

What We Can Learn From Each Other: ESOPs, Co-ops and the Future of “Shared Capitalism”

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Presentation Goals

- We're going to discuss a few issues where we think ESOPs and Co-ops can learn from each other
- We're going to offer ideas about how the two worlds could cross-pollinate and hopefully improve the model of shared capitalism
- We will invite your ideas!

The Employee Owned Performance Advantage

- Before getting into the issues, it is important to recognize that there is a documented employee ownership performance advantage
- The latest documentation is in Kruse, Freeman & Blasi, eds., *Shared Capitalism at Work: Employee Ownership, Profit and Gain Sharing and Broad-based Stock Options* published in April 2010 by University of Chicago Press

Which Structure is “Better”?

- There are sometimes differences of opinions in the culture about who is “more pure” - - ESOPs or Co-ops
- Generally
 - More worker coops are more democratic
 - More ESOPs are larger & more economically successful
- However
 - There are large & successful worker coops
 - There are highly democratic ESOPs



Which is “Better” for You?

- We think that argument is a mistake
- Rather, we think the evidence is that both can work and both can learn from each other
- What works best for you depends on your goals, and may incorporate strengths of both models
- We’re hopeful that this presentation will spark others to think about and write about these issues too



Key Areas of Consideration for Comparison and Contrast

- Governance
- Management (to the extent it is not about governance)
- Taxation
- Profit and gain sharing
- Membership or participation
- Distributions on retirement or separation

Governance: Co-ops

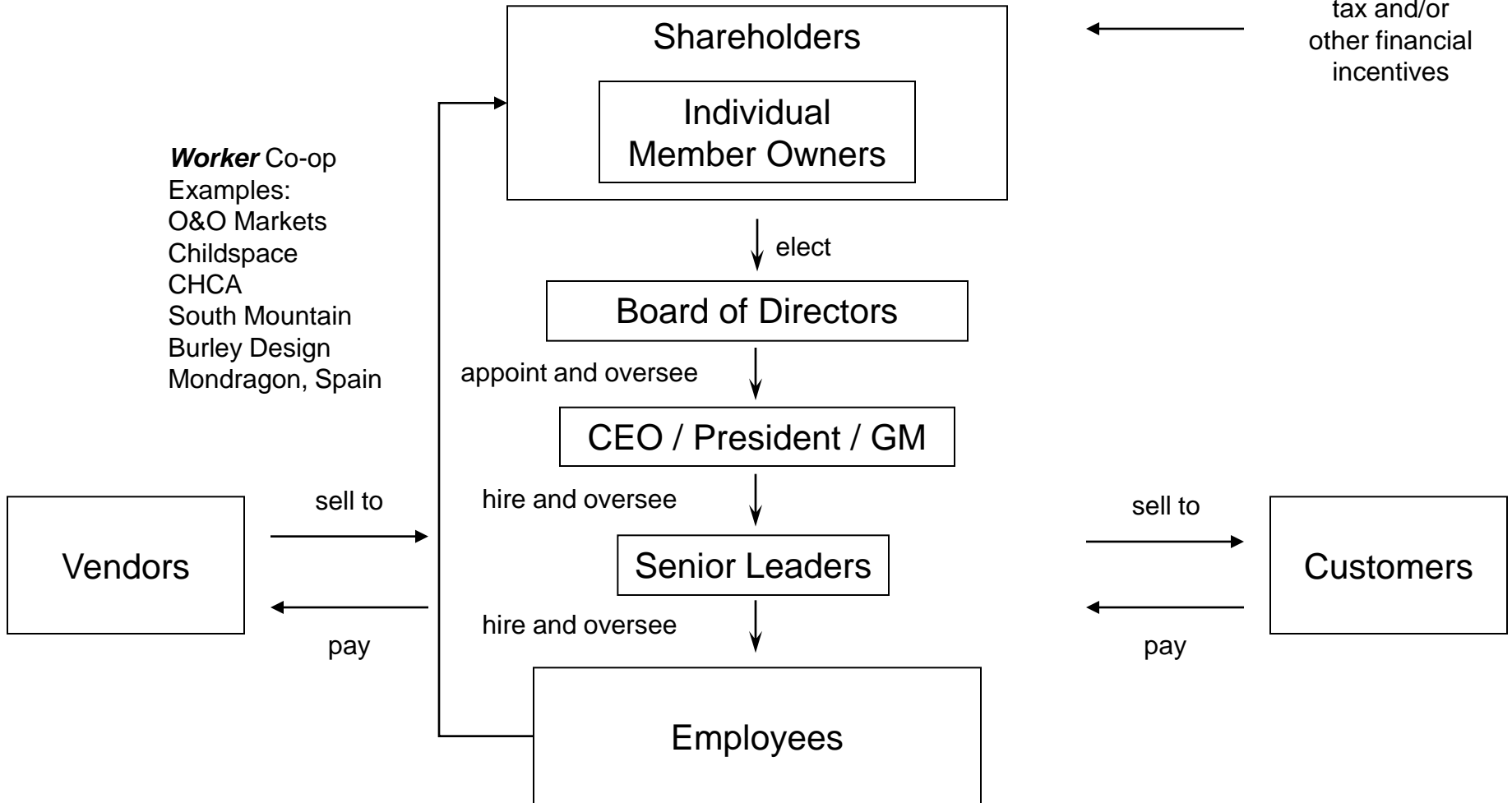
- Theory: Are stock corporations, including ESOP owned companies, really just “capital co-ops”?
- What makes a co-op a co-op?
 - One person one vote; members vote in the Board of Directors and Directors oversee Officers
 - Once you’re a member, you have equal voice...on governance issues
 - Other co-op principles

Governance: ESOPs

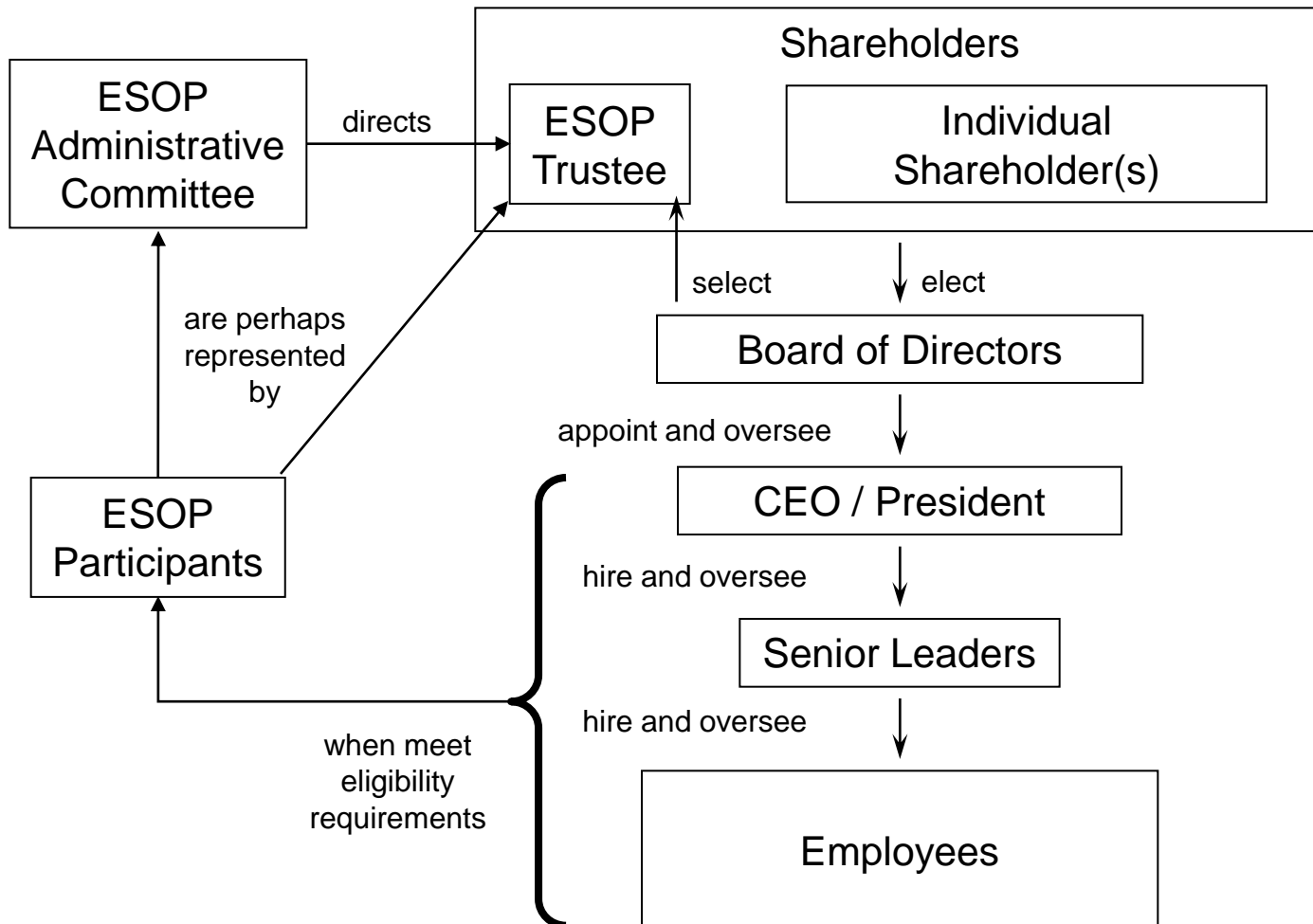
- What makes an ESOP an ESOP? Retirement plan that invests in stock of the sponsoring company
- Stock is owned by a retirement trust
- Trustee votes for the Board, and Board votes for Trustee
- Participants do not (generally) vote for the Board
- ESOP does not have to result in governance change but perhaps should
- Many 100% ESOP owned companies solicit outside Board members

Co-op Governance:

Worker Co-op
Examples:
O&O Markets
Childspace
CHCA
South Mountain
Burley Design
Mondragon, Spain



ESOP Governance - Options



Governance (3)

■ Co-ops v. ESOPs?

- Is there a “more right” answer? Dr. Freeman has commented that firms with active employee participation in governance perform better
- Should ESOPs look at the co-op model and let Participants vote on more?
- Should Co-ops adopt more hierarchical structures with outside board members?
- What are the relative risks & benefits?

Management

■ Co-ops

- Small co-ops sometimes vote on everything, including hiring and firing of employees
- The distinction between what is a shareholder decision and a management decision is not always clear

Management (2)

■ ESOPs

- When an ESOP is established, it is usually emphasized that the management structure is NOT changed
- Many ESOP companies seek to manage employees' expectations about what it means to have an ESOP

Management (3)

■ Possible Learning

- Might Co-ops look at managing expectations as well or is it because of the buy-in that those expectations are different?
- Should ESOP companies offer some changes to empower employees? If yes, what kind?

■ Examples

- What large worker co-ops do
- What highly participative ESOPs do

Taxation

■ ESOPs

- 1042 Rollover regime for C corporations
- 100% ESOP ownership results in no corporate taxation for S corporations

■ Co-ops

- 1042 Rollover regime for C corporations
- Capital account structure with elective taxation at corporate level

Taxation (2)

■ Learning

- Nothing really to choose here - - would need legislative action – why not eliminate the corporate level tax for cooperatives?
- Or, should Co-ops move to ESOP when they are sizeable enough to take advantage of 100% ESOP ownership rules?

Profit and Gain Sharing: ESOPs

- Typical structure is to seek hierarchy in salary and bonuses
- ESOP allocations are according to formula that (mostly) weighs salary heavily
- So, typically, hierarchical distinctions, for good or ill, are reinforced through the ESOP
- In addition, there is often a special bonus plan for executives (stock appreciation rights)
- More democratic mechanisms are quite feasible but uncommon in practice

Profit and Gain Sharing: Co-ops

- Typical structure is to seek hierarchy in salary and bonuses, but size of the business may lead to a creep toward homogeneity
- Allocations of “net income” founded on patronage which weighs, typically, hours worked as opposed to compensation
- Challenges – for good and ill – in recruiting in competitive labor markets

Profit and Gain Sharing (3)

■ Learning?

- ESOPs are usually larger than Co-ops and have to compete for talent; salary structure driven by the marketplace
- But, what if a more egalitarian structure attracts people more suited to your organization?
- Is there a possibility for a Co-op layer on an ESOP?

Profit and Gain Sharing (4)

- What about in an ESOP owned company:
 - Hierarchical salary
 - Bonus based on Co-op model of patronage
 - ESOP allocations based on salary but with salary capped at \$75,000
 - Profits poured back into benefits and community good
- What are your thoughts about this?

Membership/Participation

■ ESOP

- Tracks legalities – age 21, one year of service, vesting requirements
- Rarely requires or even permits buy-in

■ Co-op

- Self-made – anywhere from 2 to 5 years
- But, requires a buy-in

Membership/Participation (2)

■ ESOP v. Co-op

- Is there a different feel to requiring a buy-in?
- Would ESOPs feel differently if there was a buy-in?
- Would Co-ops work differently if the buy-in were low to zero?

Distribution at Retirement, Death, Separation, Etc.

■ ESOP Rules

- Guided by statute
- Repurchase obligation
- ERISA retirement plan status

Distribution at Retirement, Death, Separation, Etc. (2)

■ Co-op Rules

- Based on capital account
- Not a retirement plan
- Obligation payable over the period determined by the owners

Distribution Rules: Sustainability Implications

■ ESOPs

- Individuals receive “fair market value”
- Risk of hostile (or friendly) takeover
- Financial tension between maximum value for individual and sustainability of the organization

■ Coops

- Portion of reinvested surplus is non-divisible
- Financial tension is between capital structure and growth capital

Distribution at Retirement, Death, Separation, Etc. (3)

■ Learning

- Would be hard to graft Co-op rules on to ESOP because of ERISA
- Would it be worth doing if you could?

Challenges on the Horizon

Co-ops

- Formation of new co-ops
- Growth of individual co-ops
- Long-term competitiveness: operational & financial

ESOPs

- Tax policy
- Repurchase obligation
- Long-term competitiveness: operational & financial



Bottom Line

- From where you sit, what strengths do you see in the other model?
- Can you see ways to capture a better mix?

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