

# VALOREM PRINCIPIA

The Principles of Value

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## ESOP'S FABLES

By Nevin Sanli, Thomas Pastore, and Forrest Vickery

### Introduction

Employee Stock Ownership Plans ("ESOPs") have long been regarded by company owners and employees as confusing, intimidating, and detrimental to the welfare of an enterprise. Critics state that ESOPs fail to improve corporate performance, are simply strategies to defend a company from a hostile takeover, and may even lead to a company's demise.

The morals from Aesop's Fables, however, are instrumental in exposing these misconceptions as mere myths. First told in ancient Greece by the famed storyteller Aesop, these tales continue to teach contemporaries: (1) the power of unity; (2) the need to tailor solutions to specific problems; (3) the importance of diligence; and (4) there are two sides to every story.

### What is an ESOP?

An ESOP is an employee benefit plan that provides employees with stock in their corporation. ESOPs are similar to other tax-qualified employee benefit plans (e.g., 401(k)s, 403(b)s, etc.) in that contributions made into an ESOP are tax deductible for the corporation and the plan's assets may grow tax-deferred. ESOPs, however, are unique in that they may invest primarily in the stock of their own company and the company may borrow money to fund the purchase of the ESOP's assets.

In its most basic form (an un-leveraged ESOP) the company buys its own stock, which it then gives to a trust (i.e., the ESOP), which holds the stock for the benefit of the employees. The stock purchased by the company for the ESOP may be acquired from an existing shareholder(s) or may be newly issued stock that is not acquired or bought. In a leveraged ESOP, however, the ESOP borrows money to purchase the company stock. The company then makes cash contributions to the ESOP so that it can repay the ESOP loan.

Good candidates for establishing an ESOP are companies that:

- ◆ Have a large enough payroll to justify the costs to establish and administer an ESOP;
- ◆ Can afford the annual contributions and the initial costs to establish an ESOP; and
- ◆ Have a management team open to sharing ownership with employees.

ESOPs provide strong tax advantages for both the company and the selling shareholder. First, in a leveraged ESOP, both interest and principal payments on the ESOP loan are tax-deductible. Second, if the ESOP purchases existing stock, the selling shareholder(s) can defer capital gains on the sale of their stock so long as the proceeds from the sale are reinvested in similar investments (e.g., domestic publicly traded stock, etc.).

In addition to providing tax advantages, ESOPs often improve worker productivity and the company's profitability by aligning the interests of the company's employees with its owners. Perhaps the greatest benefit for the employees is the ability to share in the company's success.

While the benefits of ESOPs are many, a lack of their understanding has engendered many negative myths. The following morals, gleaned from Aesop's Fables, will help clarify the truth shrouded by the falsehoods.

### In Unity There is Strength:

In "The Bundle of Sticks", a father gives his three quarreling sons a bundle of three sticks and has each son try to break the bundle. None can do it alone, yet when the father divides the bundle, giving one stick to each boy, the sticks are easily broken. This shows that teamwork yields greater results than working alone.

The most prominent myth about ESOPs is that broad-based ownership fails to improve corporate performance because employees are not interested in ownership. Numerous studies, however, have shown that, when combined with a culture that embraces "participative management," broad-based ownership is a powerful way to improve a company's operating performance.<sup>1</sup> By themselves, however, neither participative management, nor broad based ownership, accomplishes much. In order to develop a "high performance" ownership culture, it is stressed that a company must ensure that:

- ◆ Employees understand the meaning of ownership. They move beyond "I'm an owner" to the notion of a community of owners.
- ◆ Employees can communicate openly in all directions.
- ◆ Employees understand and are committed to the company's business goals.
- ◆ The company provides extensive financial education and gives employees ways to affect corporate outcomes.
- ◆ The company's needs and the individual's needs continue to be balanced as employees understand how individual actions affect the company as a whole.<sup>2</sup>

When employees feel they are partners in the company's future, not merely paper owners, a true alignment between their interests and those of management is achieved, resulting in a stronger, more solidified workforce.<sup>3</sup>

### The Method Should Suit the Circumstances:

In "The Donkey and the Load of Salt," a donkey and a merchant are traveling to a marketplace to sell their goods. On the way, the donkey loses half of his load when he accidentally slips into a river. On the way back, the donkey decides to do the same thing in order to make his load lighter, yet the new load consists of sponges and only adds weight. By attempting to utilize a method that worked one time, he did not consider that the circumstances may have changed, and that his work actually doubled as a result of using the incorrect method.

There are many misconceptions surrounding the reasons a company adopts an ESOP as part of its overall business strategy. Some of these include using the plan as a takeover defense, a buyout of a failing company, or as an exchange of stock for labor concessions. In truth, these reasons explain less than 6% of all ESOPs.<sup>4</sup>

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## Sanli Pastore & Hill Establishes Scholarships at U.C. Irvine

During the academic break in 2005 SP&H contacted U.C. Irvine ("UCI") to establish the Sanli Pastore & Hill Student Summer Internship Award and Sanli Pastore & Hill Excellence in Economics Writing Award. Over-achieving economics majors at UCI, the alma mater of Nevin Sanli and Forrest Vickery, principals at SP&H and graduates of UCI's Honors Economics program, are recipients of these awards. The scholarships are another demonstration of SP&H's commitment to supporting UCI's students in their professional growth.

The annual Sanli Pastore & Hill Student Summer Internship Award bestows one or two UCI students with a paid summer internship. Award recipients are selected based on their academic achievements at UCI's department of Economics and recommendations from faculty. The Student Summer Internship helps finance the student's education and gives him or her an opportunity to apply classroom theory to real-world work problems.

This year's internship award recipients included Ivy Li and Daria Burns. Ivy and Daria worked on various projects, helping with market and industry research, financial analysis and preparation of reports for SP&H clients. When asked about her internship, Ivy stated: "My internship at Sanli Pastore & Hill was an invaluable learning experience, and truly added to my educational and professional experiences". Daria reflected that: "The internship was a great experience...I learned so much!! I will be able to apply what I have learned in my future endeavors".

The Excellence in Economics Writing Award is recognition for the best research paper; each annual recipient is awarded a one-time scholarship of \$500.

SP&H believes in recognizing excellence in education, as it provides the foundation for professional growth. These scholarships will reward individuals for their academic excellence while also promoting the importance of applying their knowledge every day in a work environment.

"A competitive world offers two possibilities: You can lose. Or, if you want to win, you can change."  
- L.C. Thurrow

### ESOP'S FABLES Continued from Page 1

While the reasons for establishing an ESOP vary on a case-by-case basis, ESOPs are often formed by successful companies to:

- ◆ Create a liquidity event for a departing shareholder as part of an exit-strategy;
- ◆ Diversify the investments of a majority shareholder;
- ◆ Raise capital on a pre-tax basis to fund existing operations or an expansion;
- ◆ Improve morale and reward employees;
- ◆ Privatize a government entity;
- ◆ Sell a subsidiary or division; or take a public company private.

Given the diversity of motivating factors, it is essential that companies considering an ESOP retain well-qualified ESOP experts that can complete the ESOP while helping them attain their goals.

### Don't Neglect Small Things When Thinking of Great Ones:

In "The Astrologer," a man becomes famous when he can see the future in the stars. One day as he is walking and looking into the sky for guidance, he falls into a hole in the ground. Though he could predict the future, he could not see the hole at his feet. The astrologer is thereby reminded that taking time to concentrate on things big *and* small is the way to success.

Attention to detail is a critical aspect of establishing an ESOP. Because of the tax advantages and labor issues surrounding ESOPs, both the U.S. Internal Revenue Service and the U.S. Department of Labor closely scrutinize ESOPs. As a result, ESOPs are complex transactions, which, if not structured correctly, can result in unrealized tax savings, unnecessary government audits, as well as costly litigation. While many attorneys, financial advisors and business appraisers provide ESOP-related services, few have the education, resources, and most importantly, experience to guide their clients through the complex regulatory environment. It is thus imperative that companies establishing an ESOP retain an independent appraiser that routinely provides valuations in highly scrutinized situations and that has extensive litigation experience. Taking these steps will significantly decrease the potential for a dispute and provide protection, should the valuation ever be challenged.

### There are Two Sides to Every Story:

"The Man and the Lion", was written by Aesop to convey the importance of listening to both sides of a situation before drawing a conclusion. In this fable, a lion and a man are arguing over who is stronger. The man proclaims that humans are because of a statue illustrating a man conquering a lion. The lion counters that it might have been a different story had a lion made the statue.

Perhaps the worst reputation attributed to ESOPs comes from the failure of United Airlines ("UA"). In 1995, UA formed its ESOP and experienced an incredible year: UA outperformed the S&P by 67%, sales per employee increased 10%, and employee grievances declined 74%.<sup>5</sup> By 2000, the ESOP was terminated, UA was embroiled in bitter labor disputes, and UA was plagued by poor employee morale and excessive flight delays.

Many of UA's problems could be traced, in part, to management's reluctance to create a permanent ownership culture. UA's ESOP was structured so that UA would only make contributions to the ESOP for five years. This had two effects. First, employees did not see the creation of the ESOP as a permanent benefit of their employment. Second, employees joining UA after the last year of the ESOP were never able to join the ESOP. This resulted in a two-tiered labor force: employee owners worked along side regular employees. As a result, labor negotiations became more contentious and employee morale plummeted.

Southwest Airlines, however, combined its employee ownership plan (which is similar to an ESOP) with a strong participative management culture. The airline proudly states that it "puts their employees first, the customers second, and shareholders third."<sup>6</sup> The company's employees work in teams to decide policy, information is shared freely, and employees are empowered to make decisions. Southwest Airlines now has, "a market capitalization greater than the major airlines combined."<sup>7</sup> Thus, employee ownership can and does work in the airline industry, demonstrating there are two sides to every story.

### In Conclusion:

An ESOP provides a structure and foundation for cultivating an organization that embraces cooperation, teamwork and success. In addition, ESOPs provide significant tax advantages and allow for a continuity of management. Finally, sharing ownership with employees can increase morale and productivity, making the company more competitive and profitable.

For more information regarding SP&H's services, please contact Nevin Sanli or Thomas Pastore at 310/571-3400, and Forrest Vickery at 916/614-0530 or via email at [nsanli@sphvalue.com](mailto:nsanli@sphvalue.com); [tpastore@sphvalue.com](mailto:tpastore@sphvalue.com) and [fvickery@sphvalue.com](mailto:fvickery@sphvalue.com).

<sup>1</sup> Employee Ownership and Corporate Performance, NCEO, 2002.

<sup>2</sup> Vanderslice, Virginia. *Creating Ownership When You Already Have Participation*, NCEO, 2002.

<sup>3</sup> Employee Ownership Report, May/June 2003, NCEO, page 12.

<sup>4</sup> *How an Employee Stock Ownership Plan Works*, NCEO, 2002.

<sup>5</sup> United Airlines and Employee Ownership, Employee Ownership Report, January/February 2003, pg 15

<sup>6</sup> Ibid.

<sup>7</sup> Ibid.

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Dining Spotlight

In each edition of *Valorem Principia*, SP&H features a different dining hotspot, providing highlights, reviews, and insights to our clients and friends across the state. If there is a restaurant that you feel should be showcased in future editions, please contact Soroya Imam at 310-571-3400, ext 233 or [imam@sphvalue.com](mailto:imam@sphvalue.com). We look forward to hearing from you. Until then, Bon Appetit!

*The Vic For Jazz*

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2640 Main Street, Santa Monica 888-FOR.JAZZ (367-5299)  
[www.thevicforjazz.com](http://www.thevicforjazz.com) [jazz@thevicforjazz.com](mailto:jazz@thevicforjazz.com)

Reservations, a whisper, a knock and a password are required at this charming Speak-Easy Jazz Supper Club. Cleverly complete with a back door entrance, behind a peephole and located upstairs at The Victorian in Santa Monica's historic district, we were delighted to find *The Vic For Jazz*. Built in 1894 and originally known as the Kyte House, The Victorian was relocated to Heritage Square in 1973.



Explore martini favorites such as "Ella Fitzgerald" to the "Mild Davis" or sway into the collection of Bourbon, Scotch and Wine.

Let your taste buds dance their way through such savory appetizers as Smoked Salmon with oven baked potato wafers and chive crème fraiche, Southern Crab Cakes with spicy remoulade sauce or Chicken & Brie Quesadillas with mango chutney.

Entrée favorites include Miso Glazed Salmon on a bed of sautéed spinach, a Gourmet Blue Cheese Burger with seasoned pommes frites and Goat Cheese Ravioli with shitake mushrooms in a light sun-dried tomato cream sauce.

End on a sweet note with Chocolate Raspberry Cake with vanilla mousse and raspberry coulis, an Apple Turnover with caramel sauce and fresh whipped cream or perfect Crème Brulee.

Peruse the performance calendar to discover favorite jazz artists complete with bio. After performances, stay for the late night jazz from midnight to 2:00am!

Remember, the password changes every week and reservations are required.

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NEWSFLASH

August 10th & 11th - San Jose, California

*CRA's Legal Issues Symposium*

SP&H principals were panelists.

September 27<sup>th</sup> & 28<sup>th</sup> -

Los Angeles, California

*CPA Law/Forum*

Tom was a featured speaker.

October 26<sup>th</sup>, 2005 - Oakland, California

*Lorman Estate Planning Seminar*

Forrest will be a featured speaker.

November 4<sup>th</sup> - Los Angeles, California

*SP&H Annual Fall Charity Gala*

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