OWNERS @ WORK

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Summer Means Employee Ownership

Featuring

Highlights from the 31st Annual Ohio Employee Ownership Conference
Photos
Award Winners Robin Industries and The Ruhlin Company
Keynote Address: Cindy Turcot

OAW Interviews:

Mary Ann Beyster on the Changes at the FED
Chris Michael on Employee Ownership Trusts
Thomas Dudley and Kramer Sharp on Certified EO program

OWNERS AT WORK

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The OHIO EMPLOYEE OWNERSHIP CENTER (OEOC) is a university-based program which provides information and technical assistance to retiring owners, buyout committees, labor unions, managers and community-development organizations interested in exploring employee ownership. Center staff can help locate competent and appropriate legal and financial advisors, and perform initial assessments to determine whether employee ownership is a viable option. The OEOC develops resource materials on employee ownership and participation systems, sponsors workshops and conferences for the general public, develops and delivers training programs for employee owners, facilitates cooperation among employee-owned firms, coordinates a comprehensive succession planning program, and assists international efforts to privatize businesses through employee ownership.

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Employee Ownership Trusts: A New Model of Employee Ownership?

Christopher Michael
Attorney-At-Law

Chris Michael is an attorney based out of New York City that has been involved in the creation of ESOPs, worker-owned co-operatives, and now Employee Ownership Trusts. While gaining some traction in European countries (predominately in the UK) EO Trusts are a relatively new concept here in the USA. OAW talked to Chris to get an overview of EO Trusts, how they are used, and a sense of the pros and cons of the model.

Q: Chris, thanks much for talking with us today.
A: Thank you––it's an honor to be speaking with the OEOC.

Q: After some time working with both ESOPs and worker owned cooperatives, you've begun working on what is, in the US at least, a new model of employee ownership. Can you briefly describe what is an Employee Owned Trust, and what prompted your interest in it?
A: An employee ownership trust (EOT) is a legal structure that allows a company to remain employee-owned in perpetuity. In short, the company shares go into a trust and stay there forever. The company is operated by the trustee on behalf of the employees like at an ESOP company. The company culture should also reflect its employee ownership structure like an ESOP. However, unlike an ESOP, an EOT is not a retirement plan. Employee-owners are "naked in, naked out." They don't have to make any contributions on the way in, and they don't get bought out when they exit. Employee-owners don't accumulate shares in individual accounts. Rather, they receive a percentage of ongoing profits, in accordance with a formula, throughout the duration of their employment. Of course, some of these profits can be channeled into a diversified 401k plan for retirement purposes.

I spend a lot of my time as an attorney working with employee-owned businesses, but I'm also a Ph.D. student writing a dissertation on the history of employee ownership. I tend to think long-term about things. And I'm just not quite satisfied with the idea of building employee-owned businesses that might sell out at any time in the future. Of course, the economy is constantly in motion, and business enterprises aren't always intended to last forever. Nevertheless, it seems to me that we should be aiming for stability and preserving the employee ownership structure as long as possible. We shouldn't make it easy to eliminate employee ownership at a company, and we certainly shouldn't impose requirements on companies to sell out. The EOT offers a common-sense solution to this problem.

Q: My understanding is that this model had its genesis in the UK.
A: That's right! The best-known EOT company is John Lewis Partnership, which is one of the biggest and oldest EO businesses in the world! It was founded in the late 1800s, transitioned to full employee ownership in 1950, and currently has 95,000 employee-owners. All employees are owners on day one of employment. Also, many folks don't know this, but all employee-owners at John Lewis have equal voting rights. I should add that John Lewis is kind of like the Macy's of the UK––a very upscale department store chain.

JOHN LEWIS
PARTNERSHIP

Q: How many Employee Ownership Trusts have you helped put in place?
A: I've put in place about half a dozen EOTs, and designed about another half a dozen that are soon to be implemented.

Q: What in your view are the basic pros and cons of the model as compared to both ESOPs and worker owned cooperatives?
A: EOTs are significantly less expensive and less time-consuming than ESOPs. When I describe the EOT concept to ESOP folks, it takes them quite a while to wrap their head around how simple it is. EOTs don't require annual valuations. They aren't retirement plans, so there is no reason for them to be regulated by the Department of Labor. There is far less reason for litigation, so trustee costs should be much lower. There are no repurchase obligations, and so there is no need for a fancy financial analyst to help with scheduling. You can see where I'm going with this...

As per worker-owned cooperatives, a lot of folks are nervous about the unrestricted democracy. In contrast, an EOT can be structured just like most ESOPs, with a circular "board appoints trustee, trustee elects board" structure. However, an EOT can also be structured as a "constitutional" democracy where employees have equal voting rights, but constitutional protections ensure basic elements of good governance and financial management, such as requiring reinvestment of a percentage of earnings back into the business. I should add that it's also much easier to accommodate business owners during a sale to an EOT. I have a pet theory that most selling business owners aren't altogether that worried about employee-owners having equal voting rights––they're just worried about employee-owners having equal voting rights while they're still "on the hook" with seller financing! An EOT can easily resolve this concern by providing for an independent trustee during the sale period. After the loan is paid back and the business owner is fully "cashed out" of the company, a provision in the EOT trust document can toggle on employee voting rights. You get the benefits of a worker-owned cooperative without the commonplace obstacles that prevent their formation. I'd add that this same "staging" process for employee voting rights can also be used in ESOP transactions.

Perhaps the main differentiator is that EOTs can be structured to maintain the company under perpetual employee ownership. We know that the ESOP trustee has a duty to sell the company out of employee ownership when presented with a sufficiently high offer. We also know that demutualization is a longstanding historical problem with the worker-owned cooperative. For selling business owners whose primary concern is legacy and the perpetuity of the employee ownership structure itself, and who are willing to sacrifice certain tax benefits, then an EOT is the best option.One last note here––a lot of folks also like the fact that certain core values can be locked into an EOT, such as making sure that the company is environmentally responsible, or that it donates some percentage of net income to their state center for employee ownership!

Q: One of the complaints I've heard about the model is that there are insufficient protections for employees, both at the time of the deal and as an ongoing entity. How would you respond to this?

A: For better or worse, a business owner can do about whatever they want with their company. They can shut the business down forever and sell the physical assets. They can attempt to preserve the business by giving it to a family trust. They can also preserve the business by selling to an employee ownership trust. All of these things can be done on a business owner's terms without interference from the government. An ESOP is distinguished because selling business owners and businesses receive certain tax benefits. In exchange for these benefits, ESOP transactions and ESOP companies are tightly regulated. Right now, business owners do not receive any tax benefits by selling to an EOT, and so they are not burdened by regulation. I would add that, as with an ESOP transaction, employees are not paying out of their own pockets on an EOT deal. So, again, a business owner can do whatever they want with their company––as long as employees and taxpayers aren't paying for it. I'm not unconcerned about problems that may arise, but I also don't see this as a pressing issue. The business owners that I work with are selling to an EOT for the right reasons.

Q: What in your view would be an ideal scenario in which an Employee Ownership Trust makes sense or work best?
A: Right now, ESOPs enjoy immense tax benefits. So, for any company with a valuation greater than $1M, an ESOP is probably going to be the best fit. An EOT would be great for anything smaller than that. Putting aside company size, if a selling business owner really values the idea of creating a perpetually employee-owned company that can never be sold out, and they are willing to sacrifice the tax benefits, then an EOT would be the way to go.

Q: Looking at the current legal and regulatory framework here in the US, what if any impediments do you see that would, or can, impede the growth of the model?
A: My contribution here has been to identify the appropriate legal framework for an employee ownership trust in the United States. I published two law review articles about this––one in a top tax law journal, the other in a top trust law journal. I don't see any legal or regulatory impediments to the EOT. The EOT can be used today by any company in any state in the country. That said, the main issue moving forward is whether Congress will give EOTs the same tax benefits enjoyed by ESOPs. The quickest way to do this would be to make the EOT an eligible holder of S corporation stock and grant tax-exempt status to EOTs. This would give S corp EOT companies the same tax benefits as S corp ESOP companies.

It would also be smart to ensure that ESOP companies can transition to an EOT without suffering any adverse tax impact. I've recently spoken with a couple of ESOP companies that would love to transition to perpetual employee ownership and eliminate their endless repurchase obligations, but the tax impact of a transfer to an EOT is just too burdensome. As a final plug, I would add that I recently drafted model state legislation that features the EOT, alongside ESOPs and other forms of direct employee share ownership. We don't have to wait for federal legislation. In 2017, the Ohio legislature might create a state-level capital gains exemption for business owners who sell to an EOT or an ESOP.

Q: Chris, as always I appreciate your time.
A: Likewise, Chris!

More information on EO Trusts, their uses, and relevant laws can be found at the following links:
- *http://cmichael.ws.gc.cuny.edu*
- *http://cmichael.ws.gc.cuny.edu/articles/* **oaw**

Thomas Dudley
Kramer Sharp
Certified EO

Certified EO is a relatively new membership organization based out of the Bay Area in California whose self-described goal is in "uniting employee-owned companies with a common brand that will raise national awareness of employee ownership and provide a source of differentiation for our members." OAW talked to the founders about their goals and objectives for the organization.

Q: Thomas and Kramer, thanks much for joining us today.
TD: Of course!
KS: Glad to be here.

Q: So what is a "Certified Employee-Owned" Company?
KS: There's a few ways to answer that. To the general public we'd say a Certified Employee-Owned company is a business rooted in the local community and where the employees have a stake in the value they create at work through significant and broad-based employee ownership.

To employee-owned companies we would say a Certified EO Member is a company that's looking to help make employee ownership part of the national consciousness. A company that wants to carry the flag and create visibility for the great things happening in our community.

Q: Can you describe a little the thought process and circumstances that drove you to begin the project?
KS: We want to make employee ownership something every American cares about. This is the perfect time for employee ownership to come to the forefront and address many of our country's problems, but unfortunately employee ownership is practically invisible! We're trying to spark that conversation and get visibility for employee ownership.

TD: For a bit of background, the idea for Certified EO originally came out of some research I was doing as a PhD student. I got interested in public opinion on employee ownership and found very strong support among Americans in a nationally-representative survey. I started talking about this with Kramer and we thought it was exciting, but also hard to reconcile with how hard it is to find employee-owned businesses. We figured a certification program would not only help businesses tap into popular support for employee ownership but would also create a recognizable brand that would raise awareness and make it easy for people to vote with their dollars and resumes.