# Topics in Corporate Governance: Techniques in Equity Compensation

## Class 3: Legal Implications and Future Trends

August 13, 2018
6:30 to 9:30 PM

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# Laws that Enter into the Decisions

- Internal Revenue Service – Tax Law
- ERISA – Labor Considerations
- Securities Rules
- Accounting Rules

# Statutory, Regulatory and Judicial Factors Affecting Equity Compensation Plans

- Broad Exemptions exist with regard to ERISA, Securities and corporate law for non-qualified plans; legal considerations dominate qualified plans.

- Coverage in non-qualified plans can be very selective; qualified plans must be inclusive

- Primary Restrictions on non-qualified plans relate to tax treatment - limiting deferral of income and tracking deductions to the sponsor (New IRC Section 409A); Contribution and allocation limits apply to qualified plans.

- Federal and State Securities Laws often apply to non-qualified plans (subject to some exemptions); qualified plans, funded with employer money, are generally exempt.

- No Real Fiduciary Considerations in Non-Qualified area – generally in the framework of settlor functions; qualified plans engage fiduciaries.

# IRS
# U. S. Tax Law Related to Stock Ownership Plans

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# Tax Law Issues Affecting Equity Compensation Plans

- Corporate Deductibility of Contributions (IRC Sec. 404 et.al.)
  - Qualified Plans at time of contribution
  - Non-Qualified Plans at the time taxable income is recognized

- Prohibited Transactions (ERISA Sec. 407 and IRC Sec. 4975)
  - Generally any transaction that involves a qualified plan and a party in interest is prohibited
  - Specific exemptions exist that allow ESOP and like transactions (IRC Sec. 4975)

- Benefits may have tax favored status for participants (IRC Sec. 501 and IRC Sec. 409A)
  - Qualified Plan contributions are generally not taxable to participants until withdrawn (subject to roll-over potentials)
  - Non-qualified plan benefits may be tax-deferred subject to restrictions imposed by IRC Sec. 409A (generally preventing indefinite deferral) and are tied to corporate deductibility

ERISA
U. S. Labor Law Related to Stock Ownership Plans

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# Retirement Safeguards Under ERISA

| | |
|---|---|
| E | MPLOYEE |
| R | ETIREMENT |
| I | NCOME |
| S | ECURITY |
| A | CT |

1. SPONSORS ARE 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

**Applicable to all Qualified Plans and Some Non-Qualified Plans**

# Some Representative Case Law

- Donovan V. Cunningham
  - Valuation of Assets
- Larimore v. Grant
  - Conflicts of Interest
- Oregon Metallurgical
  - Diversification
- Delta Star Inc. v. Patton
  - Fiduciary Violations



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# Donovan v. Cunningham

- Lesson:
- An ESOP fiduciary must be procedurally prudent in acting on behalf of the trust and will be judged not as a "reasonably prudent person", but as a "prudent <u>expert</u>."

- "A kind heart and an empty head is not enough."

# Donovan v. Cunningham *Cont*

- Relevance?
  - The touchstone of all fiduciary duties.
  - Created a requirement to appoint Trustees that are qualified or are willing to become qualified experts.
  - Defines basis of every transactional context and every valuation engagement.



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# Larimore v. Grant

- Lesson:
- Unlike a Trustee at common law, who must wear only one fiduciary hat, an ERISA Trustee may wear many hats, even when his acts affect the beneficiary of the trust, and may have financial impacts that are adverse to the interests of the beneficiaries.



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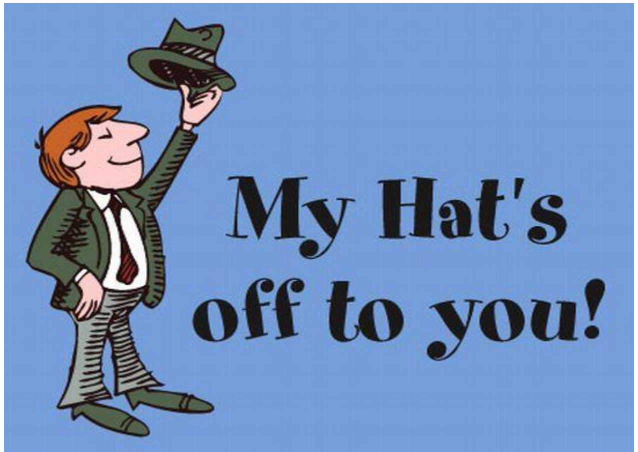
# Larimore v. Grant *Cont*

- Relevance?
  - Whenever a director or officer of the corporation also acts as a Trustee and fiduciary and is making corporate financial decisions, of both the routine and strategic kind, acting in the best interest of the company is not a fiduciary violation.



# Oregon Metallurgical

- Lesson:
- Fiduciaries will not generally be held liable for failing to diversify out of company stock merely because the stock value is in decline.

- Presumed prudence?

# Oregon Metallurgical *Cont*

- Relevance?
  - The Ninth Circuit has its own way of thinking about many things, and
  - Recent DOL actions have limited the “presumption of prudence” -Moench,
  - But there is still a strong basis for presuming that if the plan calls for stock purchases, the Trustee will be OK when making stock purchases with proper advice and analyses.

# Delta Star Inc. v. Patton

- Lesson:
- ESOP Trustees must protect shareholder interests by considering issues like executive compensation. Allowing senior management to set its own compensation without checks or balances should not be permitted to result in waste.

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# Delta Star Inc. v. Patton *Cont*

- Relevance?
  - “Bad facts make bad law.”
  - Crooks will always be crooks – even when they may not intend to be.
  - Answer for the sins of the previous Trustee?

# Securities Rules Related to Employer Stock Plans

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# Securities Rules Related to Stock Offerings

- Any “security” that is either “offered” or “sold” to the public must either be registered with the SEC or subject to one of the available exemptions.

- The Securities Act of 1933 and the Securities Exchange Act of 1934 provide basic guidance.

- State “Blue-Sky” laws also come into play.

# Significant Securities Sales Exemptions

- Regulation A (the famous Reggae Offering)
  - Up to $5.0 million of new securities in any 12 month period
  - Resell up to $1.5 million in any 12 month period
  - SEC Filing:
    - Offering Statement (notification, circular, disclosure)
    - No other exchange act reporting unless the company has more than $10 million of assets and 500 shareholders

- Regulation D (the 35 investor rule)
  - Rule 504 – up to $1.0 million in a 12 month period
  - Rule 505 – up to $5.0 million in a 12 month period to up to 35 non-accredited investors and an unlimited number of accredited investors
  - Rule 506 – any amount may be sold to up to 35 non-accredited but sophisticated investors (disclosure documents similar to registration statement are required).
  - Form D (shareholders and promoters list) must be filed with SEC

- Accredited Investor?
  - Rules are changing

# Significant Employee Plan Exemption

- Rule 701 – Shares Issued as Compensation
  - Written Plans and Written Contracts
  - Not Subject to Exchange Act and Not Investment Companies
  - May Sell Up to the greater of:
    - $1.0 million
    - 15% of the total assets of the issuer (or the parent of the issuer) per the most recent balance sheet date
    - 15% of the outstanding amount of securities of that class on the issuers most recent balance sheet
  - If more than $5.0 million in sales in a 12 month period, then disclosure rules of Regulation A must be met before the sale

- Intrastate Offerings

# Where Exemption Is Not Available

- Voluntary employee contributory plans that offer stock but do not fall under one of the previous exemptions must file a form S-8
  - Simplified Registration Statement
  - Prospectus
  - Other Disclosure documents

- If the Rules are violated
  - Buyer has Unlimited ability to rescind!
  - Issuer is responsible to make buyer whole!

# State “Blue Sky” Laws

- State Securities Laws Will Always Apply:
  - Wherever the Company is doing business, State law is an issue
  - Most States conform to Federal Law to some extent
  - All have their own additional rules

- Cheap Stock – Pre IPO

# Relevant Accounting Requirements

# Accounting Issues for Employer Stock Plans

- Sarbanes-Oxley
  - Applies to non-ESOP plans of Public companies
  - Generally requires reasonable expensing of the “cost” of equity compensation
  - Creates no new costs for employers
  - Requires CEOs to take responsibility for financials


- SOP 93-6 Accounting for ESOPs
  - Expense equals Fair Market Value of Allocated Shares for the Year
  - Balance Sheet Entries at:
    - Liability (long or short)
    - Equity (negative entry equaling ESOP Debt)

# Accounting Issues for Employer Stock Plans

- FAS 123 Accounting for Stock Plans
  - Adopted in final form December 16, 2004
  - Requires that Companies show the Fair Value of Stock Options as an expense on Income Statement
    - Valuation may include: lattice models (aka bi-nomial models), Black-Scholes, Monte Carlo Simulation
    - Performance Share Programs are treated similarly to stock plans
    - Expenses are booked as vesting of benefits accrue

# Case Study for Discussion

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# Case Study: Cove Standard Manufacturing

- Skeleton: CSM is a 35 year old manufacturer of high tolerance fastening hardware; significant business in computer and related fields; Ownership vests in 5 family entities; Company employs 120 Union Machinists, 60 Sales, Administrative and R & D employees and 4 key executives:
  - CEO Stan Cove is looking to retire within the next 5 years
  - Current Ownership: Stan Cove 57% interest, Tom Cove Family Trust (Stan’s parents’ family Trust) 14% interest, Gerry Cove 21% (Stan’s Brother (not in business)), The Bernice Cove Charitable Remainder Trust 8% (Stan’s deceased sister’s family trust)
  - Family is in conflict over the future of the business

# Case Study: Cove Standard Manufacturing

- Stakeholder:
- Objectives:
- Strategies:
- Tactics:

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# Current and Future Trends

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# Does Employee Ownership Really Work?

It depends on how you define "work" and who you are asking…FOCUS…


Sustainability – Internal Issues:

Shareholder Value:

Corporate Performance:

Employee Satisfaction:

Quality of Life:

Community Impact:

# Track Record?

# Some Highlights of Research…

- ESOP companies are ***8 – 10% more productive*** after becoming employee owned than before.

- ESOP company retirees can be expected to retire with ***2.5 to 4 times the retirement income*** they could expect otherwise.

- ESOP companies are less likely to lay people off in downturns, hire back faster and are ***only 1/5 as likely to go out of business.***

# What's the Score?…(NCEO Research 2016)

| Type of Plan: | Number of Plans: | Total Participants: | Employer Stock Held: | Total Assets: |
|---|---|---|---|---|
| Standalone ESOPs: | 5489 | 1.66 million | $102.9 billion | $115 billion |
| KSOPs: | 1306 | 12.26 million | $159.4 billion | $1.12 trillion |
| Total Literal ESOPs: | 6795 | 13.9 million | $262 billion | $1.23 trillion |
| Other ESOP-like Plans: | 2528 | 1.18 million | $22.2 billion | $64 billion |
| Total: | 9323 | 15 million | $284 billion | $1.3 trillion |

# Employee Ownership and Community Health

**General Social Survey: Post-Recession**

- 12.1% of respondents lost jobs
- but only 2.6% of employee-owners

**Translated into community impact…**

- … without employee ownership, **1.8 million more jobs** would have been lost
- … a benefit in federal tax revenues of **$14 to $23 billion** per year

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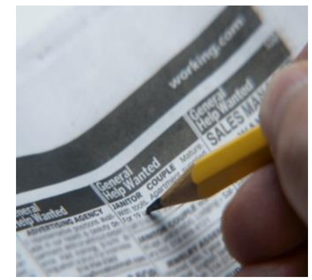
# More Recent Research – Message is the Same!

- **Sampling Recent Research from NCEO (Kellogg Foundation Grant)**
  - **ESOP creates median net worth 96% higher than non-ESOP employees**
  - **ESOP Companies Pay 33% better median salary**
  - **Employee Owners have median tenure 53% longer than others**



- **NBER Data Show:**
  - **The Extent of employee ownership is persistently linked to healthier county economies along lines of employment and income stability.**



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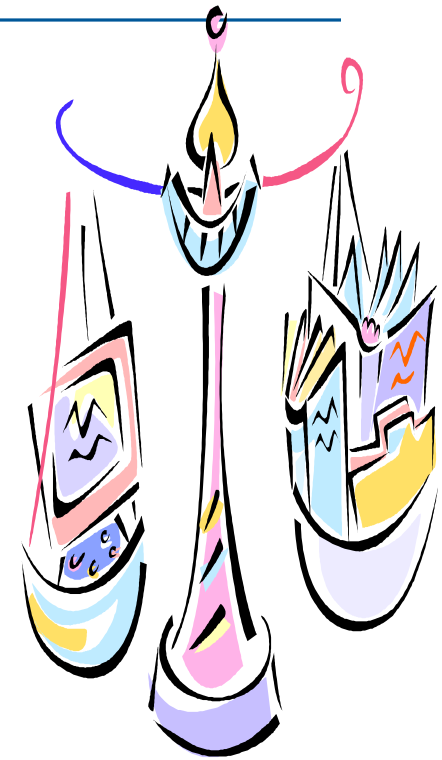
# Employee Ownership Doesn't Cure Everything

- Employee owners overall have more wealth than non-employee owners and do not give up wages (Buchele, Kruse, Rodgers, and Sharf, 2010)

- But, patterns of participation and wealth by race and gender reflect existing patterns of inequality and pay differences (Carberry, 2010)
  - Participation and allocation of value usually structured around existing pay and occupational structures
  - Could have important consequences for how these groups view employee ownership
  - Could mitigate positive attitudinal and motivational effects of these plans





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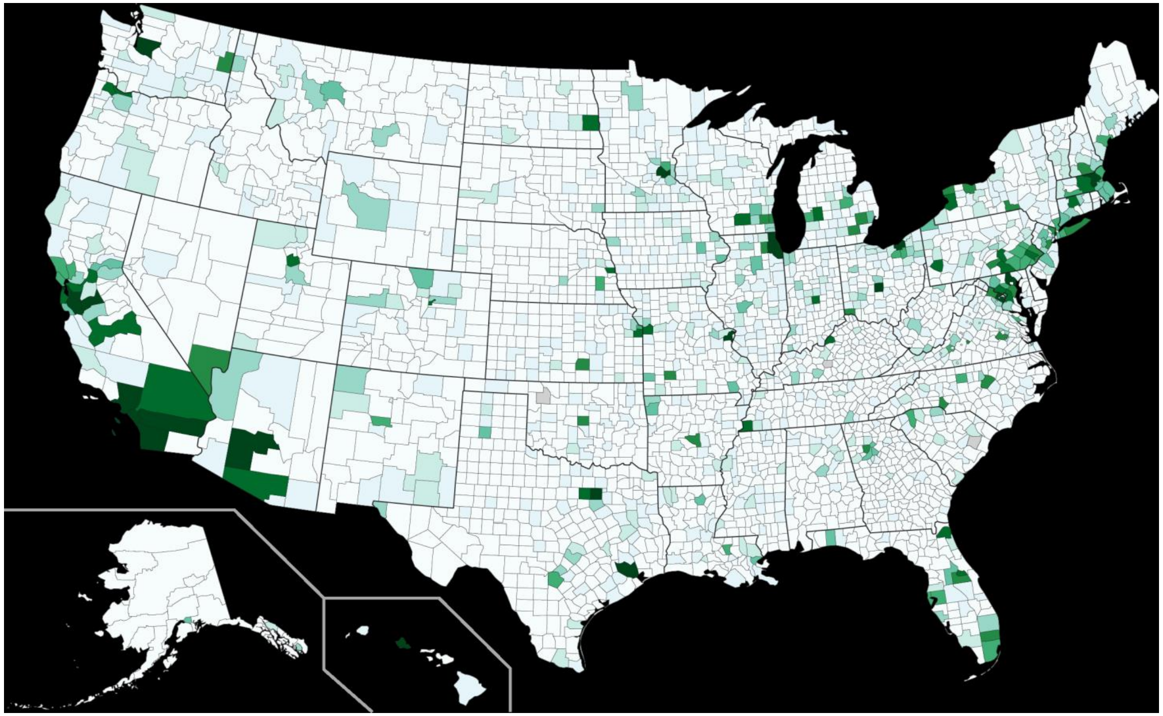
# The Unconscious Winner!

- Research by Guzek* and Others is beginning to paint a clear picture of the value of employee ownership to our communities.



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# Employee Ownership and Community Health

- The research is still in progress, but initially

- Strong Suggestions:

  - The Extent of employee ownership is persistently linked to healthier county economies along lines of employment and income stability.

  - ESOPs are positively linked at the county level to increased employment in the three fastest growing industries and to median household income.


# An Ownership Culture Implies a Community of Stakeholders

How Can I Create a Community of Stakeholders?

# Turning Employees Into Stakeholders: 5 Factors

- Information
  - "What do I need to know to have an effect on the success of the enterprise?"
- Autonomy
  - "Do I have the ability to have an effect on the success of the enterprise?"
- Opportunity
  - "Will I benefit from the success of the enterprise?"
- Respect
  - "Are my contributions to success acknowledged and valued?"
- A Stake in the Outcome
  - "Will my family and I be able to benefit directly from the success I am helping to generate?

# Factor 1: Information Means More Than Just Facts

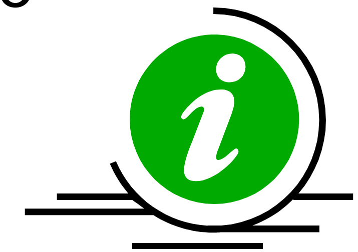
- Open book Management*
  - Giving People the Information They Need to Make a Difference in Achieving Common Objectives.
  - Determining critical metrics is the key

- The Universe of Information:
  - Financial Information
  - Operational Processes
  - Current Issues and Business Priorities
  - Future Plans/Strategies
  - Communication Networks


* With Gratitude to John Case (See 2005's release Equity, Harvard Press.)

# Why Share Information?

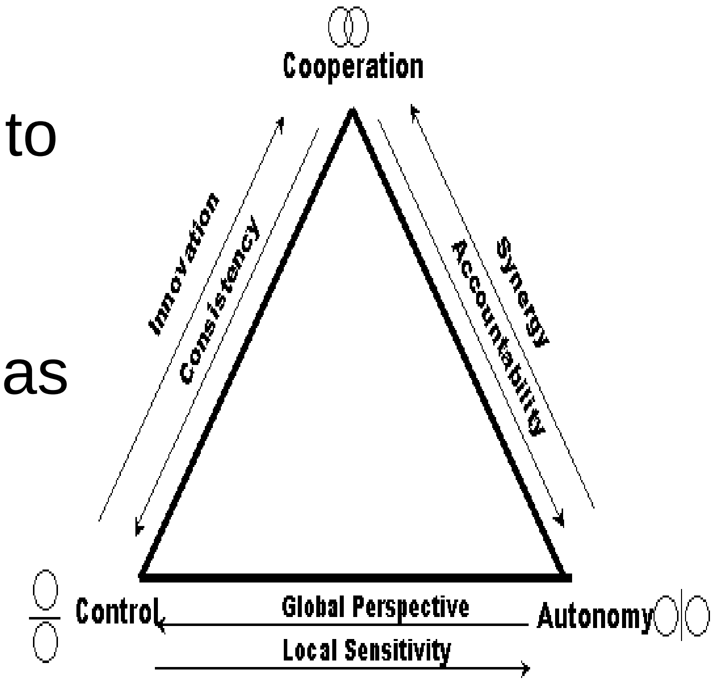
- It's the Right Thing To Do!  People Respond to Inclusion!



- Practical Reasons:
  - Studies Show Regular Information Sharing Improves the Company
    - More Profitable, Grow Faster, Less Turnover, More Likely to Weather Difficulties.
  - It is a More Efficient Development and Use of Resources
    - Input Closer to Problems, Faster Recognition and Solution, Shared Responsibility
- It's also a Lot of Fun!

# Factor 2: The Value of Autonomy

- When any problem arises, it is very likely that the person closest to the work will see the problem first.
- It is not enough to just expect them to pass it up the food chain.
- The easiest time to fix a problem is as soon as it is noticed. Delay always makes problems worse.
- Giving employees the right and responsibility to fix problems really pays off.



# How Does Autonomy Work in Practice?

- If I receive a complaint, I ought to be empowered to cure it!
  - Southwest Airlines
  - Springfield Remanufacturing
  - Nordstroms

- In an ownership culture, it should be both my right and my responsibility to contribute to the process as well as the outcome.

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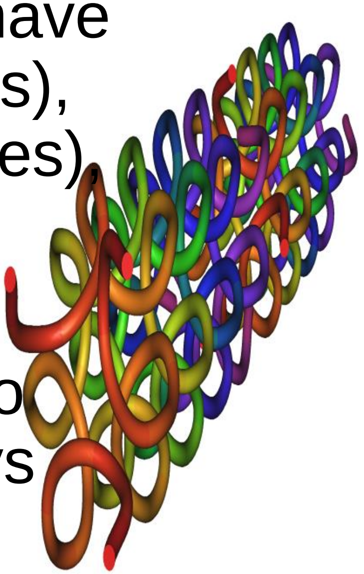
# Factor 3: Creating a Future of Opportunity

- Your Employees' ambition is not your enemy.

- When your best employees have ambitions beyond your walls, you can choose to either have a captive (Golden Handcuffs are still handcuffs), a competitor (leaving bad feelings on both sides), or an ally (invest with the best).

- Giving employees a chance to move up and to share in the outcome will engage them in ways that magnify the positive and minimize the negative.



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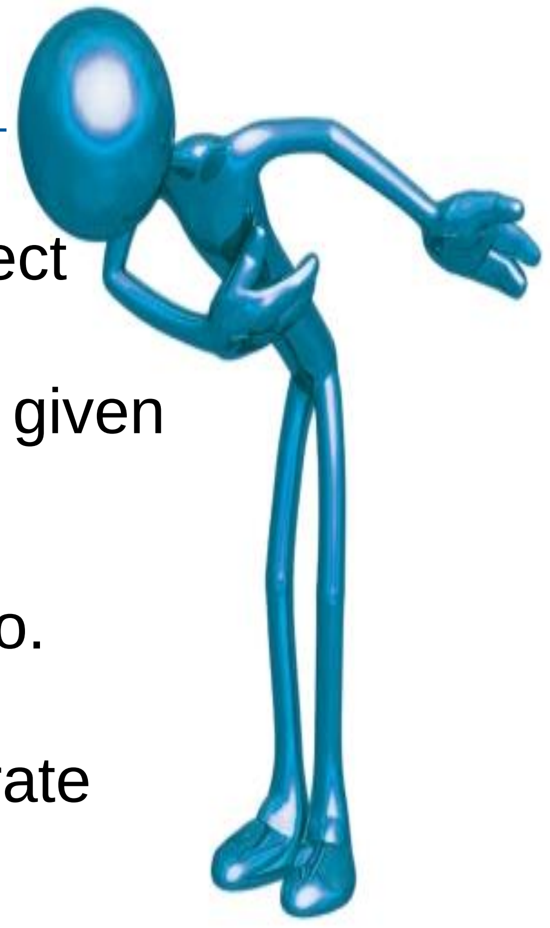
# What does Opportunity mean in Practice?

- In order to get longevity/loyalty from employees, you have an obligation to create clear paths of long-term opportunity.
- Promoting from within ought to be the first choice.
- If you do not see the resources to grow within your company, that is your challenge…no one else’s.
- When you need to go outside to fill a critical spot, engage others within the company in the process

# Factor 4: Respect



- Ownership Culture requires mutual respect
- Respect cuts both ways – it is to be both given and required
- Respect means more than just listened to.
- Respect is the driving feature of a corporate culture that is open, cooperative, multidimensional and dynamic
- This is the very nature of an “ownership culture”.

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# Factor 5: Sharing a Stake in the Outcome

- Studies show that conclusively that work environment is more important than money or benefits.
- Studies also show that when ownership is coupled with a participative management style, the performance of the company is enhanced significantly. (Blasi & Kruse, Rutgers; NCEO; etc. See www.nceo.org for details.)
- Fostering an “Ownership Culture” creates a much larger pie to share.
- You must go beyond a “sense of ownership” to create real stakeholders

# A "Steak" in the Outcome

Giving someone a "sense of ownership" is like feeding someone a "sense of lunch".

-Corey Rosen, NCEO



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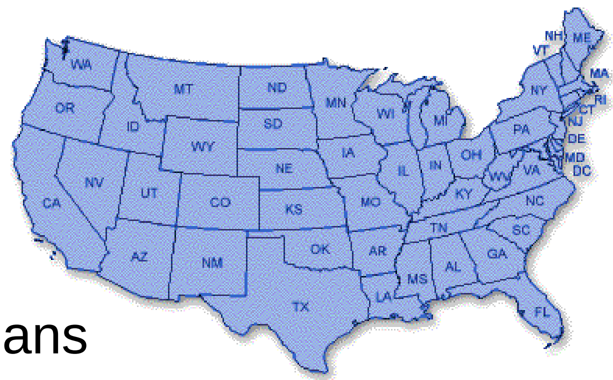
# What the Future Holds in the U.S.

- Stabilizing financing environment
- Steady Business Growth
- S Corporation ESOPs Expand
- Private equity players changing focus
- **Baby boomers retiring in droves!**

  » **So**




- Seller Financed Business Succession
- Some Increase in Direct stock ownership plans
- More large control block transactions
- Private equity/multi-shareholder transactions
- Large second stage transactions
- Favorable Legislative changes
- Buyer inspired transaction