

Employee Share Ownership Plans: Are they Right for Your Company?

Many business owners and executives consider implementing an employee share ownership plan (“ESOP”) within their company as a means of attracting, retaining and motivating employees. While the benefits of a properly designed ESOP can be significant, there are potential risks and issues that should be carefully considered before they are introduced.

How Does an ESOP Work?

In essence, an ESOP is an arrangement whereby certain employees of a company can become shareholders if they meet the specified criteria. Qualifying employees are either granted shares or an option to buy shares in a company at a specified price. The acquired shares usually are held until the employee leaves the company or a specified liquidity event occurs, such as a sale of the company to a strategic buyer or an initial public offering.

There is a considerable amount of flexibility in how an ESOP is designed. Some of the basic considerations are summarized in Exhibit 1.

Exhibit 1

ESOP Considerations

Criteria for Participation
Size of the ESOP Pool
Shares vs. Options
Characteristics of the ESOP Shares
Liquidity Provisions and Restrictions

The first issue to be addressed when designing an ESOP is to determine the criteria for participation. In this regard, there are two basic schools of thought. The first option is to restrict ESOP participation to a handful of key employees. This can be a way of recognizing and incentivizing select individuals who are viewed as critical to the long term success of the organization, and making those individuals feel distinguished within the company. However, it can also lead to the feeling of two classes of employees within a company – those that are ESOP eligible and those who are not. The other

basic alternative is to extend the ESOP to all employees that meet certain basic criteria, such as having been employed with the company for a specified period of time. In this case, the magnitude of an employee's participation in the ESOP program often varies based on factors such as job title and compensation, so that senior management employees are rewarded more than individuals who occupy administrative and junior positions. This approach allows for the benefits of the ESOP to be widespread, but requires a larger pool of shares be made available, thereby diluting the interests of existing owners. A company-wide ESOP can also be more costly and time consuming to administer.

Another key consideration when designing the ESOP program is to determine the size of the ESOP pool. That is to say, what proportion of ownership are the existing shareholders prepared to give up in favour of ESOP participants? The obvious trade-off is that a greater degree of ownership participation creates added incentive, but existing shareholders experience greater ownership dilution. Business owners and executives should also remember that an ESOP pool will grow over time, as new shares are issued each year. Therefore, if shares representing 4% of the company are issued pursuant to an ESOP each year, then the existing owners will have diluted their interest by 20% within a 5-year period. At that point, it may be difficult to modify the ESOP to slow down the rate of dilution, as employees will have established expectations.

It is also necessary to consider whether the ESOP will take the form of shares or options that can be exercised for shares. In conjunction with this decision is whether shares offered will be given to employees, or whether employees must acquire the shares at their prevailing fair market value. Requiring employees to acquire shares can be difficult for those individuals with limited financial resources – even if attractive payment terms are offered. Options are attractive because the price paid for the shares (as determined pursuant to strike price of the option) usually takes place concurrently with a liquidity event, so the employee is not out-of-pocket. However, if the value of the shares declines, then the options may be “under water” and provide little incentive. Having employees actually own shares can help to solidify retention, since they will have made a monetary commitment. Some ESOPs are designed to include both an element of physical shares and options in order to balance the pros and cons of each alternative.

Establishing the characteristics of the ESOP shares is another key decision. In some cases, the shares issued pursuant to an ESOP have different rights and privileges than those held by the existing shareholders. For example, ESOP shares may be non-voting or having limited voting rights. While this can help to ensure that the existing owners retain voting control in the organization, it can make employees feel as though they are receiving lesser economic value. Where the ESOP shares do have voting rights, it is also important to consider whether and how ESOP participants will be represented on the company's board of directors. A properly structured shareholders agreement that sets out the rights, privileges and obligations of all shareholders within a company is a critical component of any ESOP.

Finally, the provisions and restrictions governing the liquidity of the ESOP shares must be clearly established. In most cases, the shares received pursuant to an ESOP cannot be freely traded, and employees must wait for a “liquidity event” in order to get paid for their shares. Where the liquidity event involves a sale of the company to a strategic buyer or an initial public offering, then payment for the ESOP shares is a non-issue, since external financing is available. However, liquidity events are more problematic when the company must finance the purchase of its own ESOP shares, such as when an employee leaves the company (most privately held companies do not want former employees holding shares). In this regard, many ESOPs are designed such that, in the event of a voluntary departure from the company, the redemption price is subject to a discount from what their value may otherwise be. This serves as a type of penalty to an employee who leaves the company and wants to cash in.

What are the Major Benefits, Risks and Issues of an ESOP?

The major benefits, risks and issues relating to ESOPs are summarized in Exhibit 2

Exhibit 2

Major Benefits, Risks and Issues of an ESOP

BENEFITS	RISKS AND ISSUES
Attract, retain and motivate employees	Incremental costs
Reduce cash compensation	Governance requirements
Alignment of interests	Cash required for share redemption
Obtaining financing	Impact of a decline in share value
Income tax efficiency	Possible friction among employees

Major Benefits:

- ESOPs help a company in attracting, retaining and motivating key employees. This makes ESOPs particularly attractive in industries where specialized skills or knowledge are essential (such as high technology);
- ESOPs can help in reducing cash compensation paid to employees, which can be critical for smaller and rapidly growing companies that need to preserve cash in order to finance expansion initiatives;
- ESOPs help to align the interests of employees with those of the business owners. A properly structured ESOP can encourage employees to think like entrepreneurs, and find new ways to grow the company and reduce costs. In particular, an ESOP can help to alleviate employee concerns about a liquidity event that involves a sale of the company to a strategic buyer, since the employees stand to benefit financially;
- ESOPs can help in attracting financing. Many commercial lenders and private equity firms perceive that there is less risk in dealing with a company that has a well designed ESOP, since it can help ensure that key employees are committed to the company. This is particularly the case where employees must pay for shares on their issuance (rather than receiving options) since equity injections will help to strengthen the company's balance sheet; and
- income tax efficiency. Properly structured, employees participating in an ESOP will only be taxed on the disposition of their shares at capital gains rates. In addition, there can be an opportunity to utilize the lifetime capital gains exemption, which means that up to \$750,000 of income per employee may be received tax free.

Major Risks and Issues

- incremental costs. ESOPs involve up-front legal, administrative and accounting costs relating to developing and implementing the plan. Once the ESOP is established, there are additional ongoing costs in terms of financial reporting and valuation;
- additional governance requirements. Participants in an ESOP have certain rights as current or prospective shareholders within an organization. There may be a need for a formal board of directors where ESOP participants have representation. This may have an impact on the company's strategy and key decisions. Further, an ESOP will reduce the flexibility that business owners have in terms of making discretionary payments such as bonuses to themselves and family members;
- potential erosion of the company's cash reserves. As noted above, where employees leave the company, the shares that they received pursuant to the ESOP usually are redeemed. Even where the redemption price is subject to a discount, the company must still finance the redemption with other internal resources. As an alternative to a redemption discount (or in addition to one), some companies pay for redeemed shares over a period of several years (normally without interest) in order to alleviate financing issues;
- the possible de-motivating impact where share values have declined. Many companies have experienced this phenomenon in recent years with the downturn in economic conditions. Employees who acquired shares pursuant to an ESOP may feel that they were forced to overpay. Where options were granted in lieu of shares, the strike price of those options may be so far "under water" that they provide little economic incentive; and
- possible friction among employees where not everyone participates in the ESOP. As noted above, this can create the feeling of two classes of employees within an organization.

What are the Next Steps?

Business owners and executives who are considering an ESOP are well advised to do their homework and to get sound and objective professional advice. They must be satisfied that the prospective benefits will outweigh the costs involved. Further, as much as the legal and administration costs of an ESOP can be significant, the potential consequences to a company from a poorly designed ESOP can be far worse. It is much easier to implement an ESOP than to try to modify or cancel it afterwards. Hence the need to invest the time, effort and cost to ensure that an ESOP is designed properly from the start, and that the long-term implications of an ESOP are carefully considered.

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On June 1st, JR/Janus Merchant Brokers Ltd. a leading M&A firm since 1987, merged with Veracap, significantly increasing our corporate finance and M&A capabilities. The founder, Jack Woodcock, along with Kevin Tremblay, CA, CBV, CF, will become part of our team. JR/Janus has served the global market as a member of M&A International.

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- *How Buyers Establish Value and Price*
- *Tips for Increasing the Value of Your Business*
- *Finding the Right Buyer*
- *Selling to Strategic Buyers*
- *Management Buyouts*
- *Selling to Private Equity Buyers*
- *Negotiating and Structuring the Deal*
- *Common Mistakes and How to Avoid Them*

*Attendees will receive a copy of
Exit Strategies for Business Owners*



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