » Nicolo Machievelli

Employee Ownership Builds on Equity Compensation…

- Employee Ownership is a strategy for stimulating business growth and gaining competitive advantage by making employees significant stakeholders in the growth of their company’s equity value. This strategy has two elements: the award of equity interests to employees through any of a diverse range of tools and techniques, from stock options to ESOPs to synthetic equity; and management practices that engage employees as proactive partners in the improvement of business performance.
  - » Beyster Institute

- Properly constructed, Employee Ownership Programs can create a culture of real Stakeholders.

Employee-Ownership in the U.S.: A History Lesson for the Future



1900's
First Modern Employee Owners

1950's
Louis Kelso

1974
Russell Long and ERISA

Today
12,000 ESOPs
Millions of Employee-Owners

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Why is the Movement to Broader Employee Ownership Important?

- Capital Ownership is the only key to wealth.
- A very high percentage of the population will not be in a position to acquire any material amount of capital ownership without some sort of intervention.
- In the next decade as much as 60% of the productive capital in the U. S. will have to change hands – Private Equity and the Public Market cannot absorb all that equity.
- Broadening Capitalism to be more inclusive creates economic health at all levels – the 1000 millionaire posit.
- Employee Ownership has a very strong, positive relationship with corporate performance.

Some Studies of Ownership and Performance

- Studies conducted by the National Center for Employee Ownership (NCEO) show that when employee ownership is combined with a management style that encourages employees to share ideas and information, companies grow faster - 8% to 11% per year faster than expected otherwise

- A Rutgers study found that Employee Ownership Companies are significantly less likely to go bankrupt.

- A 1998 study in Washington State (Rev. 2002) found that ESOP Participants are paid better and non-ESOP Retirement Benefits rival the total retirement package of non-ESOP Companies.

- Over 100 studies with the same message: ownership and a participative style of management produces a successful company.

What We Learn from the “100 Best Places to Work

- They have a <u>supportive</u> environment
- They encourage <u>learning and training</u>
- The culture is <u>risk free</u> and <u>non-threatening</u>
- They have a <u>clear, shared vision</u> and <u>buy-in on the path</u>
- They give <u>passionate customer service,</u> and
- Employees <u>trust</u> the people they work for, and
- Employees <u>have a real stake in success.</u>

» With Compliments to: Robert Levering, The Great Places to Work Institute

The "100 Best Places to Work" Know:

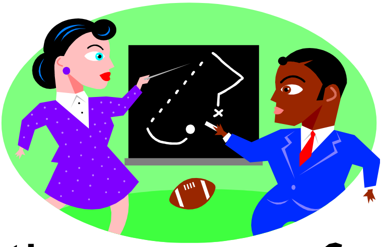
Employee Ownership is Related to "Best":

- Year after year, between 50% and 75% of the members who could offer ownership, do provide material stock ownership opportunities to employees
- Over 50% of those who provide ownership opportunities do so with broad-based stock plans
- And, according to the Russell Investment Group, the "100 Best" produced more than 3 times the gains of the broad stock market over the last seven years!
- A Culture of Stakeholders is most easily built on a foundation of ownership

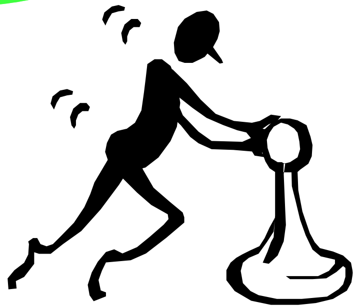
Sources: NCEO, Great Place to Work Institute

A Useful Planning Paradigm – A Four Phase Approach

- Phase One – Identify Stakeholders and Understand Objectives
  - Objectives are not Strategies are not Tactics



- Phase Two – Evaluate Strategies
  - The Shortest Distance May Be a Curve



- Phase Three – Select and Implement Tactics
  - You Can't Buy Objectives
- Phase Four – Monitor and Measure Outcome
  - If it isn't measured it doesn't exist

Case Study for Discussion

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Skyrocket, Inc.

Skeleton: A technology start-up. 20 employees. Entrepreneur owns 80%, 2 angel investors own 10% each.

Case 1. Skyrocket, Inc.

Skeleton: A technology start-up. 20 employees. Entrepreneur owns 80%, 2 angel investors own 10% each.

Flesh: Entrepreneur is in her early 60s. She has 3 adult children, one of whom works in the company. Angel investors are anxious to get liquid. There is a significant challenge being posed to their single most significant patent application.

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Break – 15 minutes

Tax Favored Techniques: Qualified Plans

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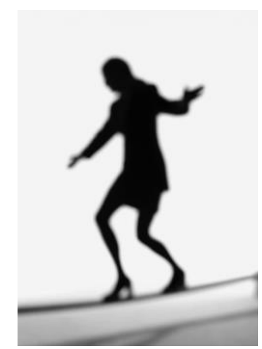
What is a "Qualified Plan"?

- Qualification (as determined with reference to Section 401(a) of the Internal Revenue Code) refers to several factors:
  - The Plan includes the creation of a separate Trust to hold assets.

  - The Plan is adopted by an employer for its employees and is represented by a formal legal document which details its operating provisions.
  - The document meets numerous requirements of the Internal Revenue Code and ERISA.
  - The Trust that holds plan assets is tax exempt under Section 501(c) of the Internal Revenue Code.
  - The contributions made by the company are eligible to be tax deductible to the company under Section 404 of the Internal Revenue Code.
  - Benefits held for employees under the plan that is associated with the Trust are not taxable to them until they are actually withdrawn from the trust.

What Are the Basic Types?

- Qualified Plans come in two varieties:
  - Defined Contribution Plans in which the benefits are determined with reference to whatever has been contributed to the plan while an employee is participating, and
  - Defined Benefit Plans (also often called pension plans) in which the benefits are specified in advance and contributions are calculated to arrive at the specified benefit level at a specified time in the future.



- The major difference is the holder of risk:
  - Defined Contribution Plans settle the risk on participants, and
  - Defined Benefit Plans settle the risk on employers.

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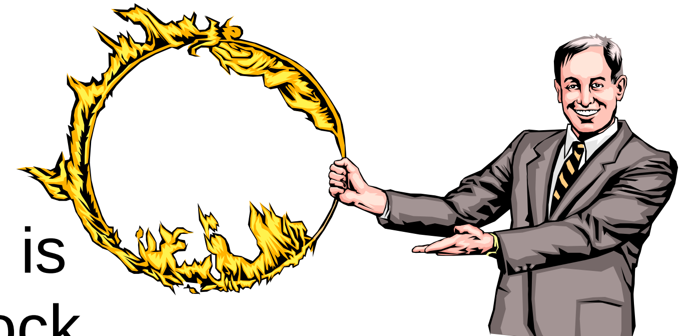
Stock Serves Best in Defined Contribution Plans

- Defined Benefit Plans make poor hosts for employer stock



  - Risk is already on the employer and would be compounded if plan is funded with employer company stock.

  - Heavy employer stock investment is generally prohibited in all but a few types of Defined Contribution Plans.

Typical Tax Benefits

- Contributions are all deductible to the Company with no corresponding taxable event for participants.

- Assets are invested and earn income or appreciation with no current taxation.

- Distributions to participants after Retirement or termination of service are subject to favorable tax treatment:
  - Roll-over to continue tax deferral
  - Forward averaging for certain distributions
  - Potential capital gain tax treatment for employer stock

Statutory and Regulatory Factors In Brief

- ERISA requires broad, non-discriminatory coverage by all qualified retirement plans
- ERISA restricts the investment of most retirement plans in employer securities to no more than 10% of the Assets (with the exception of ESOPs)
- Federal law also includes specific prohibitions against the investment of plan assets in transactions involving parties in interest (again with specific exemptions for ESOPs)
- Federal and State Securities Laws may apply (subject to exemptions)
- Fiduciary rules require trustees and other fiduciaries to act for the exclusive benefit of plan participants

Retirement Safeguards Under ERISA

E MPLOYEE
R ETIREMENT
I NCOME
S ECURITY
A CT

1. **FIDUCIARIES**
   - No Self-Dealing
   - Minimize Risk of Loss
2. **DISCRIMINATION NOT ALLOWED**
   - Required Coverage
   - Consistent Participation
3. **VESTED BENEFITS PROTECTED**
   - Reasonable Schedule
   - Vested Means Non-forfeitable
4. **EXCLUSIVE BENEFIT RULES**

-BUT-

THE PERFORMANCE OF A DEFINED CONTRIBUTION PLAN IS NOT GUARANTEED!

Typical Arrangements to Offer Company Stock in a Qualified Plan

Type of Arrangement	Structure
Profit Sharing Plan with Employer Securities as An Investment	• Any eligible individual account plan can be written to include company stock as an investment option within the plan. • Deferrals, match, profit sharing or any combination may be invested in company stock as determined by the Trust Agreement. • Specific ESOP tax benefits are generally not available since this approach does not generally include an ESOP.
ESOP or Stock Bonus Plan	• A Defined contribution Plan specifically qualified as an ESOP (designed to be invested primarily in employer securities) or Stock Bonus Plan (designed to allow for distribution of benefits in the form of Co. Stock)
Coordination of separate ESOP and 401(k) Plan	• Separate plans generally. • The ESOP design may include a dividend pass-through provision. • Section 404(k) dividend deductions may be available available within the ESOP feature.
KSOP	• Fully Integrated ESOP with 401(k) plan features

How Does a Qualified Plan Work?

Typical Defined Contribution Plan Structure


1. Company (Plan Sponsor) establishes Qualified Trust.

2. Company and/or employees contribute cash or other assets to the Trust out of earnings and profits.

4. Assets are invested either by Trustee or by Participants.

3. Qualified Trust Receives Contributions and holds benefits for eligible employees.

5. Eligible employees receive benefits after retirement or other termination of service.

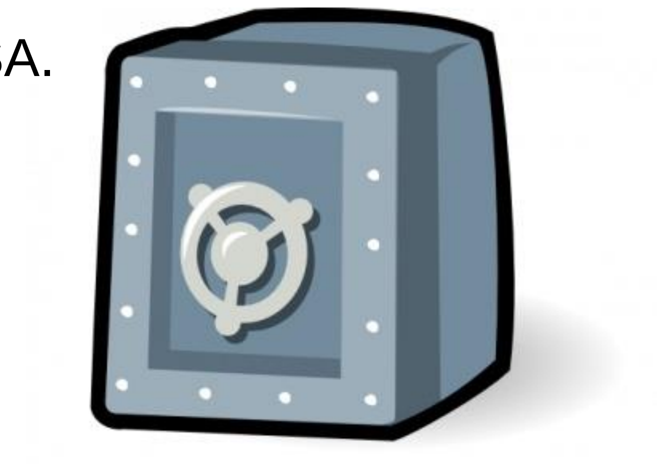
Trust has separate Legal Status

- Trust is separate from the company both legally and financially.
  - Files its own tax returns (informational only)
  - Has its own tax ID number

- Assets of the Trust are exempt from the claims of creditors of the company.

  - Are also not available for compromise by participants.

- All Benefits are protected by ERISA.



What Is an ESOP?

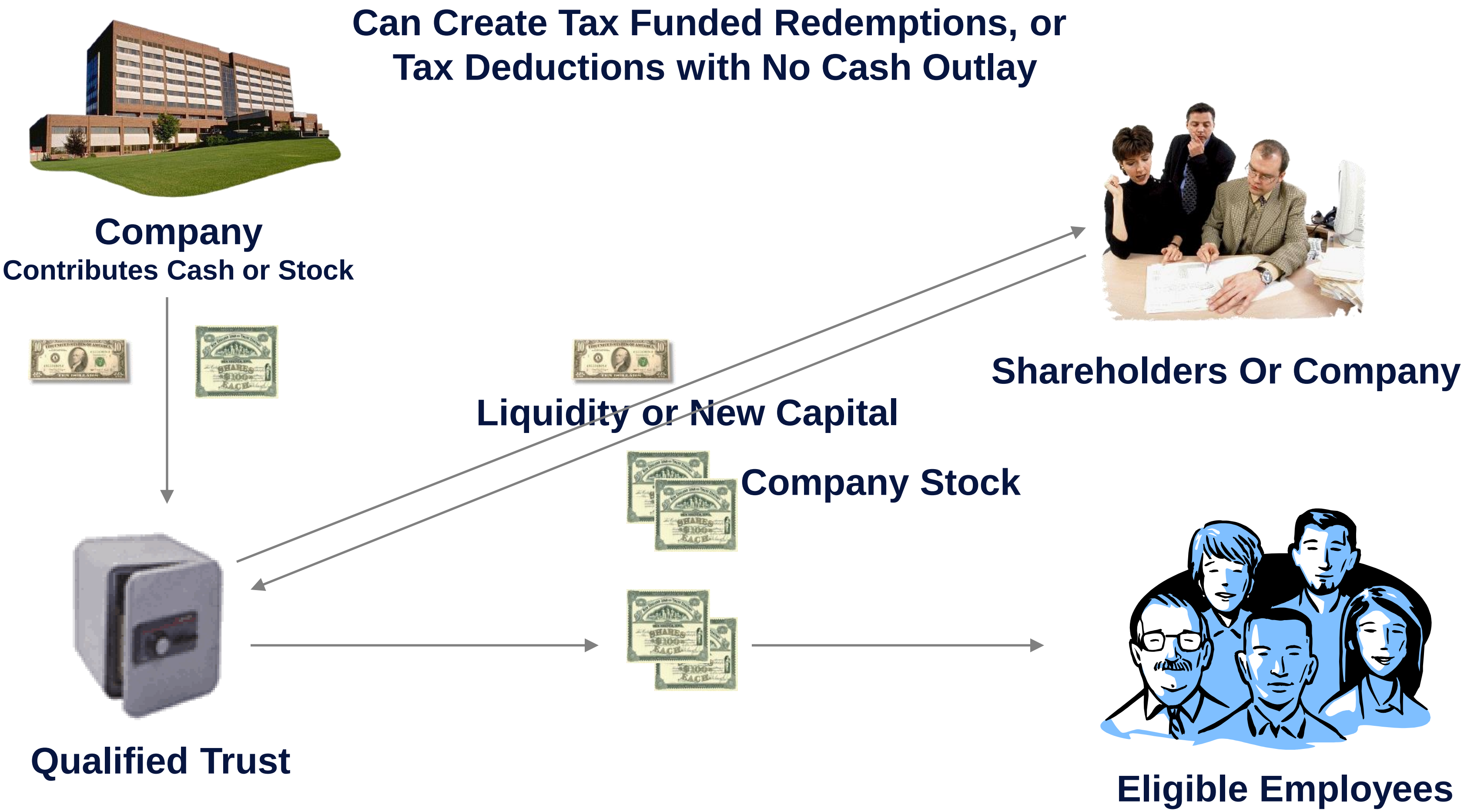
- Defined contribution retirement plan like Profit-Sharing or 401(k) with two significant differences:
  - Required to invest primarily in the stock of the sponsoring company
  - May borrow money backed by the credit of the Company in order to do so (leveraged ESOP)

- Can be used for stock transfers from existing shareholders or as a capital raising vehicle acquiring newly issued shares from the Company

- A versatile tool used to accomplish a wide range of financial and employee relations objectives

How Company Stock Fits In the Picture?

Funding with Company Stock



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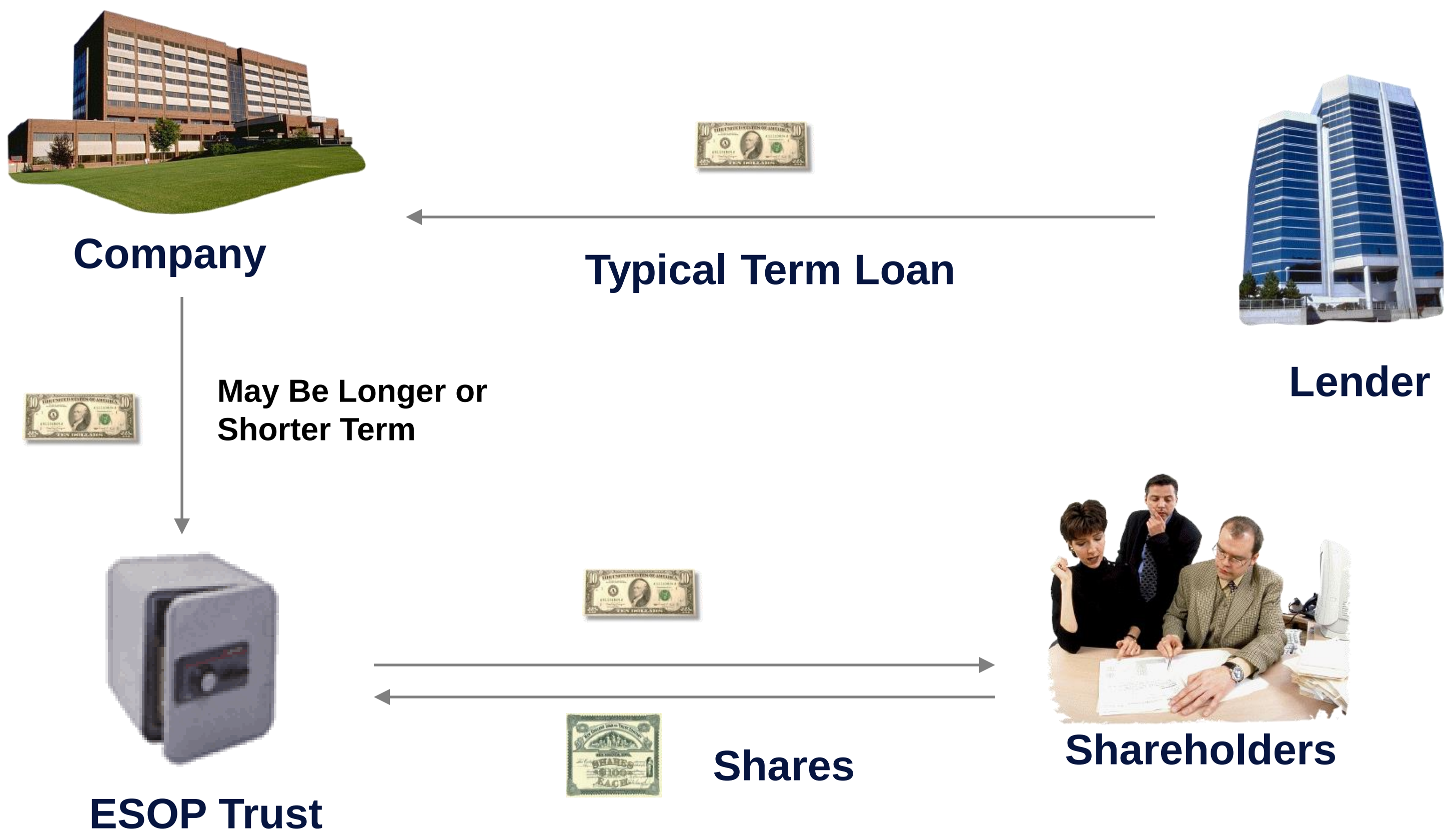
Leveraged ESOP

Leveraged ESOP Transaction Structure



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Amortization is 100% Pre-Tax

Repaying the Loan

Company

Loan Repaid
Over Negotiated Period

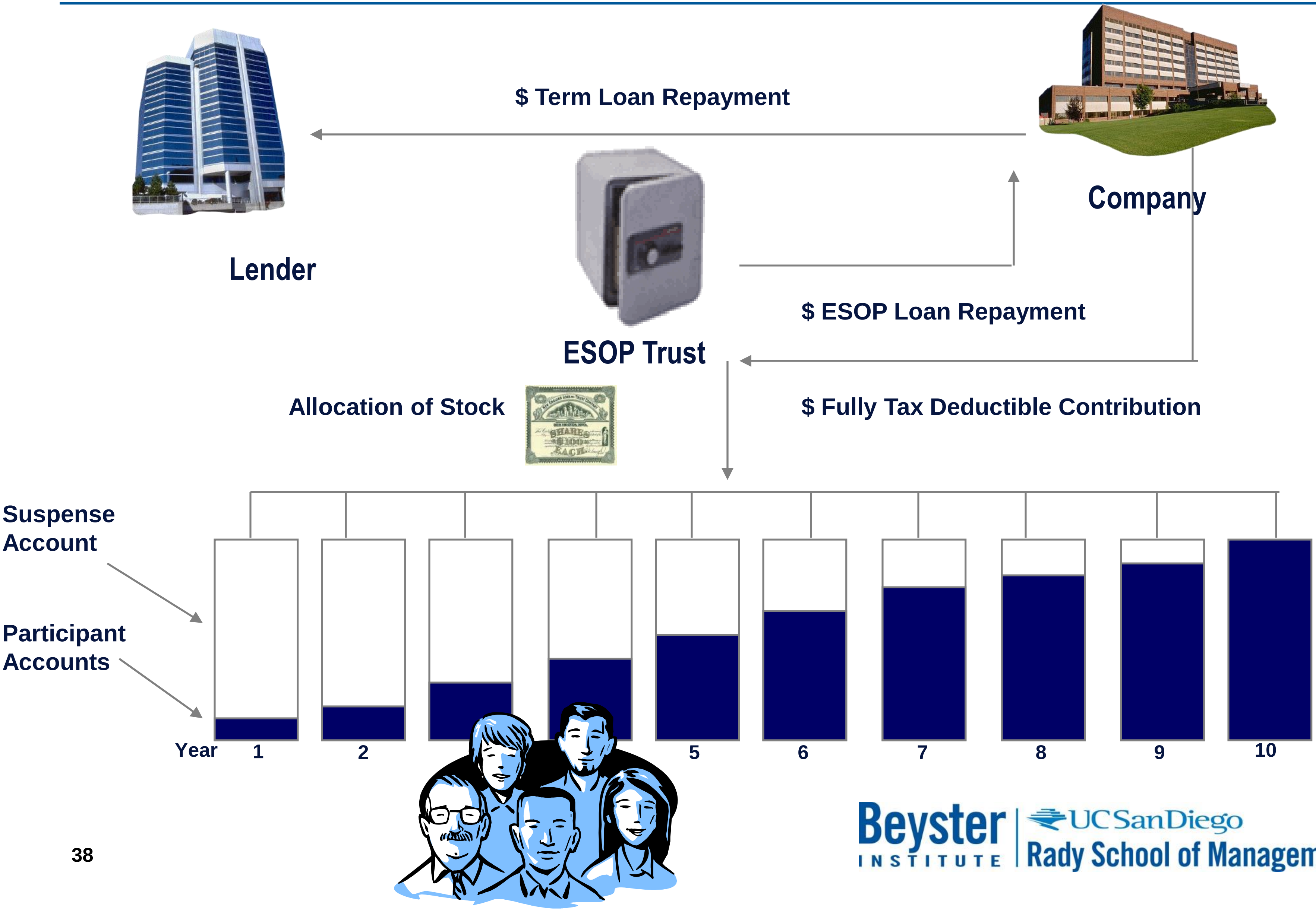
Lender

Contribution/
Dividend

Debt Reduced over
Whatever period
Makes sense

ESOP Trust
Suspense Account Allocation

Participants Earn Stock Over Time



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ESOP Statistics

- About 10,000 ESOPs in the U.S. with about 14 million employees
- $985 Billion in Current Assets (plus amounts already distributed to employees)
- 1,200 ESOPs are sponsored by public companies
- Estimated 4,500 ESOPs are majority owned
- Estimated 3,500 ESOPs own 100% of the company

What ESOPs Do Well!

- Provide cost effective employee benefit
- Improve overall productivity
- Participate in Succession Plan
- Improve overall employee loyalty
- Provide Significant Tax benefits
- Reduce employee turnover
- Prevent corporate takeover

What ESOPs Don't Do Very Well (or even at all)!

- Incentivize Key Individuals X
- Reward Individual Achievements X
- Serve as an Attractive Executive Incentive Program on their Own X
- Create Tax Benefits Without Broadly Distributing Ownership X

Case Study for Discussion

Continental Hardware, Inc.

Skeleton: Distributor-Wholesaler of construction hardware; 2 Owners in their 60s (Gerry and Orv); 30 year history of profitability; 65 employees

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Skeleton: Distributor-Wholesaler of construction hardware; 2 Owners in their 60s (Gerry and Orv); 30 year history of profitability; 65 employees

Flesh: Orv has son in the business, Gerry has no family involved; Gerry is within 5 years of retirement, Orv will work 10 or more; Interest rates at this time (1980s) are at historic highs; demands for capital to fund inventory are significant; more?

Guidelines for Case Study Analyses

Stakeholder(s): ___________________________

- Objectives Leading to Consideration:

- Strategy Alternatives:

- Specific Tactics to Recommend:

- Measurement Techniques: