Navigating through Tough Times with the Aid of Employee Ownership

How ESOPs and/or MSOPs Can Become Viable Economic Allies

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Abstract: *Is it just the employees' attitude of thinking like owners that has helped companies to survive in tough economic times? The authors of this article, with over 80 years of collective experience, suggest that in some situations, perhaps yes, but in many others, company management and the board of directors have used employee stock ownership plans and/or management stock ownership plans to provide vital liquidity during critical times when the cost of capital is prohibitive, and liquidity from banks, private equity groups, or other outside sources is not readily available.*

This issue of the Journal went to press in June 2009.
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Today, even the best of companies may find themselves in a financial "perfect storm" that threatens their survival. This article looks to first develop your understanding of why ESOP (employee stock ownership plan) companies have better survival rates and often are successful in difficult times. It then will explore how employee ownership in the form of an ESOP and/or MSOP (management stock ownership plan) as a technique of corporate finance can assist companies in temporary economic distress to increase cash flow and survive until conditions improve. A number of proven and successful techniques are examined. The authors caution that only experienced professional advisors, including attorneys, consultants, appraisers, and third-party administrators should be engaged when any of the strategies outlined in this article are pursued by a company.

Survival and Success

ESOP companies have better survival rates in tough economic times. Examples of the collective experience and methodical research since the formal beginning of ESOPs in 1974 include the following:

1. A 1997 study examined the stabilizing effect on a company caused by employee ownership plans. Results showed that the survival rate for the companies that shared ownership with employees was markedly higher than for their comparison companies and that shared ownership firms had a significantly lower variance in employee numbers from year to year. The firms sharing ownership with

employees also outperformed competitors in terms of return on assets and total shareholder[1] returns.

2. In 1987, the Government Accounting Office (GAO) had done a similar survey focusing on productivity and profitability, and the conclusions were the same.[2]
3. In the largest and most significant study to date of the performance of ESOPs in closely held companies, Douglas Kruse and Joseph Blasi of Rutgers University, in 2002, found that ESOPs increase sales, employment, and sales per employee by about 2.3% to 2.4% per year over what would have been expected absent an ESOP.[3]
4. The Employee Ownership Foundation states:

   There is nothing magic about employee ownership. Employee ownership does not guarantee success, nor prevent or cure business problems. But it does stand to reason, and experience and research have shown, that employee owners have a different attitude about their company, their job, and their responsibilities that makes them work more effectively, and increases the likelihood that their company will be successful. Fundamentally, employee owners are more accountable for their job performance—and their fellow workers' job performance—simply because they have a common stake in the success of their company. It's a simple formula: if employees perform extraordinarily well company performance is more likely to be extraordinary, and that translates into significant stock value for the employees. Someone once said that ownership is a powerful incentive for ordinary people to do extraordinary things.[4]

Additional research can be found at the Web sites for the National Center for Employee Ownership (www.nceo.org) and The ESOP Association (www.esopassociation.org).

ComSonics' Story

A good illustration of the impact of employee ownership is an event that happened at ComSonics, Inc., a company headquartered in Harrisonburg, Virginia, that serves the cable television industry in a number of ways. The ESOP was established in 1975, and until 1990, the stock of the corporation had appreciated every year.

The company recognized from an early date that employee involvement and education would maximize the ESOP's effectiveness. A significant amount of financial and performance information was shared freely with employee owners, providing them with constant measurement criteria regarding the performance of the company and its varying functional areas.

In 1990, an economic downturn hit the cable industry particularly hard. Management agonized regarding a layoff as one had never occurred in the history of the company. When they finally announced a 10% layoff, the response from many of the remaining employees was, "Why did you wait so long?! We could see the constant deterioration of our performance and profitability; you should have laid off people sooner."

Encouraged by that response, management initiated a second 10% layoff shortly thereafter. As a result, the company survived and prospered. Since the early 1990s, the stock that declined a small percentage during the recession is now valued at more than five times the 1990 price.

Financial Techniques to Conserve Cash

For companies that currently do not have an ESOP, as well as companies that do, we will discuss a number of approaches to strengthen a company's cash position in troubled times.

401(k) Company Stock Match

Virtually all of our clients have 401(k) plans, and the vast majority make some type of annual, cash-matching contribution. The investment of these matching contributions is normally directed by the employee participants. An approach to conserving cash is to replace the cash match with a match made in company stock to an ESOP. If an ESOP does not already exist, then a new ESOP can be adopted by the board of directors of the corporation. In addition to the normal "company stock" and "other investment" accounts, the ESOP can have a "stock-matching" account where the stock resides. Those individuals who make a deferral to a 401(k) plan receive stock in the stock-matching account.

The plan described above is not a combination ESOP and 401(k) plan (KSOP). KSOPs can be adopted

by the company, but they are complex to administer and not necessary if employee wage deferrals will not be used to purchase company stock.

Because employees are not given the option to invest their employee wage deferral in company stock, thus not making an investment decision, and because the 401(k) operates as a separate plan, there should be no disclosure or security law filing requirements.

Newly Issued Stock

Another approach to increasing corporate cash is to utilize newly issued stock, frequently called "treasury" stock. C corporations can make contributions to an ESOP of newly issued shares that are tax deductible to the corporation. This will reduce what the company will pay in income tax in any given year. If the contribution will generate a loss, then the company can recapture taxes paid in the prior two years. Note: the American Recovery and Reinvestment Act of 2009 allows a carryback of 2008 losses for five years. The same rules do not apply to an S corporation because the income or loss of the S corporation is reported on the individual tax returns of the S corporation shareholders. The individual S corporation shareholders may apply for carryback of an individual net operating loss, but the taxes recaptured may not be as significant. The individual tax refund can be loaned to the corporation by the shareholder. A C corporation or S corporation can contribute stock and get a tax deduction valued up to 25% of qualifying payroll to an ESOP each year. Contributions to all other qualified retirement plans must be included in calculating this limit. In certain circumstances, the contribution limits referred to above can be exceeded.

Dilution

A contribution of newly issued common shares is dilutive; therefore, the individual or individuals owning 100% of the common stock before the contribution to the ESOP will own less than 100% of the company after the ESOP contribution has been made. The impact of the dilution can be substantial if the value of the company has declined significantly due to economic distress. One strategy to lessen this dilutive impact is to have the company contribute preferred stock rather than common stock. The value of preferred stock does not fluctuate like common stock. The preferred stock must pay a market rate dividend determined by an independent appraiser. However, it is possible for the dividend to be a "payment in kind" (PIK) dividend rather than a cash dividend. Because preferred stock is not convertible ("straight preferred"), the stock is not defined as qualifying employer securities and must be contributed to a stock bonus plan rather than an ESOP. There are many similarities between stock bonus plans and ESOPs, but there are also important differences that are beyond the scope of this article. Later in this article, we will discuss the use of a stock bonus plan to help create cash flow.

Conversion of Existing Plan Assets

Converting profit-sharing plan (PSP), 401(k), or other qualified plan assets to an ESOP allows for the purchase of stock. If the stock is newly issued this creates an infusion of cash for the company.

Approach this strategy like you would a porcupine—very, very carefully. While there is significant risk in this strategy, it has occasionally been used with success. Employees can be given a one-time option to move funds from a qualified profit-sharing retirement plan or the discretionary employer contributions made to a 401(k) plan into an ESOP to purchase company stock. An independent ESOP trustee may not be willing to take the fiduciary risk to make this decision, but offering the investment choice to employees, if done properly, greatly reduces the fiduciary risk.

Full Disclosure

Federal and state security law exemptions may apply regarding the offering to employees. However, employees are required to be given full disclosure under state law prior to making their investment election. A full disclosure package that will resemble a prospectus must be prepared and distributed to all eligible employees, and there is significant cost involved in compiling, distributing, and presenting the information. We know of instances where employees have elected to convert a substantial percentage of their liquid account balances to purchase stock and other situations where the percentages were very low.

Seller Financing—"Becoming the Bank"

This structure does not increase corporate cash flow like the other strategies discussed above. It addresses the situation in which a shareholder desires to sell and also to perpetuate the business. One or more shareholders may desire to sell their stock for a variety of reasons, including retirement, death, or disability, change in family situation, etc. Even if a bank loan can be found, the terms and conditions offered by the bank may be unacceptable. Loans by private equity groups may be deemed too expensive, even though these loans will normally be made without requiring any collateral. If no alternative to a "cash sale" can be found, the shareholder may be forced to sell to an outside buyer, despite the desire to perpetuate the business. Assuming an independent appraiser determines a value acceptable to the selling shareholders and the sellers are willing to hold an uncollateralized loan at a high rate of interest, the sellers can "become the bank"; that is, they can take back a note at the market rate of interest. In many cases the corporation can provide warrants or an "equity kicker" to increase the rate of return on the seller loan. Because the selling shareholder takes the risk of an unsecured creditor, he or she is entitled to a return as determined by the market returns achieved by private equity groups.

Example: The seller note is for seven years at 4% above the prime rate with a 10% warrant that can be exercised on a "cash-out" basis when the ESOP debt is repaid. If the company grows at a modest pace over the seven-year term of the note payment, a typical warrant could be worth approximately 20% of the sale price. For example, if the sale to the ESOP was for $5 million at 7% interest, the warrant could potentially have a value of $1 million at the end of seven years. It is the risk the seller is taking that justifies a potential total return that can equal or exceed 15%. However, if the company did not grow at all, the warrant would have no value.

Existing ESOPs Only

For companies that have existing ESOPs, there are other options to conserve cash in addition to the strategies outlined above.

Distribution policy

Distribution policies drive the outlay of cash to departed plan participants in all ESOP companies. This policy dictates when the company must repurchase shares and distribute cash to terminated, retired, or disabled participants or beneficiaries. Many ESOP companies, especially if there is no ESOP debt, make lump-sum distributions to participants shortly after they terminate service. During times of economic distress, the company may find it necessary to defer the starting dates for payments and to "stretch out" installment payments over the maximum period allowed under the law and by the plan document.

The law allows payments to be deferred for approximately one year after the retirement, death, or disability of a plan participant. For other terminations, distributions can be deferred for approximately six years. If the shares were acquired with proceeds of a loan, then the payout can be deferred for the greater of the six years referred to above, or until the ESOP loan is repaid.

Once the payout begins, regardless of the reason, payment of the total account balance must be completed in a maximum of five years and made in equal, annual installments over the five-year period. This translates to a maximum of six annual installments. There are provisions for lengthier payouts when account balances exceed $985,000. For example, an ESOP participant retires with 120 shares in her ESOP account. Shortly after the year-end allocation statement is distributed to participants, the participant receives a payout in cash equal in value to 20 shares of stock. Each year after the fair market value has been determined by an independent appraiser, he or she will receive a check equal in value to 20 shares. At the end of five years, his or her full account balance has been cashed out.

New or Revised Distribution Policy

If a company has a current ESOP distribution policy, it would then modify the policy in close consultation with ESOP counsel. If the company does not have an ESOP distribution policy, it is imperative to establish one, clearly stating the reasons for the distribution policy that is being adopted.

The best practice among ESOP companies is to

adopt a distribution policy that is more specific than the plan provisions, which normally allow maximum flexibility regarding ESOP payouts. The distribution policy typically is not part of the plan document and can be changed from time to time without amending the plan document. One of the principal reasons that an ESOP company's board of directors and an ESOP trustee would review and determine a need to change the timing of ESOP payouts is because of the cash position of the company. If the company is experiencing difficulties in generating sufficient cash flow, it is very appropriate to look at the cash position of the company and modify the existing or de facto distribution policy to defer payments in the event of other terminations, and to spread out payments in installments to participants entitled to a payout due to death, disability, retirement, or other termination. Provided that the ESOP allows for distribution flexibility, the change in the distribution policy should not be a "cutback" under ERISA rules.

Refinancing Existing ESOP Loans

To the extent that the existing ESOP has a loan with a bank, a private equity group, or from a selling shareholder, the company can attempt to negotiate better terms in a form of extended payments and/or a reduced interest rate. However, it is essential that the Department of Labor (DOL) guidelines be followed in refinancing an ESOP loan. These guidelines require that the refinancing is "arranged primarily in the interest of participants and beneficiaries." In layman's terms, the refinancing needs to be a "good deal" for the ESOP, while at the same time the refinancing can also be beneficial to the company. An example would be a lower interest rate with an extended payment term. While reduced cash flow from a company in economic distress is certainly a valid reason to attempt to renegotiate the loan, it is still imperative that the company's board of directors and the ESOP trustee be aware of and in compliance with these DOL guidelines.

Existing Cash in the ESOP

Some ESOP companies will have accumulated a significant amount of liquid investments that reside in the "other investments" account of the ESOP. The board of directors of the corporation can offer to sell newly issued shares to the ESOPs. The stock could be common stock in an S corporation or common or preferred stock in a C corporation. The ESOP trustee could then purchase the newly issued shares with some of the cash residing in the ESOP. There are a number of fiduciary issues that the trustee must consider before making this decision. At the top of the list is the issue of the long-term prospects and viability of the company. If the crisis is clearly short term and purchasing newly issued shares would almost certainly cause the company to survive the crisis, the trustee should be comfortable in using ESOP cash. On the other hand, if there is clearly no end in sight to the crisis, or selling liquid investments held by the ESOP will incur substantial losses, the trustees incur significant fiduciary risk if they use existing ESOP cash to purchase stock. Immediately prior to the purchase of shares, the trustee must obtain a current valuation of the company by an independent appraiser that considers the dilutive effect of the newly issued shares.

Management Incentive Plans

A 19th century French colonel and military theorist wrote:

> Four brave men who do not know each other will not dare to attack a lion.
>
> Four less brave, but knowing each other well, sure of their reliability and consequently of mutual aid, will attack resolutely.[5]

Just as in sports, team play is essential for business success. The management team of a successful company must be able to attack tough business problems, like those being encountered today, without worrying about whether members of their team may be marching to a different beat. The successful CEO carefully selects and coaches his or her key people to ensure that there are no ego-driven, selfish members on the team.

Providing key executives an opportunity to get some "skin in the game" through direct stock ownership assures their constant interest in the financial performance of the company, both to protect their investment and to create real wealth over time as share value increases. When a manager invests more than he or she can afford to lose, he/she will aggressively learn the entrepreneurial game!

A major trend under way in recent years in both public and private companies is the requirement that senior personnel have a significant investment in the company. Where such an expanded internal market is installed, it will often produce an entrepreneurial spirit and a shared commitment to ensuring the long-term success of the enterprise among those key players.

Entrepreneurs who offer stock purchases often find that employee investors take a more active interest in their company and are more likely to ask questions about financial performance and take action to maximize results. Stock purchases help build employee commitment to the company.

To be effective, an equity-based incentive plan, hereinafter a management stock ownership plan (MSOP), must be carefully designed so as to create the right mix of incentives for the participants in the MSOP without creating unacceptable disadvantages or penalties for other shareholders. Ultimately, an MSOP must be a good deal for both the participants and the company.

The following factors should be considered in the design or modification of such a plan:

1. Impact of dilution on all shareholders including the ESOP, if there is one
2. Appropriate "golden handcuffs" (and "golden harpoon") provisions to prevent the possible loss of talented people after a rapid run-up in stock value, or in the event of a business downturn
3. Ultimate cost to the company of the projected benefits for the plan participants
4. Whether the plan will increase or decrease capital available to the company

There are several methods that can be used to create opportunities for direct stock ownership and/or create other equity-based incentives for key personnel.

Employee Stock Purchase Plans[6]

We have concluded after more than three decades of designing such plans for privately held companies that, wherever possible, if a company permits direct stock ownership by employees, the stock should be *purchased* by the key individuals so as to ensure that they incur a degree of risk in their investment. In doing so, they have a significant amount of their own "skin in the game," and thus feel the same pressures as other owners in sharing both the risks and rewards that all owners of private firms experience. Stock purchases by participants of an MSOP also provide an infusion of cash for the company, which may be not only welcome but vital in difficult economic times. As an incentive to encourage key employees to take this risk, we normally recommend two following additional measures: a special cash bonus plan and a qualified incentive stock option plan.

Special Cash Bonus Plan

Senior management and other key employees may participate, by invitation, in a cash bonus program that is tied to specific performance objectives. These objectives, normally financial, may be either a financial goal for the firm or a financial goal for a discrete business activity such as a division or subsidiary. This ongoing cash bonus program is distinguishable from other cash bonuses that may be used from time to time to reward employees for specific performance or events of short duration, or it may employed as an ongoing bonus tied to other performance measures. In the case of an ongoing cash bonus program tied to discrete financial measures, a continuing incentive is created that provides a powerful motivation for the participating employees to achieve the financial objectives that are prerequisite to achieving the cash bonus. The criteria might be a corporate financial objective, such as year-to-year growth in earnings before interest taxes depreciation and amortization (EBITDA), achieving a margin or profitability objective in a discrete operation, or a combination of both.

Qualified Incentive Stock Option Plan

As an enhancement to a stock purchase plan, a qualified *incentive* stock option plan (ISO)[7] with appropriate "golden handcuffs" can be established. The plan could provide that each participant who agrees to purchase a certain number of shares at fair market value (FMV) (with his or her own money) will have the opportunity to acquire a multiple of the number of shares purchased via qualified ISOs, exercisable over a period of years.

Many privately held companies favor stock options because they vest over time—as long as 10 years—and

tend to encourage key employees to remain with the company to avoid loss of benefit should they voluntarily leave. In addition, if ISOs are granted, there should be no tax or cash impacts on either the company or participants until the options are exercised *and the underlying shares are sold* by recipients.

In an MSOP such as this, participants are required to purchase a block of company stock, which then entitles them to receive a grant of ISOs exercisable over a period of years and subject to vesting tied to achievement of company performance objectives. The ISOs vest based upon achieving performance objectives as discussed in the previous paragraph, and they are also subject to a *use or lose* provision that requires the participant to exercise vested options or lose the right to the currently vested options *and* all future options. In this way, participants have a very powerful incentive to ensure that the objectives' prerequisite to vesting of the options are achieved each year, and further, that the financial performance of the company as a whole is very strong in order to maximize the growth in value of company stock over time. The use or lose provision will eventually separate the stars (crusaders) from the average performers (cruisers). This initial investment requirement creates a powerful incentive for participants, by virtue of having their own skin in the game, to ensure that objectives are met so that their capital investment is preserved and grows in size and value over time.

Restricted Stock Bonus Plan

In addition to a stock purchase and/or ISO plan, a restricted stock bonus plan may be used as a further reward for extraordinary performance by one or more top achievers. Such a plan might provide for discretionary awards of restricted stock, or it could stipulate that recipients receive a portion of bonus compensation in the form of restricted company stock, which would be deductible to the company at grant or as the stock vests, depending upon the participant's tax election.[8] A restriction, such as a period of time, a performance measure, or both, is normally applied to the grant and must lapse or be achieved before vesting occurs. This measure would increase company cash flow, as the stock bonus would be deductible as a compensation expense. A special cash bonus might also be added to assist recipients in paying taxes on the stock bonus. Normally, vesting of restricted stock would be subject to a financial or other metric to encourage the recipient to focus on and enhance corporate performance.

In addition to the equity-based plans described above, there are also other equity-based incentives that are not *qualified*—meaning that they are not entitled to special tax treatment and are not generally subject to the Employee Retirement Income Security Act (ERISA). Therefore, employers have substantial freedom to tailor arrangements to suit their needs and objectives as well as those of their executives. One objective of all of these plans is to incentivize the recipient toward performance directly linked to the goals of shareholders—normally, increased stock value over time.

These deferred-compensation arrangements, under which the employer promises to pay a key individual an amount of money in the future based upon the performance of the employer's stock, are known as synthetic equity plans and include two variants: stock appreciation rights (SARs) and phantom stock plans.

Stock Appreciation Rights

A SAR is generally an unfunded promise by an employer to pay an executive an amount of money equal to the appreciation in value of a share of the employer's stock on the date the SAR becomes payable as compared to the value of the share on the date the SAR was granted.

Under a SAR program, participating executives do not have ownership of employer stock. Participating executives are awarded SAR units, which have no initial value. A participating executive is not required to pay cash in order to exercise the SAR.

The valuation of employer stock is a critical issue in privately held, non-ESOP companies. A fair and consistent method of valuation is essential to achieving long-term results from a SAR plan and has acquired additional importance since implementation of new IRS rules regarding deferred compensation under IRC Sec. 409A.

SARs are generally not pension benefit plans and therefore are not subject to ERISA. For financial accounting purposes, increases in the value of a SAR

unit generally result in additional accrued compensation expense for the company.

For income tax purposes, the participating executive does not recognize income until the SAR is exercised. Upon exercise, the participating executive has taxable compensation income and the employer is entitled to a tax deduction.

Phantom Stock

Phantom stock can be regarded as a variation of the SAR. A phantom stock plan is typically an unfunded promise to pay an amount of money equal to the value of a share of the employer's stock. Again, the idea is to provide the participating executive with the economic equivalent of stock ownership and the benefit of growth in share value over time without actual ownership and legal rights (i.e., voting rights).

For financial accounting purposes, phantom stock plans are similar to SARs. Compensation expense results as the value of employer stock rises and the increases in value must be charged against earnings. Like SARs, phantom stock should not produce income for the executive until he or she cashes in. At that time, the employer is entitled to a deduction.

Note: Several important changes to the IRC regarding deferred compensation,[9] antiabuse tests for ESOPs in S corporations,[10] and Financial Accounting Standards Board (FASB) standards for accounting for stock options,[11] have been implemented recently, which may have a significant effect on the tax and financial implications of a stock-based incentive plan for senior managers and other key employees, especially in companies with ESOPs that have elected to be taxed as an S corporation. These must be taken into account when designing such a plan. In view of the complexities and potentially serious consequences of implementing a defective plan, it is wise to engage the services of an experienced professional advisor who is knowledgeable in this area.

Wage Forbearance

In situations of dire economic circumstance such as that being experienced today, even the best companies can find themselves in a financial perfect storm that threatens the very survival of the enterprise. A wage-forbearance plan is one action that a company in such a circumstance might take to overcome adversity and survive long enough for economic conditions to improve.

Wages and benefits are typically the biggest operating expense of most companies. An approach to consider is a carefully designed wage-forbearance plan that trades near-term reductions in employee wages and/or benefits to improve the company's cash flow for an equity position in the company that will provide future value that may offset, or exceed, the current loss of wages and/or benefits. A carefully designed wage-forbearance plan can provide near-term cash flow improvements that might be the difference between survival or failure of the enterprise, while at the same time helping to bring all employees into the process of working as an entrepreneurial team that will apply its collective energy, creativity, hard work, and enthusiasm toward achieving the survival and future success of the enterprise.

A company might start by reducing payroll expense by 10-15% through a careful process of eliminating nonessential employees. Then, payroll expense might be further reduced by designing and implementing a wage-forbearance plan that provides for near-term compensation reduction—with wage and benefit reductions totaling another 10-15%—proportional to compensation, that includes creation of a new stock bonus plan for all employees. This new plan would include a contribution by the company of a block of newly issued, nonvoting, preferred stock with a dividend [possibly a payment in kind (PIK) dividend until cash flow allows a cash dividend] to the stock bonus plan. The company may make a contribution to the stock bonus plan of up to 25% of qualifying payroll[12] (maximum of 100% of an employee's income or $49,000,[13] whichever is less) as future compensation for the current wage reduction in order to provide an incentive to employees. In companies with an ESOP, the company may make a contribution of 25% of payroll to *both* the ESOP and the stock bonus plan,[14] the importance of which will be explained shortly.

The wage-forbearance plan might also include a cash performance bonus plan that will pay quarterly bonuses if certain financial metrics are achieved at the company, department, and individual level. These bonus payments, when the company achieves profit goals, could

offset some or all of the wage/benefit forbearance.

Vesting for the new stock bonus plan does not have to consider past service and can be based on future service. This serves to help tie the employee to the company while lessening the potential impact of repurchases on cash flow. In addition, the distribution policy for repurchases can be designed with extended payouts, similar to ESOPs, so as not to place a cash flow burden on the company.

We hasten to note that this approach requires careful coordination with an experienced appraiser. The discretionary stock bonus plan contribution in many cases will be considered by an experienced appraiser to be an extraordinary event, which should minimize the impact on value of the common shares.

Example: In this situation the company has been cut off by its bank due to declining profits, while simultaneously facing significant net operating losses for both the current year and next year. Following are the specifics:

- XYZ company is a privately held C corporation.
- The company has been profitable each of the past two years and has paid over $1 million in federal income taxes in each of the past two years.
- The company pays $10 million in wages annually.
- The company projects a net operating loss of $1 million for 2009 and $1 million for 2010.

The C corporation is the best candidate for this plan, because S corporations pass income and loss down to the individual shareholder level, which would negate the benefit of the cash refund to the company discussed below. However in an S corporation, such a plan might still produce cash benefits to individual shareholders, which could then be loaned to the company.

The company implements a $2 million reduction in wages and benefits, half from a carefully considered head count reduction and half from a wage-forbearance plan, which will take effect in 2009.

The company makes a contribution of newly issued preferred stock to the recently created stock bonus plan trust of $2 million, which is 25% of reduced 2009 compensation. If the company has a leveraged ESOP, it could also make another contribution of up to 25% of 2009 compensation. The leveraged ESOP could acquire newly issued common stock.

Thus, if the company made the maximum allowable contributions to both the ESOP and the stock bonus plan trust, the net loss for 2009 would be increased from the projected $1 million to roughly $5 million. The dilution of existing shareholders must be considered carefully in such a plan, but in dire financial situations such as this, most shareholders will accept the dilution in exchange for keeping the enterprise alive.

This plan serves to increase the loss to facilitate recovery of federal and state taxes paid in the two previous years. In this scenario, the company might recover 35% of the current year loss, or as much as $1.75 million in cash from federal taxes paid the prior two years (2008 losses may be carried back five years), plus (in some states) a portion of any state taxes paid. By filing for an IRS (and possibly state) quick refund, this cash could be recovered within 90 days after the close of the company's fiscal year.

The $2 million wage and benefits reduction in 2009 could eliminate the projected loss for 2010. The increased earnings due to the wage and benefits reductions should also serve to lessen the reduction in the fair market value of the company. Since in this example the company has an ESOP, the preferred stock accounts in the stock bonus plan trust might offset to some extent the loss in common share value in the ESOP for employees. Cash dividends on the preferred stock can be accumulated in the trust and used to help offset future repurchase liability of the new stock bonus plan, or a PIK dividend, as discussed earlier, might be paid.

In determining whether a wage forbearance plan can work for a company, the bench strength and partnering culture of management must be carefully assessed. Companies with a well designed and established MSOP have a much better chance in successfully implementing a wage-forbearance plan such as this, where key executives who are personally invested in the success of the enterprise will have a much stronger motivation to ensure that a wage-forbearance plan succeeds.

Summary

This article began by citing research that demonstrates that ESOP companies have greater survival rates and dis-

cussed some of the reasons for these results. The article then examined a number of proven financial techniques employing an ESOP, MSOP, or a combination of both that companies can use to increase liquidity and cash flow. While several of the techniques apply to companies that already have an ESOP, the majority of them can be utilized by the companies if they install a new ESOP and/or MSOP. While the use of these techniques is not confined to companies facing economic distress, they deserve more attention in turbulent economic times because of their ability to assist companies in energizing their employees to help the company survive in difficult times and to create critically needed cash flow that may ultimately mean the difference between corporate life and death. ■

The authors of this article appreciate and recognize the contribution and editorial comments of Patrick H. Flynn, CPA.

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