Western Talent & Innovation Review

Strategizing Employee Shared Ownership Plans (ESOPs) for Business Success

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Abstract

Canada faces great uncertainty as it moves into an untested and uncertain future. There is a definite need to rekindle the flames of innovation and assess the viability of our organizational strategies to effectively plan for the future. To see the future with new eyes to consider the advantages and pitfalls this fluid future represents. When that future arrives, it will require a strong strategic identity to form a solid foundation and develop an effective trajectory toward long-term operational success.

Canadian businesses need to pay close attention to these important steps and effectively plan to revitalize their businesses strategically and develop the best trajectory they can toward the future and enhance their commitment to effective best practices. An ESOP allows employers to collaborate with already invested and talented employees in the company, to enhance their investment of time and commitment, and build a future where they can share company success together. This paper explores the history and literature of ESOPs and outlines the journey of a company (Selkirk) that implemented ESOP into its company strategy.

I am not usually one to get overly concerned about the situations unfolding around me, but Canada faces great uncertainty as it moves into an untested and uncertain future. We are in need of a rekindling of innovation to assess the viability of our organizational strategies and plans for the future. There is a need to see the future with new eyes that consider the advantages and pitfalls this fluid future represents. This time it is COVID-19, major stock market crashes, multiple industry shutdowns and a general uncertainty about how all this fits into the future we thought we had under control. What will tomorrow bring Canadian business in general and Western Canadian businesses in particular?

This present reality will eventually pass. In its wake, we will see new realities introduced, new challenges rising up and possibly the implementation of more cautious approaches to business and investment. Where does business go after a crisis? When that future arrives, regardless of its appearance we need to think about what it might look like and prepare for the future it represents, now!

It is times like this that everyone needs an effective strategic plan in place, with purpose, vision and values firmly attached to achieve their goals, inform investments and focus their most innovative ideas for the future. A strong strategic identity forms a solid foundation for future planning and develops an effective trajectory toward long-term operational success. This identity informs next steps and anticipates the possible challenges your company can face going forward.

Every part of the country needs to remain innovative, and use its talent wisely, but Western Canadian businesses specifically need to pay closer attention to these important steps and effectively plan to revitalize their businesses strategically and develop the best trajectory they can toward the future and enhance their commitment to effective best practices. Newfoundland and Labrador suffered the most business failures in 2019, but BC and Alberta represented a full 1/3 of all failed businesses in Canada.[1] That means the other 66.6% of registered business failures spread across eight other provinces and three territories beyond the borders of BC and Alberta.[2]

With this being the case, what does the future hold after COVID-19? What about the unpredictable and tumultuous economic environment it leaves behind? How does business recover from stock market crashes, industry shutdowns and general uncertainty about the future? One option is Employee Stock Option/Shared Ownership Plans (ESOP). An ESOP allows employers to collaborate with already invested and talented employees in the company, to enhance their investment of time and commitment, and build a future where they can share company success together. This paper explores the history and literature of ESOPs and outlines the journey of a company (Selkirk) that implemented ESOP into its company strategy.[3]

Significant Growth

For Western Canada, there is a specifically beneficial opportunity to stem the tide of business failures experienced in 2019 and now the uncertainty of 2020. The oft-quoted proverb, “it takes a village to raise a child,” (unknown origin), applies directly to raising up effective ESOP business plans and transitions. Many business owners are proficient, entrepreneurial, self-driven and have a strong desire to see their company succeed, despite the uncertainties they face. Facing the future alone however, seems to take social isolation a bit too far. This is especially true when there are committed people already available, to share the ownership load and participate in company success. It does not make long term sense to go it alone in today’s trying economy, when there are so many talented people around us to make it work.

With British Columbia and Alberta experiencing the highest percentage of business failures in the country, pre-COVID-19, it is only reasonable for business to look toward implementing an ESOP, as a solid consideration for investing in and creating an innovative company approach for the future. Especially, when ESOPs generally outpace the competition in their respective sectors.[4] As the National Center for Employee Ownership notes, “Companies that combine employee ownership with employee workplace participation programs show even more substantial gains in performance.”[5]

ESOPs have experienced significant and continuing growth in the past 40 plus years.[6] Dean Ell, Chair for the ESOP Association of Canada, stated that, “ESOP companies have highly engaged employees who take on more responsibility. It’s a great recruiting tool, turnover and absenteeism drop, and you will see increases in productivity, which all benefit culture and profitability.”[7] The plans vary from company to company depending on the structure, strategy and need represented. Nevertheless, all represent positively measured strategies for experiencing future success for the company and employee shareholders. “In the U.S., ESOPs take on specific, legalized structure; in Canada, the term is more loosely applied to include any plans that allow employees to purchase or be granted shares in their firm.”[8]

ESOP History

The history of ESOPs in Canada indicates the important part they have played in developing healthy Canadian business structures. From tax benefits, evolving organizational structures, diversity of practice and the ongoing development of rudimentary business practices, ESOPs have played an important role. Whether prior to 1948, or in present day Western Canada, ESOPS developed robust and complex expressions of employee ownership in various businesses across Western Canada.

Beginnings were meager. Prior to 1948, Western Canada was heavily invested in agricultural farming, logging and natural resources industries like oil.[9] In the early Canadian experience, employee shareholders had no income tax assessed regarding stock options held in a company. According to Sandler (2001):

> *Prior to 1948 – with no explicit provision in the Income Tax Act – it appears that benefits realized from employee stock options were accorded capital gains treatment (and thus not taxable since Canada did not tax capital gains prior to 1972).*[10]

From 1948 onward however, significant tax decisions changed the landscape for ESOPs in Canada.

The ESOP Taxation Timeline

To get an idea of the importance contributions ESOPs made to the Canadian economy, we need only review the evolution of the tax structures related to ESOPs through the years. The evolution from normal employment income through to today’s development of special tax rules related to ESOP tells a compelling story of their value to Canadian business and the economy as a whole. Sandler (2001) outlines the following timeline of ESOPs:

1948-1953

- Sandler notes that “employee stock option benefits were treated as normal employment income.”[11]

1953

- Legislation granted special tax treatment to the benefits associated with ESOP.
- Benefits were only taxed when the options were exercised versus the date the stock was realized.
- Legislation also included “preferential tax rates for the resulting benefit.”[12]

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1972

- Special tax treatment of ESOP benefits ended.
- Benefits were only taxed when the options were exercised versus the date the stock was realized.
- Employees no longer received preferred taxation rates when cashing in their stock options.
- Employers no longer received corporate deductions from the implementation of ESOP.

1977

- Special tax treatment re-introduced for "deferral for stock option benefits."[13]
- Benefits were taxed when shares dissolved. If the shares dissolved in under two years, the entire amount treated as employment income. If the shares dissolved in over two years, the amount was treated as a capital gain.

1984

- Special tax treatment spread across a range of other stock options.
- Employees obtaining 'qualifying equity shares' were taxed at the same rate as a capital gain.
- The full benefit included as "income in the year the option was exercised."[14]
- Employee was also "entitled to deduct an amount equal to 50 percent of the benefit provided (2001) as long as they met preconditions set out in the legislation." [15] The measures were introduced to "promote greater employee participation and increased productivity."[16]

1985

- Stock option taxes deferred until disposed of stocks/shares.
- After disposal – benefit proceeds taxed as employment income.
- Further value increases after disposal treated as a capital gain.
- 50% employment income deduction available if shares are "held for 2 years or more."[17]

2000

- Stock/share options could defer.
- Maximum allowed deferral $100,000.00.
- "To assist corporations in attracting and retaining high-calibre workers and make our tax treatment of employee stock options more competitive with the United States."[18]

2010

- Minor amendments to the process and tax implications related to ESOP.[19]

2019

- ESOP provides the right to acquire shares at a designated price

- Acts as alternative method for compensating employees (shareholders) "to attract and engage employees, and encourage growth."[20]

2020

- Anticipation of new limits imposed regarding the receipt of special tax treatment under current ESOP tax rules.

Additional information on Canadian tax expenditures can be retrieved from the *Report on Federal Tax Expenditures - Concepts, Estimates and Evaluations 2019*.[21]

ESOP Benefits

Tax regulations and benefits aside, there are many other positive benefits for engaging ESOPs. Phillips and Jensen (2015) refer to a 1986, Toronto Stock Exchange study comparing ESOP and non-ESOP businesses, showing:

> *ESOP companies had: 123 per cent higher five-year profit growth 95 per cent higher net profit margin 24 per cent greater productivity a 2-10 per cent premium on the stock market 92.26 per cent higher return on average total equity 65.52 per cent higher return on capital 31.54 per cent lower debt/equity ratio.*[22]

Recent studies in the U.S., U.K. and Australia over the past 20 years support the TSE findings.

No plan is perfect. But, taking the time to strategize for results can create important strides forward for any company willing to take the journey toward a well-planned and prosperous future. Creating strategies to recognize the unique mission, vision and values represented by your company goes a long way in securing the future leaders want for their company. Many owners enter ESOP agreements to preserve the mission and values of their company, rather than see their missions and values dilute through merging, selling, or offering themselves publicly.[23]

The options available for merging, selling, or offering the company for public trading versus transforming to an ESOP are numerous. Mergers create a clash of two cultures - your company and the merger. You might have compatible goods and services, but company culture can change or disappear depending on the size of the companies.[24] Culture can change by osmosis, blending the two, or experience a complete make over with layoffs of employees' from only one side of the merged company.[25]

Selling outright also has its challenges. Business owners invest their lives into their companies and selling is not a detached event. The decision to sell is often an attempt to ensure longevity for the business, brand or culture. For that reason, selling requires owners to watch for misalignments of focus, culture and purpose between the company sold and what future owners present to employees, customers and other stakeholders.[26]

The lure of going public, while advantageous for raising increased capital, can also lead to unforeseen challenges as well.[27] Stikeman Elliott lists several pitfalls here:

1. *Loss of control:* You cannot make independent decisions and share decision making with other shareholders.

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2. *Increased regulatory oversight:* This can cause the loss of investment flexibility, related to who and how you invest company funds.
3. *Enhanced reporting requirements:* Increased accountability to shareholders, regulatory bodies, directors, ever increasing financial reporting and other public offering requirements can become a burden quickly.
4. *Increased liability:* May require a more formal approach to how you do business in order to avoid unwanted publicity, damage to company reputation and other relationships necessary to keep the public company going forward.[28]

ESOP Structure

Transitioning a wholly owned business to an ESOP is an important consideration and generates many questions for that company. What is the impact on the present owner, or the company as a whole? What will it mean to employees? What are the tax implications for the owner, the business, employees and everyone involved versus the present structure practiced by the business?[29] Perry Phillips, from ESOP Builders, provides a "Free ESOP Feasibility Survey" to help businesses confidently and confidentially explore the option of an ESOP for their company. This is a great resource for determining if an ESOP is best for a company's specific situation.[30]

Once a company decides to create an ESOP: what then? The first consideration is deciding the best structure for meeting specific company needs and goals.

Most ESOPs use a combination of three components:

1. Employees purchase shares outright via share-equity plans;
2. Employees are given stock options; or,
3. Employees are granted "phantom" shares, for which dividends are paid but title is not legally transferred from employer to employee.[31]

Each option has pros and cons. The best is the one that fits the specific industry or business venture.

One Accord, a private equity firm in the Pacific Northwest, outlines several advantages for business owners to consider as they take a serious look at an ESOP. Any business owner will do well to research their options even beyond this list of advantages:

1. *There is already a built-in buyer.* As mentioned previously, the people who purchase the organization are already committed to its success through their employment with the company.
2. *There are tax advantages to entering into an ESOP purchase.* The tax advantages vary from province to province, state to state and country to country in North America. Independent research on tax advantages shows this to be a positive reason for an ESOP, for the originating owner as well as the new owners coming onboard in the newly developed partnership framed by an ESOP.
3. *The opportunity of business ownership can enhance employee engagement.* For many employees, the dream of owning something that provides an ongoing benefit is not something they see as possible. The opportunity of ownership with minimal capital allows that to happen. This can be

especially appealing for long-term committed employees, whose efforts helped the company to succeed before the opportunity to purchase arose.

4. *Originating owner and employee owners mutually benefit from the new partnership.* An ESOP engages all the key people in the organization and enhances the opportunity for success in the process. Because owners do care about their businesses more than people who have no stake in the success of the business. As One Accord puts it: "The ESOP then has the potential to reward key managers and employees for their performance and loyalty while maintaining the legacy and stability of the business. The company remains in the hands of people the owner knows and trusts."[32]

ESOPs afford employees the opportunity to share ownership with other ownership partners in the company to build a future together. ESOPs go a long way in changing employee morale. The focus changes from employees getting paid and placing expectations on employers to treat them fairly, to the adoption of an ownership way of thinking, where the playing field is levelled with the other company owners.[33] As Phillips notes, "when employees actually own shares in a company, they believe that they are owners, and the process of participation is easier to implement."[34] An ESOP moves "employees away from only the "me" way of thinking and toward the concerns of the business and its financial performance."[35]

Stock option plans create important contracts between employers and employees to buy stock in the company at a discounted rate, against future company stock value increases. It affords employees an option for shares in the company, as a substitute for direct ownership, but does not become the same outright ownership as in share-equity plans.[36] Well-run and profitable companies can benefit employees, and the company, through offering stock options via an ESOP. However, because there is no risk position on the part of employees, the stock option is more a benefit received than an invested ownership position. That being the case, many employees do not take their investment as seriously as in share-equity plans.[37]

Phantom plans aka "participation or value-added plans,"[38] tend to appear as stock equity, but without an attached vote to stock held. Phantom plans usually indicate owners are uncomfortable with employees sharing ownership in the company or having a vote in how the company runs. The lack of confidence can become counterproductive to company success, if employees feel the lack of trust runs beyond the compensatory parts of the plan.[39] Taxes on phantom plans payouts are as income versus receiving preferred tax treatment, compared to capital gains or dividends.[40]

One Accord lists the following disadvantages for companies weighing the potential for going forward with an ESOP.

1. These plans can represent high expense in getting them ready for launch. The more complex the plan the greater the expense to administer. There are numerous expenses related to launching an ESOP. Once launched however there will be ongoing legal, administrative, compliance, valuation, loan repayment related to establishing the plan, and trustee fees to consider. Not to mention the fees related to buy-ins and payouts for adding new employees to the plan and "the retirement of established ones."[41]

2. Theoretical valuation of an ESOP can be considerably lower than the valuation for selling the company outright. Sometimes the difference is as much as "20-30% higher than an ESOP valuation."[42]

3. The additional burden of fees and repayment requirements can impede the cash flow for a healthy business. Though there are savings when employees begin to think like owners and look at cost cutting the same way the originating owner does, there are additional costs to managing and operating an ESOP. The biggest downside is a reduced cash flow, requiring stricter management of resources.
4. It is a complicated process going from a singular owner or limited partnership to an ESOP. Previously, decisions were made by a limited few, now you engage a larger number in the pool of owners, which adds complexity to the maintenance of equity shares and the need to ensure clear guidelines regarding conflicts of interest.
5. You might really need a lawyer. Many businesses have lawyers, just in case. But with an ESOP, you might really need one to deal with any conflicts arising amongst the newly minted, but novice owners.
6. Dissolving an ESOP is no easy feat. Deciding to go forward is easy. The originating owner drives the process, invests the resources and takes the risk. Walking back that decision however, involves the newly minted owners. Their lack of experience and risk averse thinking may not let you return to the 'good old days.'[43]

ESOP Plan Variance: Selkirk Signs Case Study

ESOPs are showing themselves beneficial to several Canadian companies. Each plan however, represents a measured strategy toward the company's future success for the owner, company, and employee shareholder. Selkirk Signs in Cranbrook, BC is one company benefitting from forming an ESOP. Moving to employee ownership after the owners considered the best succession plan of them and the company, Selkirk moved through the various processes and structural decisions to make an ESOP a reality.

The information below stems from a presentation by Sarah Turk at Trinity Western University. Turk noted the choice for Selkirk to move to a share-equity plan, or ESOP, was the best strategic choice for the company. Turk listed the reasons and the process Selkirk followed for making their decisions to enlist an ESOP as follows:"

1. ESOP decision based on owner considerations of succession plan options for the future of the company.
2. Owners did not want to sell Selkirk Signs to a stranger and have them rewrite everything they worked hard to achieve over the years.
3. Process started with a couple of seminars to learn more about the process, and understand what ESOP involved.
4. Following a brief education about ESOP, owners brought ideas to a management team at the Selkirk Signs Head Office in Cranbrook BC.
5. After receiving feedback from the management team, the company decided to explore what an ESOP would mean for the company.
6. Owners and employees alike, shared excitement about what an ESOP could look like, and what it would mean for employees becoming owners of the company they work for.

7. The company then formed an ESOP committee to write the draft document that would eventually become the binding agreement for shareholders.
8. This required the committee to look at a wide variety of perspectives to create and implement the agreement to move the company forward in an ESOP.
    a. Employer perspectives: What would be fair to the owner?
    b. Employee perspectives: What would be fair to the employees as they become owners?
    c. What would the guidelines look like when responding to the perspectives involved?
9. The committee met weekly to review basic documents from other Canadian companies establishing an ESOP.[44]

From here, the Selkirk Signs committee established guidelines for employee eligibility to buy ESOP shares. As they entered these discussions, they paid close attention to what they believed were the most important things for shaping an effective ESOP:

1. Valuation (to determine the price and number of shares that should be issued
2. Program design
3. Tax concerns
4. Legal implications[45]

Additionally, the committee determined what was fair for the present owners to offer as shares, since they planned to share their accumulated success with others. They also determined a benchmark amount for share allocations, and defined the correct baseline for shares purchased. This involved discussions about shares restrictions and the maximum allowable shares available for employee purchase, based on company valuation. They also determined how employees could buy shares (cash, payroll deduction, or pre-tax bonus), a minimum share purchase amount, conditions needed for buying out company shares, and the terms and conditions for shares payouts.

The final step for them was seeking legal advice to ensure each step in the process was legally sound and the benefits intended would be the benefits realized. Without this important step, all the previous consultations would amount to very little, since the ideas and plans expressed would not receive legal substantiation. It was important for them to ensure that the document(s) formed were in the best interests of all concerned. The employer, the employee, the shares, and decisions made around the formation of effective ESOP all had merit since this agreement would serve to provide effective protection for everyone involved. If they are going to build a company, improve owner and employee morale, and effectively share the ownership at Selkirk Signs, through the ESOP formed, it warranted their full attention.

By taking the time to hammer out these important principles, understand the best ESOP design, along with the tax and legal implications; Selkirk avoided one of the more paralyzing issues in shifting to an ESOP. The issue of "how much of the company should be up for grabs by employees."[46] They also engaged a very positive side of ESOP development - employee participation.[47] Without employee participation, trust amongst employee groups often erodes. "A lack of employer/employee trust is a major reason why ESOPs underachieve."[48]

Additional steps – Ownership Thinking

Following the formation of the ESOP, there was still work to do. Selkirk needed to train employees to understand what it means to think as owners versus continuing to think as employees.[49] Shifting from thinking about when the next raise will come, whether the employer offers fair wages, benefits and other employment benefits to enhance the employment experience, can be difficult mindsets to break. The shift to becoming central to the wealth creation for the company is not an easy feat. For many, employment is about what they get in return for their work, not wealth creation for the company.[50]

Selkirk's approach dovetails with the approach outlined by Brad Hams book, *Ownership Thinking: How to End Entitlement and Create a Culture of Accountability, Purpose, and Profit* (2012), Selkirk initiated principles to transition the workforce from an owner/employee dichotomous relationship, to a place where both embraced ownership thinking.[51] To make this happen, Selkirk identified Key Performance Indicators (KPIs) necessary to measure productivity in every sector of the company. The KPIs became the basis for measuring corporate and individual performance through the development and implementation of Rapid Improvement Plans (RIP) attached to each KPI.

The RIP process breaks KPIs down into singular modules of measure, to create a detailed plan of measurement for every part of the company generating profit or expense.[52] RIPs require measurable goals, the identification of financial benefits for meeting the goals, and the actions, behaviours, or results required for reaching those goals. The RIP reinforces company KPIs and employees move closer to understanding the complexities related to becoming owners through the development and implementation of the ownership thinking strategy.[53]

To enhance the RIP process, Selkirk established assumed values of trust, truth, caring and forgiveness to transition to ownership thinking in the company.[54] Assuming everyone is trusted means giving everyone the benefit of the doubt and hearing what they say regarding the issue at hand, until they prove otherwise. When it comes to the value of truth, the assumption carries, that everyone needs to be informed as completely as possible, with as many facts as possible, address the issues or observations as they arise, which leads to increased transparency in all company relationships. Though there are levels of responsibility getting information first, the company as a whole receives all necessary information, regardless of their employment or ownership level.[55]

For Selkirk, everyone operates in the spirit of goodwill for every company member. It does not foster a culture of rivalry and jealousy, but a collaborative and supportive culture for every member. This is a winning attitude for helping everyone reach goals together. The assumption of forgiveness commits to seeing all people as improvable, and that forgiving imperfections and working toward best opportunities for success are central to the overall success at Selkirk. This encourages everyone to speak first, seek resolution informally, and act formally when necessary. Cooperation with these assumptions is often a good indicator of longevity with the company.[56]

Selkirk's ESOP committee also worked on what their corporate conscience, or culture, would look like when the ESOP they planned became a reality. Taking time to flesh issues out regarding corporate culture, what organizational communication looks like, and how RIPs will function, assisted with creating a positive and effective transition from owner/employee thinking to ownership thinking. Their commitment resulted in transparent communication and the effective development of RIP ideas to assist with the company's returns on investment (ROI) and KPIs, and the adoption of these ideas by new hires taking an ownership thinking course in their first three to six months of joining the company. These steps, taken together, helped Selkirk ensure ESOP ownership thinking continued through the addition of each potential owner for the company.[57]

As Hams (2012) and Turk (2019) note, the quality improvements ownership thinking brought to the table, created favourable results for realizing a positive impact on the company's bottom line.[58]

Conclusion

In a time of uncertainty, companies need to rekindle the flames of innovation and assess their organizational viability with new eyes on a fluid future. Every part of Western Canada needs to remain innovative and use the talent they possess wisely. Western Canadian businesses need to take important steps for planning to revitalize business strategy and move toward the future they envision with effective best practices.

With BC and Alberta experiencing the highest percentage of business failures in the country, it is only reasonable for businesses to look toward implementing an ESOP, as a solid consideration for investing in and creating innovative approaches. It is important for business owners to give entering into ESOP agreements, serious consideration, to preserve company assets and progress, rather than merging, selling, or offering themselves as a public company.[59]

An ESOP is an important consideration and a great resource for determining the future you want to develop. There are pitfalls, but taking time to strategize results can help you and your company make important strides forward to protect and revitalize its future. You have the will and talent needed to make it work. All you need to do is take the time to hammer out important principles, understand the best design, and make the decisions necessary to transform your company into an effective ESOP, to create favourable results and realize the positive impact it can make to your company's bottom line.

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