ESOP Questions and Answers From the Experts

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Employee Participation

What are the pros and cons of limited employee participation vs. broad-based employee participation?

Answered by Perry Phillips, President, [ESOP Builders Inc.] (2017)

There are two main categories of ESOPs, key-person (limited participation) and broad-based.

***Key-person plans** are defined as an ESOP that is limited to certain identified employees, usually in upper management or highly skilled technically. The owners are tasked with identifying who these key people are in the company.*

***Broad-based plans** are defined as plans that are open to all employees that meet eligibility criteria.*

The Pros of a Key-Person Plan:

- *Focuses engagement and productivity within the group of employees that drive company value.*
- *Attracts and retains key people.*
- *Allows mentoring of the employees that potentially can take over ownership when owners exit.*
- *Increases value by locking in key performers.*

The Cons of a Key-Person Plan:

- *Morale can be compromised if some employees who consider themselves as key are excluded from the plan.*

The Pros of a Broad-Based Plan:

- *Every person in the company can impact profitability and productivity by their decision making. A broad-based plan creates a culture of ownership thinking.*
- *Attracts and retains employees.*
- *Increases profitability and productivity.*

The Cons of a Broad-Based Plan:

- *Employees' expectations in regard to decision making must be focused on their area of responsibility and not in areas in which they have no expertise. This is done through proper education and communication of the plan.*

What are the pros and cons of having unionized employees participate in an ESOP?

Answered by Perry Phillips, President, ESOP Builders Inc. (2017)

The pros and cons of having an ESOP in a union setting are the same as a broad based plan. However, unions have a special relationship vis-à-vis the owners, especially in a private company. Unions generally are suspicious of owners and management and vice versa. Some unions are pro-ESOP, usually because they work in tandem with owners and management. These unions tend to be in the minority. Most unions are anti-ESOP and will try to stop its implementation for fear of losing control over the union members at the company.

What are effective ways to keep the Plan fresh and alive, i.e. keeping the employees engaged and excited about buying more shares?

Answered by Dean Ell, Director of Finance, iQmetrix (2017)

- ***Share your financials*** *- be transparent and share financial results in a way your average employee can understand.*
- *I am a firm believer in* ***allowing your employees to purchase shares all year long via payroll deduction****. It is much easier for most employees to do a deduction each pay run versus coming up with an annual lump sum payment at a specific time of year.*
- ***Do some research into ownership thinking*** *or do some brainstorming internally as to how you might encourage your employee owners and even non-employee owners to think like owners.*
- *Stress to your employee owners that they are owners, so think and act like one, make the right decisions and reap the rewards.*

- ***Don't be afraid to change your ESOP****- much like a vehicle, an ESOP requires maintenance. Yes, some ESOPs have been around for a long time and remain unchanged and if that works that's great, but others need to be tweaked or even reinvented.*
- ***Be straight in sharing both positive and negative news*** *about finances in the good and bad years.*
- ***Attend the annual Canadian Employee Ownership Conference*** *to learn and to network.*
- *The ESOP Association of Canada is helping by declaring Canadian Employee Ownership day or week in October - a perfect time to promote and celebrate your ESOP.*

Tax and Legal

My company has 100 common shares. To sell shares to my employees over the next 10 years, I need to split or duplicate these. For tax purposes and to minimize legal costs, what is the most effective way to do this?

Answered by Edward A. Heakes, Partner, Dale & Lessmann LLP (2017)

Most corporate jurisdictions allow the shareholders to file an amending document to split/ subdivide their common shares and typically this can be done fairly easily without substantial costs or adverse tax consequences. In rare cases I have seen a "split" accomplished through the payment of a stock dividend but normally I find that the direct corporate split is easier.

Valuation and Share Value

If our company valuation is based on current company assets and a projected growth curve, how is the 'Key Man' (our founder and current President who is front and centre with the brand) risk factored in vis-à-vis the prospect that the assets and growth rate could change if the Key Man is no longer involved?

Answered by Paul Maarschalk, President, Maarschalk Valuations Inc. (2017)

Generally, I value business enterprises on the company's current earnings and profitability capacity. In simple terms, I capitalize the pro forma cash flows using a capitalization rate that may include recognition of the dependence of the business on the "key man". This may be a simple recognition that, regardless of who the key man is, there is a continuing dependency on one person. The final capitalization rate is basically equivalent to the yield that a prospective owner would want on an investment in the business.

*Once I have calculated the value of the enterprise using the capitalized cash flows method, I deduct the value of the net operational assets (at fair market value) to arrive at an amount for **goodwill**. Goodwill in the company is the amount that is truly at risk.*

Goodwill usually divides into (a) transferable goodwill (such as patents, trademarks, location etc), and, (b) non-transferable goodwill, which is the amount of the goodwill that is tied to the specific key man selling the business (i.e. potentially lost following the transfer of the business). Estimating how much goodwill is transferable can be very subjective but involves an assessment of how much of the goodwill (a) can be identified or (b) would be lost if the key man disappeared overnight.

I prefer to add a third category of goodwill, what we could call "flexible" goodwill. This is that part of the "non-transferable" goodwill that, although derived from the skills and contacts of the key man could, in the right circumstances and with an effort from both the seller and the buyer, be transferred to the new owners. It requires the full cooperation of the key man and the new owners and involves the seller staying on long enough so that all his skills and contacts are, as far as possible, transferred over to the new owners. I usually suggest that specific terms relating to the seller's continuing role in the company be captured in the sale agreement.

We currently have a small number of "owners" within our company with company shares. We are trying to determine whether there might be a way for the small number of current owners to hold the value of their current shares if a new company-wide Share Plan was put in place. As an example if current shareholders had a $10,000 value invested in the company, is there a way that they could retain at least that $10,000 if other owners came on board with new shares?

Answered by Perry Phillips, President, ESOP Builders Inc. (2017)

The current shareholders can maintain their $10,000 value by selling treasury shares in the company. There are two sources of shares for sale. Treasury shares are shares that come from the company issuing new shares. Shares currently owned by the owners are another source of shares. Shares from treasury are sold to the employees and the money goes into the company. The cash from shares sold from the owners to the employees goes to the owners.

The sale of treasury shares causes dilution. As long as treasury shares are sold at Fair Market Value then the current owners dilute their percentage of ownership. However their investment value (in this case $10,000) remains the same because the cash goes into the company and the value of the company increases equal to the cash infusion. If treasury shares are sold below Fair Market Value the current owners will see both a percentage dilution of ownership as well as a dilution of their $10,000 investment.

If a company is owned by a father who wants to create an ESOP for his son to obtain some ownership in the business, does that still qualify? The reason I ask is because the Income Tax Act in Canada puts many restrictions on transfers between family members that are not done at fair market value. Can you please provide some information regarding this?

Answered by Perry Phillips, President, ESOP Builders Inc. (2018)

You are correct that there are many rules and regulations concerning family members when it comes to family ownership in a family business. However in Canada there is no specific legislation dealing with ESOPs whether family or not. When you design an ESOP in Canada you have to meet the general rules regarding share sale or transfer of ownership under the Security Act of the Province you operate the business in. The Canadian Income Tax Act also has specific rules when selling or transferring shares to a family member. Because the tax penalties can be severe if the transfer or sale of shares to a family member is not at Fair Market Value you will need to consult a tax adviser on how to sell or transfer shares to a family member. Further you will need to consult a professional business appraiser such as a Chartered Business Valuator for the Fair Market Valuation assessment of your company.