

Testimony of Paul S. Horn

**Before the
Senate Finance Committee
Maryland General Assembly**

**In support of Senate Bill 820
“Employee Opportunity to Purchase Act”**

March 10, 2009

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify about SB 820. My name is Paul Horn and I am President of WorkPlace Consultants, LLC, located in Bethesda, MD. I have been an employee benefits practitioner for over twenty-five years, beginning my career in the Internal Revenue Service Office of Chief Counsel in 1983.

I have been asked to provide testimony on SB 820 because I am well-acquainted with the significant opportunities and benefits available to employees through the use of Employee Stock Ownership Plans (“ESOPs”). I served as Benefits Director for one of the country’s largest S Corporation ESOPs for over ten years. This began my active and continuing participation in the ESOP community. I currently serve on the Board of Governors of The ESOP Association, the Board of Directors of the National Center for Employee Ownership, and for over ten years as an officer of the ESOP Association Mid-Atlantic Chapter whose membership includes many ESOP companies in the State of Maryland. These successful companies, like Flippo Construction in Forestville, Tricon Construction and Mid-Atlantic Door in Beltsville, and Creative Direct Response in Bowie, demonstrate the promise of ESOPs here in our own backyard.

My remarks today will focus on the following three areas:

- How ESOPs work & perform;
- How State government can facilitate ESOP implementation; and
- The application of SB 820

How ESOPs Work & Perform

An ESOP is a tax-qualified retirement plan with assets that can consist solely of company stock. Approximately 10,000 ESOPs in America cover about ten million employees at both small private companies and large public entities. The ESOP may own 100% of the company or, in the case of a public company, generally a much smaller percentage.

An ESOP allows small business owners to sell all or part of their shares (often on a tax-deferred basis) to their employees, rather than to an outside buyer, thereby keeping the business and jobs intact. The ESOP process starts with a feasibility study that examines current enterprise value, future company cashflow, and the amount/type of debt that can be assumed in purchasing the shares. If the ESOP is a "go," company counsel drafts the plan and trust documents, and the company appoints an ESOP trustee. The trustee can be senior managers who are not selling shareholders or may be an outside individual or institution who can serve just for the sale transaction or on an ongoing basis.

The ESOP trustee engages an independent appraiser to determine the updated fair market value for the seller's shares. By law, the ESOP cannot pay more than fair market value ("FMV") for these shares. The company commonly funds the ESOP stock purchase by borrowing from a lender ("outside loan") and then loaning this cash to the ESOP (the so-called "inside loan" that may have different terms, such as a longer period, than the "outside loan"). The outside lender will take a collateral interest in the ESOP stock and, if the company has insufficient unpledged assets, may take a security interest in the sale proceeds paid to the selling shareholders.

The ESOP trust holds the purchased shares in a "suspense" account. The shares are released from this account and allocated each year to employees as the ESOP loan is repaid by the company. Employees receive an annual share allocation based on their compensation and satisfaction of applicable eligibility standards (e.g., 1,000 hours of service). The company has an obligation to repurchase the shares of ESOP participants eligible for an ESOP distribution (e.g., retirement, death, disability, or other termination of employment).

Academic research clearly demonstrates that companies with majority ESOP ownership outperform their competitors. This research confirms the belief that employees work more productively when they have a meaningful equity stake in the future success and growth of the business.ⁱ Of course, capitalism and ESOPs provide no guarantee against business failure. However, in many situations the tax incentives and productivity enhancements available through an ESOP can be the "life jacket" that keeps a distressed company afloat.

Government Facilitation of ESOP Implementation

The Federal government provides various tax incentives in the Internal Revenue Code for ESOP creation and operation. Much in the way Congress favors home ownership over renting via the mortgage interest deduction, Congress similarly favors employee ownership through ESOPs in various ways:

- Tax-free rollover of seller's sales proceeds
- Deductibility of dividend payments made on ESOP shares
- Higher deduction and allocation limits for ESOPs than other tax-qualified plans
- Tax "shield" from business income for shares held in an S Corp. ESOP
- Special benefit distribution rules

State government's role in facilitation of ESOPs generally has centered on providing ESOP information and low-cost ESOP financing. For example, many small business owners and their advisors may not be familiar with the ESOP concept as a business transition strategy. State government can serve as a centralized, cost-effective resource for education and ESOP outreach.ⁱⁱ In other situations, low cost financing, either directly or guaranteed by the State, may be needed to facilitate the ESOP buyout. For example, the Maryland Industrial Development Finance Authority has guaranteed loans to facilitate ESOP transactions, like at the Hedwin Corporation in Baltimore.

Specifics of SB 820

SB 820 represents an important step in promoting the use of ESOPs to facilitate employee buyouts of distressed businesses or those contemplating sale to out-of-state third parties. A suitably designed and implemented SB 820 can help retain jobs and businesses in Maryland.

Importantly, SB 820 does not require the company to be sold to the ESOP; only that the ESOP be given an opportunity, in certain circumstances, to make a purchase offer. As a practical and legal matter, an ESOP cannot compete with a strategic buyer offering more than FMV for the company. In this instance, the Department's review of the 3rd party offer vs. company FMV should be brief and no feasibility study needed. The Department's primary role here can be to educate owners and advisors about ESOPs as a business transition alternative.

The ESOP vehicle is more likely to be the only option where a struggling business is facing possible liquidation or piecemeal sale. In this case, the ESOP feasibility study will determine if an ESOP “life jacket” can help keep the company afloat and intact. The ESOP generally will purchase 100% of the company in a distress situation.

The Department can provide resources to help incumbent management “right the ship” and expedite a streamlined ESOP transition process to minimize cost. For example, the Department could have an approved list of local ESOP appraisers, counsel, and trustees providing a “turnkey” ESOP solution.

- Possible Changes

Voting. The employee voting requirements for initiation of the ESOP study and ultimate purchase are well-intentioned but in practice could be quite cumbersome. A simpler approach may be to require notice to the Department and to employees for designated sales or closures wherein the Department then (1) reviews the notice, as well as any comments submitted by employees within a requisite timeframe, (2) decides whether to conduct an ESOP study, and (3) informs the owner whether a study will occur and, if so, the study conclusions.ⁱⁱⁱ If the ESOP is a possibility, the Department and the selected ESOP professionals would work with the owner on implementation.

Size. ESOPs generally do not make sense for companies with less than fifteen employees. Thus, the definition of an exempted “microenterprise” could be enlarged to include firms with fifteen or fewer employees.

Governance. The term “democratic participatory governance mechanisms” is undefined and could raise resistance to bill passage. It may be preferable to omit this phrase and instead have the ESOP trustee negotiate those governance mechanisms, such as pass-through voting for the Board of Directors or an employee Board member, which may work best in a particular situation.

Conclusion

SB 820 is an important step in promoting ESOPs to facilitate employee buyouts of distressed businesses or those contemplating sale to third parties. SB 820, with appropriate modification, can help retain jobs and businesses in Maryland. I offer my assistance to the Committee, if needed, to revise SB 820 so it can be favorably reported by the Committee. Thank you again for the opportunity to testify and I welcome your questions.

ⁱ Joseph Blasi, Douglas Kruse, James Sesil, Maria Kroumova, *Public Companies with Broad Based Stock Options: Corporate Performance from 1992-1997*, Oakland, CA; National Center for Employee Ownership, 2000; Corey Rosen and Michael Quarrey, “How Well is Employee Ownership Working?” *Harvard Business Review*, Sept/Oct, 1987, Vol. 65, No. 5; Gorm Winther and Richard Marens, “Participatory Democracy May Go a long Way: Comparative Growth Performance of Employee Ownership Firms in New York and Washington States”, *Economic and Industrial Democracy*, Vol. 18, No. 3, August 1997; Peter A Kardas, Adria L Scharf, and Jim Keogh, *Wealth and Income Consequences of Employee Ownership: A Comparative Study from Washington State*, National Center for Employee Ownership, Oakland CA, 1998; originally published in *Journal of Employee Ownership Law and Finance*, Vol. 10, No. 4, Fall 1998; .Hewitt Associates, *Unleashing the Power of Employee Ownership: A Research Report*, July 1988; Margaret M. Blair, Douglas L. Kruse, and Joseph R. Blasi, “Is Employee Ownership an Unstable Form? Or a Stabilizing Force?” in Margaret M. Blair and Thomas A. Kochan (Eds.), *The New Relationship: Human Capital in the American Corporation*, The Brookings Institution Press, Washington, D.C., 2000; Michigan Center for Employee Ownership and Gainsharing, *A Study of Employee Ownership in Michigan*, October 1990; John Logue and Jacqueline Yates, *The Real World of Employee Ownership*, Cornell University Press (ILR Press), Ithaca (NY) and London, 2001.

ⁱⁱ For example, the Ohio Center for Employee Ownership located at Kent State University provides ESOP education, free buyout assistance, and access to subsidized financing. State Treasurer of Indiana, Richard Mourdock, in May 2008 implemented an initiative to encourage ESOP creation in Indiana by investing up to \$50M of State money in banks that reduce loan interest rates to ESOP companies.

ⁱⁱⁱ This is similar to the notification process used in the submission of retirement plan determination letters to the IRS. See Treas. Reg. sections 1.7476-1& -2.