REPORT OF THE
SECRETARY OF ADMINISTRATION AND THE
COMMONWEALTH COMPETITION COUNCIL ON

METHODS TO PRIVATIZE APPROPRIATE STATE GOVERNMENT FUNCTIONS THROUGH THE DEVELOPMENT AND PROMOTION OF EMPLOYEE-OWNED COMPANIES (ESOPs)

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA

SENATE DOCUMENT NO. 12

COMMONWEALTH OF VIRGINIA
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ESOP PRIVATIZATION STUDY

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COMMONWEALTH of VIRGINIA

Office of the Governor

George Allen
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Michael E. Thomas
Secretary of Administration

December 15, 1997

TO: The Honorable George Allen, Governor
and
The General Assembly of Virginia

The report contained herein is pursuant to Senate Joint Resolution No. 284, as approved by the 1997 General Assembly. The Resolution requested the Secretary of Administration, in cooperation with the Commonwealth Competition Council, to study methods to privatize appropriate state government functions through the development and promotion of employee-owned companies, commonly know as ESOPs.

This report constitutes a summary and evaluation of the potential methods and the process to privatize appropriate state government functions through the development and promotion of employee-owned companies. As required by Senate Joint Resolution No. 284, the report includes the results of (i) examining the current state rules, procedures, policies, and limitations of converting state functions or services to a for-profit Employee Stock Ownership Plan (ESOP) company; (ii) examining the current and innovative employee stock ownership plans in other states; and (iii) the determination of the necessary level of state financial support for such plans.

Also included in this report is a summary of important and essential research data, major federal and state legislation pertaining to ESOPs, and the key organizations supporting the implementation and development of ESOPs. We are grateful to the organizations and the participants that assisted us in this study. Much of the information was gathered from The ESOP Association; the Foundation for Enterprise Development; The National Center for Employee Ownership; the Reason Public Policy Institute; The Ohio Employee Ownership Center; surveys of ESOP companies; ESOP consultants; and various federal and state government agencies.

In compliance with Senate Joint Resolution No. 284, this report of the findings and recommendations is submitted to the Governor and the 1998 General Assembly.

Respectfully Submitted,

Michael E. Thomas
Secretary of Administration

Otis L. Brown
Chairman, Commonwealth Competition Council

Table of Contents

PRIVATIZATION STUDY

METHODS TO PRIVATIZE APPROPRIATE STATE GOVERNMENT FUNCTIONS THROUGH THE DEVELOPMENT AND PROMOTION OF EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

EXECUTIVE SUMMARY

Employee ownership is having a significant impact on employee motivation and corporate productivity in the United States economy. Whether through employee stock ownership plans (ESOPs), broadly granted stock options, or 401(k) plans with the option to purchase employer stock, American employers are more and more interested in making their workers owners. Just as important, however, are potential productivity gains. Studies consistently show that when broad employee ownership is combined with a highly participative management style, companies perform much better than they otherwise would be expected to do. As a result of this, the number of employers sharing ownership broadly with employees has grown substantially. The employee ownership experience in the private sector and in other countries can be applicable to developing the ESOP concept in Virginia government.

There are approximately 12,000 ESOPs in the United States covering about 15 million participants and controlling over $300 billion in company stock. Of these companies, 15 percent are publicly traded and 85 percent are privately held. The median percentage ownership for private companies is about 35 percent with approximately 2,500 companies now majority employee-owned. Included in this report is "The Employee Ownership 100", listing the largest ESOP companies in the country.

An ESOP is a federally qualified employee benefit plan regulated by the Department of Labor and the Internal Revenue Service according to the guidelines of the Employee Retirement Income Security Act (ERISA), as amended, of 1974. ERISA is the enabling legislation which gave ESOPs their specific statutory framework. Since 1974, federal legislation has provided ESOPs with additional tax benefits.

The ESOP gives the employees of a company sponsoring the ESOP a beneficial ownership in the company, which is why the employees are referred to as "employee-owners" and the ESOP is referred to as the "employee ownership" plan.

There are several unique features about employee ownership in an ESOP. First, the assets in an ESOP, which are primarily the stock of the company, are held in trust. As the company increases in value, the stock in the ESOP, including the value of employees' shares, increases in value. The reverse can also happen and the stock can go down in value. With

an ESOP, gains such as productivity, profits, revenues, and efficiencies increase the value of all the employee accounts in the ESOP. Second, unlike other employee benefit plans, an ESOP may borrow money. There are significant tax savings to the ESOP company as it repays the ESOP loan. As the company makes contributions to repay the ESOP loan, it receives a tax deduction for *both* principal and interest. An ESOP that borrows is referred to as a "leveraged" ESOP.

Leveraged or unleveraged, the ESOP is unique from other employee benefit plans in transferring ownership of company stock to employees. Other plans can transfer ownership, but the ESOP is specifically designed to transfer shares to employees, and its ability to borrow money to acquire the shares makes the leveraged ESOP unique from other employee benefit plans. The ESOP creates a direct link between company interests and employee interests. This report shows an example of the flow of funds and the accounting treatment of a leveraged ESOP, facets of which would apply to a government ESOP privatization.

The increasing interest in combining employee ownership and privatization in other countries suggests that employee buy-outs of government enterprises and service functions is an idea whose time has come. The use of employee ownership and ESOPs as a means of privatizing government services and enterprises is much further along in the United Kingdom, parts of Europe, Russia, Latin America, and Canada, than in the United States. More than 50 countries have included employee ownership as part of their privatization initiatives.

In the United States, the first ESOP privatization of a government function occurred in 1996 when the federal Office of Personnel Management assisted over 700 federal employees in creating a new ESOP company called US Investigations Services, Inc. This national ESOP company, based in Annandale, Pennsylvania, now conducts all the personnel background investigations for the federal government, which were formerly performed by the Office of Personnel Management. There are a number of other federal and local government functions that are currently being analyzed for potential ESOP privatizations.

It is clear from the research conducted during this privatization study that ESOPs have become a "cottage" industry and that federal legislation continues to strongly support employee-owned companies. This strong support has continued in the 1997 Tax Act, which contains a provision expanding ESOPs to Subchapter S corporations beginning in 1998. Also, a number of state governments have enacted "Employee Stock Ownership Assistance Acts" as part of their economic development and retention programs to assist current and potential companies in developing and converting to an ESOP. From national trade and research organizations devoted to employee ownership, to quality expert consultants, law firms, and specialists, there is an abundance of expertise available to implement ESOPs.

This report details the process the experts use to implement an ESOP: conduct feasibility studies; provide and arrange financing; incorporate a new company; establish and administer the ESOP; develop marketing and business plans; recruit senior management; and develop and train management and employees in open book communications and participative management.

The research has determined that the Commonwealth of Virginia is the only state government entity in the United States that has undertaken an effort to study the privatization of state government functions through the development and promotion of employee-owned companies, and that the ESOP community supports the purpose of this study. This support was confirmed through meetings with major Virginia-based ESOP companies and surveys of ESOP companies in the Mid-Atlantic region of the country. Some of these companies have indicated a willingness to become financial and strategic partners with a state "government" ESOP company to ensure its success in the private sector.

With many governments undergoing the process of "reengineering", "retooling", or "reinvention", a perennial concern is the employee factor in these movements. An ESOP can be the solution to this human element. There is strong evidence in the United States that ESOP companies tend to be more efficient than their competitors. The economic benefits of employee ownership are numerous. Public agencies via ESOPs can achieve cost savings above and beyond other methods of privatization and studies have shown that employee-owners are very motivated. The more shares employees own, the more committed they are with their jobs. Since an initial contract of an ESOP company with Virginia government would presumably be a sole source procurement, the former government employees who are now employee owners of the ESOP company, would not be displaced.

This report discusses in depth the analysis of the three groups that were assigned to this study. Also included is comprehensive information on the features and unique tax-favored advantages of ESOPs; motivation/corporate performance of employee ownership; ESOP survey results; ESOP examples; ESOPs in other countries; an ESOP process; federal and state laws pertaining to ESOPs; and key organizations supporting ESOPs.

Summary

This study did not reveal any current Commonwealth of Virginia rules, procedures, policies or limitations that would preclude an ESOP privatization of a government unit or service. Moreover, there is no current recognition or implementing regulations in the Code of Virginia pertaining to ESOPs.

At the federal and local government level, there presently exists, or are underway, innovative ESOPs generated from former government functions. It will be necessary for the Commonwealth to make an initial investment in funding a pre-assessment analysis and feasibility study in promoting ESOPs. The original investment is recoverable through cost savings or a favorable repayment contract provision with the newly created ESOP company/s performing the government service.

Conclusion

An ESOP is an excellent privatization method for performing government services. It gives employees a direct stake in the equity growth of the privatized company and more control over their own future. Employees will have an incentive to support the privatization process since job displacement concerns will be reduced.

The employees can achieve greater financial rewards when the ESOP is combined with other retirement plans, such as a 401(k) plan, which can provide substantially higher retirement benefits than under the state system. The rewards are predicated upon the success of the new privatized company. Experience in the private sector has demonstrated that once employees understand the potential for financial accumulation in the ESOP, many will become enthusiastic supporters of the privatization process.

In the ESOP privatization process, the opportunities for everyone to gain is present. The state can realize a fair selling price from the privatized entity to perform the service, taxpayers can look forward to a reduced cost of providing the service, and the privatized entity can offer the potential of significant financial rewards to the former government employees that have become employee owners. Lastly, the reduction in the capital gains tax in the 1997 Tax Act will provide a strong motivation for substantial growth in ESOP formation.

An ESOP privatization of a government function can produce multiple results: more cost-effective and efficient services; reduced government payroll with little or no job displacement; employee support for the privatization process; private sector job creation; increased tax revenues; and promotion of economic development.

Recommendations

Consideration should be given by the Governor and the General Assembly to enact legislation for funding to support and assist current ESOP companies and to promote the creation of new ESOP companies in both the private and public sectors. This ownership transition service function should be assigned to an appropriate state agency. The mission of this service and state agency should be to promote employee participation and stock ownership by providing information, education, and technical services to employee groups and business owners and to generate awareness of the concept with the general public.

By providing practical information and assistance to help organizations implement equity-based compensation and broad-based participation programs, the designated agency providing this service will enhance economic and social development through broader ownership and involvement in the free enterprise system.

It is further recommended that funding be provided in the 1998-2000 budget to conduct a pre-assessment analysis and feasibility study on selected state functions that may be candidates for an ESOP privatization.

**REPORT OF THE
SECRETARY OF ADMINISTRATION AND THE
COMMONWEALTH COMPETITION COUNCIL
CONCERNING METHODS TO PRIVATIZE APPROPRIATE STATE
GOVERNMENT FUNCTIONS THROUGH THE DEVELOPMENT AND
PROMOTION OF EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)**

**To
The Governor and the General Assembly of Virginia**

Richmond, Virginia

December 15, 1997

I. INTRODUCTION

Senate Joint Resolution No. 284 (1997) requested the Secretary of Administration, in cooperation with Commonwealth Competition Council, to study methods to privatize appropriate state government functions through the development and promotion of employee stock ownership companies, commonly referred to as ESOPs *(Appendix A)*. The resolution called for an examination of (a) the current rules, procedures, policies, and limitations of employee stock ownership plans in Virginia government; (b) current and innovative employee stock ownership plans in other states; and (c) the determination of the necessary state financial support for such plans.

II. STUDY METHODOLOGY

A separate study group consisting of private citizens and state government officials was organized to review and study the three charges of the Resolution. It was not the purview of the study groups to identify specific governmental units, functions, or services that may be candidates for an ESOP.

The study groups examined current Virginia statutes, policies, and potential limitations that may deter employee stock ownership plans of Virginia governmental units or functions; examined if other governmental entities have considered ESOP privatizations in their jurisdictions; and analyzed the costs of implementing an ESOP. The groups also conducted extensive research on the background of ESOPs in general; specific federal and state laws pertaining to ESOPs; collected information and data from The ESOP Association; ESOP Advisors, Inc.; ESOP Services, Inc.; The Foundation for Enterprise Development; The

National Center for Employee Ownership; The Ohio Employee Ownership Center; The Ownership Transition Services Division of the Empire State Development Corporation; The Massachusetts Corporation for Business,Work, and Learning; and the State of Washington Department of Community,Trade and Economic Development.

Other organizations that assisted in this study included the American Legislative Exchange Council, The Council of State Governments, The Reason Public Policy Institute, and The National Association of Counties. On-site interviews with officials of the U.S. Office of Personnel Management provided an analysis of the process and the documents they used to privatize their personnel background investigations unit into an ESOP.

The groups also interviewed ESOP consultants who have implemented ESOPs. In addition, surveys were conducted nationally with the twenty (20) chapters of The ESOP Association, and over 100 ESOP companies in the Mid-Atlantic Chapter (Virginia, Washington, D.C., Maryland and West Virginia) were surveyed for information.

Appendices in this report identify the largest ESOP companies in the country (*Appendix B*), major federal and state laws pertaining to ESOPs (*Appendix C and D*), key organizations supporting ESOPs (*Appendix E*), examples of a leveraged ESOP (*Appendix F and G*), Commonwealth Competition Council Process (*Appendix H),* employee benefits (*Appendix I*), employee ownership/corporate performance studies in ESOP companies (*Appendix J*), and a copy of the Mid-Atlantic Region ESOP survey instrument (*Appendix K).*

III. EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

What Is an ESOP?

An ESOP is a qualified employee benefit plan primarily used for retirement purposes. An ESOP is governed by the Employee Retirement Income Security Act (ERISA), which gave ESOPs specific statutory framework in 1974. Since 1974, ESOPs have been given a number of additional tax benefits which are detailed in *Appendix C.* ESOPs are a form of a stock bonus plan designed to make a broad spectrum of employees stockholders in the sponsoring company. Like other qualified deferred compensation plans, they must not discriminate in their operations in favor of highly compensated employees, officers, and owners. ESOPs must appoint a trustee to act as the plan fiduciary. Larger companies tend to appoint an outside trust institution, while smaller companies typically appoint a manager or create an ESOP trust committee. The ESOP trust maintains the *tax-deferred* individual accounts for the participating employees.

An ESOP provides attractive tax-advantaged benefits with one of its most sophisticated uses being able to borrow money. These tax benefits allow an ESOP company to borrow money and repay *both* principal and interest in *pre-tax* dollars. In this approach, the company sets up an ESOP trust. The trust then borrows money from a lender and the company repays the loan by making tax-deductible contributions to the trust which in turn pays the lender. The loan must be used to acquire stock in the company and the loan proceeds can be used for any legitimate business purpose. The stock is put into a "suspense account" where it is released and allocated to employee accounts as the loan is repaid. *Appendices F and G* show an example of these transactions. As employees leave the company or retire, the company pays them the value of the stock allocated in their accounts. In return for agreeing to funnel the loan through the ESOP, the company gets a number of tax benefits. In addition to deducting for tax purposes the entire loan contribution it makes to the ESOP, the company can deduct dividends paid on the shares acquired with the loan proceeds. In other words, the earnings of the stock in trust help pay for the stock itself.

How ESOPs Are Used

The ESOP can buy both new and existing shares for a variety of purposes:

- The most common application for an ESOP is to buy the shares of a departing owner/s of a closely held company. Owners can defer tax on the gain they have made from the sale to an ESOP if the ESOP holds more that 30 percent of the company's stock. The purchase can be made in pre-tax dollars.

  This purpose would not apply with an initial government ESOP privatization, but could apply after the ESOP has been in existence for a period of time. This tax-advantaged feature offers an outstanding opportunity for original investors in the government transferred ESOP, whether they be former government employees or executives recruited to manage and invest in the company.

- Buy newly issued shares in a company with the borrowed funds being used to provide new capital. The company can, in effect, finance growth or acquisitions in pre-tax dollars while these same dollars create an employee benefit plan.

  This purpose would be the appropriate application of an initial government ESOP privatization.

- The above uses generally involve borrowing money through the ESOP, but a company can simply contribute new shares of stock to an ESOP, or use cash to buy existing shares, as a means to create the employee benefit plan.

Rules for ESOP Loans

The ESOP can borrow money from anyone, including commercial lenders, sellers of stock, and the company itself. Any loan to an ESOP must meet several requirements. The loan must have reasonable rates and terms and must be repaid only from employer contributions or dividends on shares in the plan. There is no limit on the term of a loan other than what lenders will accept, which is normally five to ten years, and the proceeds from the sale of the shares to the ESOP can be used for any business purpose. Due to the company's tax-favored deduction of both principal and interest loan repayments, lending institutions provide very favorable interest terms.

Limitations on ESOP Contributions

Companies can deduct up to *25* percent of the total payroll of loan participants to cover *both* loan principal and all of the loan interest expense (IRC 404(a)(3) and 404(a)(9) and § 58.1-402 of the Code of Virginia). In addition, "reasonable" dividends paid on shares acquired by the ESOP loan can be used to repay the loan, and these dividend payments are not included in the 25 percent of payroll calculations. Most consultants define the term "reasonable" as the percentage of share value consistent with what other companies in the industry would pay given similar levels of profit. If the ESOP is not leveraged, the normal annual contribution limit is *15* percent of payroll, but the contribution can be increased to 25 percent of payroll if special plan provisions are provided in the employee stock ownership plan.

Companies can also "pass through" tax-deductible dividends directly to employees. Typically, companies will pay dividends on allocated shares in the employee accounts, whether in a leveraged or unleveraged plan.

How ESOP Shares Get To Employees

The rules for ESOPs are similar to the rules for other qualified plans in terms of participation, allocation, vesting, and distribution. Shares are allocated to individual employee accounts based on relative compensation (generally, all W-2 compensation is counted), on a more level formula (such as per capita or seniority), or some combination. The tax-deferred allocated shares are subject to vesting. Employees generally are 100 percent vested after five years of service. An example of how purchased shares are allocated in a leveraged ESOP is shown in *Appendix G.*

When employees reach age 55 and have 10 years of participation in the plan, the company must either give them the option of diversifying 25 percent of their account balances among at least three other investment alternatives, or simply pay the amount directly out to the employees.

When employees retire, die, or are disabled, the company must distribute their vested shares to them not later than the last day of the plan year following the year of their departure. For employees leaving before reaching retirement age, distribution must begin not later than the last day of the sixth plan year following their year of separation from service. Payments can be in equal annual installments for five years, or in lump sum.

ESOP Valuation

ESOP shares must be valued at least annually by an independent outside appraiser. All ESOP transactions must be based on a current appraisal and the valuation process must assess how much a willing buyer would pay a willing seller for the business. The calculation is performed by looking at various ratios and comparable companies and then it is adjusted to reflect marketability. An independent appraisal is not required on publicly traded shares.

Financial Issues for ESOP Participants

When an employee receives a distribution from the plan, it is taxable unless rolled over into an IRA or other qualified plan. Otherwise, the amounts contributed by the employer are taxable as ordinary income, while any appreciation on the shares is taxable as capital gains. In addition, if the employee receives the distribution before normal retirement age and does not roll over the funds, a 10 percent excise tax is added.

While the stock is in the plan, it is not taxable to employees. Moreover, ESOPs either are in addition to existing benefit plans - 401(k) or profit-sharing plans - or replace other defined contribution plans, usually at a higher level of pay.

Determining ESOP Feasibility

Several factors are involved in determining whether an entity is a good ESOP candidate:

- *Is the Cost Reasonable?* - This depends on the nature of the transaction. The cost of installing and maintaining an ESOP varies depending upon the complexity and size of the transaction, and the experience and fee structure of the consultants involved.

- *Is the Payroll Large Enough?* - Limitations on how much can be contributed to a plan may make it impractical on some transactions. For instance, a $5 million purchase would not be feasible if the company has $500,000 of eligible payroll because annual contributions to the plan can be no larger than $125,000 (25%) per year, which is not enough to repay a $5 million loan.

- *What makes a Good ESOP Candidate?* - A generally accepted rule of thumb is that an entity considering an ESOP should have at least 20 employees, a minimum annual payroll of $500,000, potential pre-tax profits of at least $100,000, and/or a positive cash flow capable of loan repayment.

- *Will the Company Be Able to Afford the Contributions?* - An assessment is necessary to determine whether the entity will have the available earnings to make contibutions.

- *Is Management Comfortable with the Idea of Employees as Owners?* - While employees do not have to run the company, they will want more information and may have more say (open-book management). Unless they are treated this way, they are likely to become less motivated by ownership.

ESOP Summary

This is a summary of the significant points of ESOPs:

WHAT IS AN ESOP?

- An Employee Stock Ownership Plan.
- A tax-advantaged corporate financing tool.
- An employee benefit plan in which workers receive stock in their company.

HOW DOES AN ESOP DIFFER FROM A CONVENTIONAL PENSION PLAN?

- An ESOP is designed to invest primarily in the stock of the employer company.
- An ESOP is permitted to borrow funds in order to acquire stock.

HOW DOES A LEVERAGED ESOP WORK?

- The ESOP borrows money from a bank, the seller, or through private financing to buy the company stock.
- The company repays the loan by making tax-deductible contributions to the ESOP.
- As the loan is repaid, the stock is allocated to the accounts of individual employees based on their relative compensation.

HOW DOES AN UNLEVERAGED ESOP WORK?

- The company makes annual contributions of stock, cash, or a combination of both to the ESOP.
- The company uses the cash accumulated in the ESOP, along with additional cash contributions, to purchase company stock.
- The stock is allocated to the accounts of individual employees based on their relative compensation.

WHAT ARE THE FINANCIAL ADVANTAGES TO THE COMPANY?

- In an unleveraged ESOP, cash contributions to buy company stock are tax-deductible.

- In a leveraged ESOP, cash contributions to the plan to repay both principal **and** interest on ESOP debt are tax-deductible.
- Dividends paid on ESOP stock are tax-deductible if paid in cash to participants or are used to repay the ESOP loan.
- Because of their unique status, ESOP companies benefit from an increase in cash flow which can be used for debt reduction, acquisition financing and other corporate purposes.
- Loan financing terms are usually very favorable because of the increased cash flow.

WHAT ARE THE FINANCIAL ADVANTAGES TO EMPLOYEES?

- By making workers owners of the company, ESOPs enable employees to share directly in the equity growth of the company.
- Over the course of their employment, employees accumulate stock in their accounts tax-free, which they redeem at the current appraised value of the stock when they leave the company.
- ESOP participants can receive dividends on their stock.
- Over a five to ten-year period, the average ESOP employee accumulates over 150 percent of annual pay.

HOW TO KEEP EVERYONE AN OWNER INCLUDING NEW EMPLOYEES?

- Non-vested shares are forfeited and reallocated to employee accounts and repurchases of shares from departing employees are reallocated to employees.
- "Rebalancing" of employee accounts by transferring shares from existing allocations to new employees and replenishing the transfers with cash.
- Releverage the ESOP to buy more shares. One of the most appealing uses of an ESOP is to finance growth. The ESOP can borrow money to buy new shares with the company using the funds to buy new assets, repaying the loan with pre-tax dollars, and depreciating the asset to pay for itself
- Companies can create internal markets by making the stock available for employee purchase in a 401(k) plan.

Because of these advantages of employee ownership, the existing 10,000 ESOPs in the country represent a fivefold increase in the past 20 years. Giving employees a few hundred shares of stock over time adds up to significant cash benefits. For example, in Lowe's, the home improvement company where the employees have a 20 percent minority percentage of Lowe's stock in their ESOP, it is reported that the company makes annual contributions of up to 17 percent of employees' gross income in Lowe's publicly traded stock to their employee stock ownership accounts. Robert Tillman, CEO, says that many lower level employees have retired with six figure accounts. This demonstrates that the percentage of ownership is not as important as the percentage of compensation contributed to the ESOP.

IV. CURRENT RULES, PROCEDURES, POLICIES, AND LIMITATIONS OF EMPLOYEE STOCK OWNERSHIP PLANS IN VIRGINIA

The ESOP Privatization Process

An ESOP is a unique form of privatization that requires additional steps beyond the traditional privatization/competition process. In addition to the five-step process recommended by the Commonwealth Competition Council (*Appendix H)*, a pre-assessment analysis, feasibility study, and an implementation plan is necessary to transfer a government service to an ESOP. These additional steps are detailed on pages 23 and 24 of this report.

No Specific Prohibition Exists

A review of the following sources has led to the conclusion that no specific statutory prohibition exists in the formation of ESOPs by state employees:

- Constitution of Virginia;
- Code of Virginia, Title 2 (Administration of the Government Generally);
- State and Local Government Conflict of Interests Act (§ 2.1-639.1 et seq.)
- Virginia Public Procurement Act and the implementing regulations of the Department of General Services (DGS);
- Statutes and regulations of the Department of Personnel and Training relating to employee benefits;
- Statutes and regulations of the Virginia Retirement System;
- Statutes and regulations of the Department of Taxation pertaining to ESOP initiatives;
- Appropriation Acts;
- Executive Orders (past and current).

However, the following were identified as significant points to consider in establishing a government ESOP program:

- **Employee benefits** (*Appendix I* is a complete listing)
  - retirement
  - leave, various provisions
  - health insurance
  - life insurance
  - salary administration
  - incentives
  - grievance rights

- **Licensing and permitting exemptions**
  - professional licenses
  - building permits
  - business licenses
  - sales permits
  - real estate license, etc.
  - any statutory license or permit required for business ranging from commercial to personal

- **Commonwealth's legal protection**
  - representation by the Attorney General's Office
  - sovereign immunity
  - anti-trust

- **Inability to sell or transfer state property to an ESOP vs. offering the property competitively to the public**
  - § 2.1-457.2 et seq. of the Code of Virginia
  - § 2.1-511 et seq. of the Code of Virginia

While these are important considerations, the ESOP process detailed on pages 23 and 24 is structured to address these concerns. The steps in the ESOP process require the professional ESOP implementation team consultants to form a management/employee representative group to design a comparable or improved benefit program, legal representations and protections, assess capital equipment and facilities needs, and identify legislation, or amendments to current legislation, required to effect the ESOP transaction.

Alternate State Procurement Procedures Allowed

As stated above, there is no specific prohibition to the establishment of an ESOP identified in Virginia's Procurement Act, or the implementing DGS purchasing regulations. Moreover, § 2.1-442 of the Code of Virginia is the panacea to any unknown procurement barrier that may surface in the future. This section of the Code allows the Director of the Division of Purchases and Supply wide latitude in allowing alternate procurement procedures for any good or service:

> § 2.1-442. **Purchases to be made in accordance with Chapter 7 of Title 11 and rules and regulations of Division; exempt purchases.** - All purchases made by any department, division, officer or agency of the Commonwealth shall be made in accordance with Chapter 7 (§ 11-35 et seq.) of Title 11 and such rules and regulations as the Division may prescribe. Such rules and regulations shall include a purchasing plan which shall be

> on file at the Division and shall be available to the public upon request. Such rules and regulations shall require that before any public body procures any computer system, equipment or software, it shall consider whether the proposed system, equipment or software is capable of producing products which facilitate the rights of the public to access official records under the Freedom of Information Act (§ 2.1-340 et seq.) or other applicable law. The Division shall have authority to make, alter, amend or repeal regulations relating to purchase of materials, supplies, equipment, nonprofessional services, and printing, and may specifically exempt purchases below a stated amount or particular agencies or specified materials, equipment, nonprofessional services, supplies and printing.

Although there is no outright prohibition of ESOPs in Title 2, there are several general statutory provisions that may impair the creation of ESOPs. For example, § 2.1-481 of the Code of Virginia, **Care of Public Buildings and Property**, states that the Division of Engineering and Buildings shall have charge of all public buildings, grounds, and all other property at the seat of government not placed in the charge of others. This statute may require an amendment if an ESOP was formed to perform this service. Therefore, depending on the area of state government selected for an ESOP, the specific statutes governing that area may need amendment. This will need to be examined on a case-by-case basis and will be a requirement of the ESOP feasibility study.

ESOP Loan Guarantees by State Government

A review of the Constitution of Virginia was further undertaken to determine if the state could use its full faith and credit to guarantee the loans of a state government ESOP. Article X, § 10, prohibits the state from specifically supporting such a financial obligation. Although the Constitution prohibits loan guarantees, the state has the authority to develop contracts with favorable terms that could include various incentives, escalation clauses, and flexibility in payment schedules to assist a new ESOP company performing a government service.

Virginia Retirement System Portability

If a member of the Virginia Retirement System (VRS) terminates employment, the member has the following options: (1) leave his or her *member contributions,* and accrued interest, with the Virginia Retirement System; (2) take a cash refund of member contributions and accrued interest; or (3) roll over the contributions and accrued interest to another qualified pension plan. These options are available whether the member is vested or not vested. Member contributions represent the state's contributions of five percent of salary, plus accrued interest, paid to VRS on behalf of the member. These refunds are authorized in § 51.1-161 of the Code of Virginia, **Withdrawal of Contributions Before Retirement**.

The roll over options above include the ESOP itself, if this is option is negotiated in the ESOP development phase, a 401(k) plan that the ESOP company sponsors, or an Individual Retirement Account purchased by the member. These options avoid the payment of taxes by the member at the time of the roll over.

Conflict of Interest and Ethics

The state's Conflict of Interest provisions were examined closely to determine if a conflict exists when a state employee is placed in the posture of negotiating the development of an ESOP that he or she will eventually be a part of. A conflict may exist, although this finding is variable due to the interpretation of when the break is made from being a state employee and subsequently becoming an ESOP employee. Nonetheless, the state must exercise extreme caution to avoid the appearance of impropriety.

It appears that a conflict does not exist when the original decision is made that the service will be acquired as an ESOP sole source procurement. Presumably, the Governor, as Chief Executive Officer, may elect to act in this regard. Further, a conflict does not exist when active discussions are held in the initial development of an ESOP because a state employee does not know at that time if the ESOP will employ him. Likewise, as an ESOP employee, control over the affected state agency would not exist, therefore a conflict would be diminished. Conversely, an interpretation of the "prescribed participation" and "official responsibility" of state employees in contract opportunities found in not only the Conflict of Interest statutes, but also in the Ethics section of the Procurement Act, appear to identify a conflict when there may be employee discussions concerning the development of an ESOP. The federal government's first ESOP privatization did not constitute a conflict of interest since the employees involved in negotiations agreed not to join the new ESOP company.

Enabling Legislation is Needed

The most effective method to promote ESOPs is through enabling legislation. One approach was recognized as an overall authorization of the General Assembly for ESOPs. The other approach was specific to the area of state government identified as a likely candidate for an ESOP.

Each approach has its advantages and disadvantages. For example, legislation drafted to impart an overall acceptance of ESOPs by the General Assembly could result in a debilitating discussion regarding the "ESOP concept" as a whole, which could defeat any initiative. On the other hand, overall legislation promoting ESOPs will provide an extremely strong position to begin their establishment in state government and could be crafted to remove limiting barriers, such as the initial stages of conflict of interest challenges.

In the other approach, there are strengths and weaknesses in relation to developing legislation specifically identified to a particular function or service of government that is presently being performed. The strength of such legislation was found to remove it from an overall scrutiny of ESOPs over the entire spectrum of government. It allows for a targeted removal of limitations to the ESOP initiative by specifically reviewing the implementing statutes associated with the particular government service to be privatized. Moreover, it allows the General Assembly a case-by-case approval of ESOPs that will displace established government operations. However, the obvious weakness of such a strategy lies in its timeliness to initiate ESOPs in functions of state government and limiting the windows of opportunity.

By comparing both approaches, it is believed that if ESOPs were authorized by general enabling legislation instead of establishing them as "pilots" in the Appropriation Act, it would strengthen the appeal of ESOPs as a method of good government. This conclusion was reached because the inherent nature of programs established as "pilots" tend to associate themselves with risk and the potential for failure. Legislation supporting ESOPs as a generally recognized method for government to increase its efficiency is a far superior posture to assume.

V. CURRENT INNOVATIVE EMPLOYEE STOCK OWNERSHIP PLANS IN OTHER STATES

The ESOP Association, The National Center for Employee Ownership, the Foundation for Enterprise Development, and the Reason Public Policy Institute confirmed that, *with the exception of Virginia*, they are not aware of any state government that has or is undertaking a comprehensive study of ESOPs as a method of privatization of government services. A national survey of all 20 chapters of The ESOP Association also did not reveal any comprehensive government ESOP studies similar to this Virginia study.

There is movement, however, on a *select* basis in the federal and local government to implement ESOPs. In addition to the first major ESOP privatization of a federal government function described below, the federal government completed an ESOP feasibility study of the Army Management Engineering College (AMEC) in Rock Island, Illinois. Although the feasibility study indicated that this function was a prime candidate for an ESOP privatization, the Department of the Army recently decided to close the facility. However, one of the four firms that proposed to be a strategic planner with AMEC, Synectics Corporation of Fairfax, Virginia, formed a separate division without government support. The new division is named Synectics Advanced Management Engineering Center (Synectics AMEC). Two other military installations are being advised on converting their manufacturing operations to ESOPs and feasibility studies are being performed. In Washington, D.C., a feasibility study has been completed and an implementation plan is proceeding to privatize via an ESOP all institutional medical services in the city. Approximately 220 employees are involved in this transaction, which is expected to close in 1998.

A description of two innovative ESOPs follows. One is the first major government ESOP privatization and the other is a private company ESOP.

US Investigations Services, Inc.

When the U.S. Office of Personnel Management (OPM) decided it was necessary to reduce the cost of its division performing background investigations, the double edged question was - should it be privatized and in what form, and how can OPM protect the employability of over 700 employees currently performing the background investigations? After a feasibility study was conducted, an implementation plan was developed to form a new private organization to serve the needs of its customers and national security with integrity, quality, and affordability, while providing financial stability and opportunity for its employees.

This vision was converted to reality with the creation of US Investigations Services, Inc. (USIS), which was incorporated on April 8, 1996 and commenced operations on July 8, 1996. The former federal employees now own the largest private investigations company in North America. USIS, based in Annandale, Pennsylvania, is a for-profit employee-owned company, in which the former federal employees, plus officers and managers, own 100 percent of the company. The 700 plus employee-owners own 90 percent of the company valued at $141.8 million as of September 30, 1997. Twelve company officers and managers, who put up an initial seven-figure investment, hold the remaining shares. The company's main source of revenue is the $60 million annual contract it executed with OPM. The three year sole-source contract, with two one-year renewal options, represents a 25 percent cost reduction from previous federal operations and it is estimated that USIS will save the federal government up to $25 million over five years. All the former federal employees were offered positions with USIS at base salaries that at least matched the pay they received in government. The fringe benefits are comparable to their former federal benefits. With the ability of USIS to seek other federal, state, local government and private business, USIS anticipates that the stock value will increase every year from its original $20 per share value.

Cutting edge technology and state of the art communications equipment support USIS activities in all 50 states, Puerto Rico, Guam and the U.S. Virgin Islands. The field personnel operate from over 125 locations nationwide, conducting over 300,000 investigations.

On April 14, 1997, Philip R. Harper, President and CEO of US Investigations Services Inc., made a presentation to the Commonwealth Competition Council. He stated that in less than one year of operations, USIS provided a financial gain to the federal government of $14.7 million in the form of new taxes paid and other cost reductions. Within the first year of operations USIS increased the pay of over 200 employees, awarded a 5 percent cash bonus to all employees in December 1996, an 8 percent cash bonus in March 1997, and an 8 percent cash bonus in September 1997. USIS also made a stock distribution equivalent to 10.23 percent of payroll from the USIS ESOP, which was allocated to each ESOP participant based on pro-rata relative employee compensation. A stock distribution of 12 percent was made as of September 30, 1997. The stock value has increased from $20 per share as of July 8,1996 to $43.33 as of September 30, 1996, and to $218.18 a share as of September 30,1997.

It is important to note that this ESOP privatization of a government service is saving significant tax dollars, avoiding reductions in force, providing significant financial gains for the former federal employees, and USIS is also showing a healthy profit.

Web Industries

Web Industries is a converting company headquartered in Framingham, Massachusetts. The company's primary services include converting various materials (paper, film, plastic, etc.) according to the custom specifications of its customers. Web's 240 employees own about 40 percent of the company through an ESOP, and the goal is for the employees to eventually own the entire business. The fascinating part of Web's story is how it has flattened its management and organizational structures and created a work environment in which employee owners are viewed, treated, and rewarded as true partners in the business. This transformation has allowed Web to tap the full potential of employee ownership and redefine itself as one of the most innovative companies within both the converting industry and the employee ownership community. Web was founded in 1969 and the company set up the ESOP in 1986. In 1989, founder Robert Fulton and his management team started to discuss that Web was still not the truly empowering workplace of Mr. Fulton's vision. They realized that employees needed to be trained to think and act like owners if ownership was to mean anything. The discussions instigated a process of cultural change, which began with the company soliciting input from all employees regarding their ideas about ownership, participation, and how to transform the company.

The organizational structure that has gradually evolved at the company is one that is truly participative. At the core of this structure are self-managed work teams which seek to give all employees more autonomy in their immediate jobs. Work teams are involved in everything from setting production schedules and maintaining inventory, to hiring new employees. Upper management acts more as in-house consultants to the work teams rather than as traditional managers.

Web realizes that employees do not just jump into these roles and that training and education are essential for creating effective decision makers. Web places great value on the power of learning not only to train employees to be business people, but also to foster their personal growth. The unique approach to training that has emerged at Web was created with the input from employees from all departments. A great deal of time is devoted to financial training. All employees at Web receive ongoing explanations of the financials by reviewing the same three page financial statement each month, and the entire staff meets to discuss it. An employee (often someone from the front-line) will go through the financial statements and explain it to everyone else. So far, Web's experience has been quite successful. Employees at Web are encouraged to act and react, confront problems, treat customers as they treat each other, and participate in the company every single day. The new structure has made Web a more meaningful and exciting place to work. It has also meant rapidly growing retirement accounts for the employee owners. Since 1989, the share price of Web's stock has jumped from $127 to $256.

VI. STATE FINANCIAL SUPPORT FOR EMPLOYEE STOCK OWNERSHIP PLANS

ESOP Opportunities: Cost vs. Benefits

ESOPs offer extraordinary opportunities for win-win situations to the citizens of the Commonwealth and the employees of Virginia state government. This is not to say that ESOPs are without risks. However, it is apparent from the success of ESOPs in the private sector, the federal government and governments in other countries, such as Canada and Great Britain, that there are opportunities for improved services at reduced cost by employee-owned companies.

One of the most important policy considerations is the extent to which Virginia government is willing to assist in encouraging employee ownership. In many instances, limited assistance is appropriate as government can reasonably expect to benefit in two ways: eliminating an inefficient operation and the sale proceeds from selling the service.

However, if government stands to benefit only from savings expected by spinning off a service, a portion of the anticipated savings could still be tapped to assist former government employees in getting started in the new ESOP company. However, before determining the extent of assistance, one needs to develop an understanding of the areas of potential state costs versus the potential revenue gains and cost savings.

The following charts list the major implementation costs, and the revenues and/or cost savings categories, that may be expected as part of a state government privatization to an ESOP.

The determination of the actual respective costs, revenues, and cost savings depends on the size and a pre-assessment analysis of a specific ESOP opportunity.

List of Potential Government ESOP Implementation Costs

- Briefings for employees and managers
- Management search cost
- Feasibility study/business valuation
- Business plan
- Working capital
- Legal, administrative, and trustee fees
- Sale of assets at less than book value
- Privatization transition cost and contract administration cost
- Workforce Transition Act payments
- Accrued benefits severance cost
- Maintenance of government equipment (If government-owned/contractor-operated function)

Potential Revenues

- Purchase of state asset at fair market value
- Franchise fees at a contracted % per month
- Variable payments on a contracted % of operational savings
- Lease/purchase payments on assets/equipment
- Sale of government equipment
- Tax revenues from private company ESOP

Potential Cost Savings

- ESOP contract costs
- Employee retirement cost
- Operations overhead
- Administrative overhead
- Central support overhead
- Implementation savings via increased employee productivity
- Cost avoidance-facility costs, utilities, grievance procedures
- Future open competition

ESOP Transition to Private Sector Performance

A goal of state ESOP initiatives is to change the workplace culture by creating incentives for cost-effective services. It will also mitigate against the adverse impacts on employees of an agency's decision to convert to a private sector organization.

The use of an ESOP to facilitate the transition of state employees to private sector performance should address such issues as employment guarantees, pension portability, stock ownership, opportunities to share profits, and other incentives that may serve to mitigate the potential adverse employee impacts of an agency's conversion decision. **However, these issues may incur costs that the state would have to bear as part of the transaction. These costs are not dissimilar to costs incurred in other types of privatization transactions.** The potential benefits of a state government ESOP warrants a full analysis of the costs in creating an ESOP.

Actions to Facilitate State government ESOP Formation

There are several options to facilitate the formation of a state government ESOP. These options can reduce the potential costs of creating the ESOP and facilitate the growth of the new company. The new ESOP organization may initially be awarded a contract noncompetitively using the sole source selection process, financial and strategic partnerships with the private sector, and other procurement approaches. This would provide an appropriate source of funds which the new company could use as a source of collateral for private loans. Further, it affords the new company the opportunity to be self sufficient during development of other business lines with the private sector or other government entities. After the initial contract, subsequent competitive solicitations for the service contract would be open to all interested businesses with the ESOP company competing for the contract.

Equipment could be transferred to the new company at little or no cost, purchased through a leveraged buy out transaction, or sold to the new company at book value. In many cases, equipment used in state government has been fully depreciated.

There are other options to provide the new company the opportunity to use existing equipment without adding costs to the state. Real property assets could be retained by the government and made available to the ESOP on a case-by-case basis. Another alternative would be to provide existing equipment and facilities to the new company as a Government-Owned /Contractor-Operated (GOCO) transaction.

The contract and the assets transferred, or otherwise made available to the new company, should be sufficient for the ESOP to obtain financing and perform the required services. Additionally, the service contract could be structured to require offerors to provide a stated percentage of the initial capitalization to finance the ESOP.

Potential Costs and Dollar Thresholds

ESOPs do have a cost to set up and run. The legal, accounting, actuarial and appraisal fees to establish a typical ESOP can total up to $50,000. Annual company expenses for administration of trust accounts and annual stock appraisals/valuations should be less than $10,000 per year.

It is recommended that the Governor and General Assembly consider only activities having at least 20 employees, a minimum annual payroll of $500,000, and the demonstrated expectation of a reasonable pre-tax profit and positive cash flow by the ESOP. These thresholds may be adjusted in the future as the state gains experience in the development and use of the ESOP concept.

ESOP Selection Criteria

The following ESOP selection criteria is recommended:

- The business line should be one where there is a continuing need in both the public and private sectors and the ESOP installation and maintenance cost is reasonable;

- The agency or institution must have a reasonable expectation that the ESOP is a financially viable option;

- The activity or business line must be large enough to be financially viable as a business entity, and;

- The agency must have the authority to contract out for commercial services.

Government Participation and the Decision Process

Employees and employee groups may not have the resources, or the incentives to commit their own financial resources to seek, form or negotiate for the development of ESOP alternatives. Like retraining, relocation or other "good employer" expenses, the agency considering the conversion to an ESOP may award an advisory and assistance service contract (pre-feasibility and feasibility study) to a qualified firm for assistance and to obtain financing. In general, the contract would provide ESOP related analyses and support to the government, new ESOP company, and other public and private sector interests. Moreover, it would provide for the experience in negotiating the financial transactions attendant with ESOPs and the knowledge of the legal relationships that must exist between the ESOP trustee, the employees, and the "new company."

Since the government also needs much of this information, the cost of retaining the initial legal, financial and valuation specialists may be borne, in whole or in part, by the government, with possible repayment, in whole or in part, by the new company after it is in operation.

The cost of a pre-feasibility study may be in the range of $10,000 to $15,000 depending on the selected function. A full feasibility study may cost $50,000 or more depending on the selected function. However, it is the feasibility study which provides the accurate information on which to base the final decision to proceed.

The pre-feasibility study will establish the broad financial parameters of the potential ESOP opportunity. It will determine if the entity, function, or service can be privatized. This should include the estimated cost to establish the ESOP and the expected financial benefits to the state. This establishes a preliminary cost-benefit ratio. Clearly, the expected benefits to the state must outweigh the cost to establish the ESOP. A rule of thumb for the ratio should be that the savings realized in the first 12 months of operation would equal or exceed the costs to establish an ESOP.

VII. EMPLOYEE OWNERSHIP AND CORPORATE PERFORMANCE

Since 1974, when ESOPs first received their statutory authority, there have been at least 16 major studies pertaining to employee ownership and corporate performance. The overall results from these studies confirm positive improvement in both employee motivation and corporate performance. A list of these studies is included in *Appendix J.*

During the 1980s, The National Center for Employee Ownership (NCEO) conducted exhaustive investigations of how employees react to being owners. The NCEO surveyed over 3,500 employees in 45 companies. The results were very clear. Employees did like being owners. The more shares they owned, the more committed they were to their company, the more satisfied they were with their jobs, and the less likely they were to leave.

The NCEO found that for a company to use employee ownership effectively, it needs to do more than just motivate people to work harder. Instead, it must enlist employee ideas and information to find the best ways to do the most important things. To do that, companies need to get employees involved by seeking their opinions and developing task forces to solve problems. Both a 1987 study by the General Accounting Office (GAO), and a 1993 study by the Ohio Employee Ownership Center, found that about 60 percent of companies had active employee involvement programs, and that the incidence of participation nearly doubled after the initiation of an ownership plan. The GAO reported that these participative companies showed a strong improvement in productivity when they combine their ESOPs with participative management practices.

While past studies have shown that participation translates the motivation of ownership into the reality of the bottom line, it alone is not enough. One reason is that few participation programs last more than five years in conventional programs. By contrast, over the past decade, NCEO did not find a single ESOP company that has dropped its program. Improving corporate performance is one of the principal goals of Congress in supporting employee ownership and companies in setting up plans. Recent research by the NCEO has shown that ESOP companies with strong participative management grew approximately 8-11 percent per year faster than they would have without an ESOP.

The next section of this report provides the results from surveying ESOP companies in the Mid-Atlantic Chapter of The ESOP Association. The survey form is *Appendix K.*

VIII. SURVEY RESULTS FROM MID-ATLANTIC ESOP COMPANIES

The Mid-Atlantic Chapter companies are located in Virginia, Washington, D.C., Maryland and West Virginia. Of 106 company surveys requested, the final responses totaled 48. A compilation of these responses revealed the following:

- 22 companies, or 46%, have been ESOPs since 1974, whereas 26 companies, or 54%, have been ESOPs since 1988.

- The size of the companies range from a low of 9 employees to a high of 17,000 employees with 81% of them having a personnel complement of 400 employees or less.

- 83% of the ESOPs have been or are currently leveraged.

- The percentage of the employee ownership of the companies is spread evenly. In 24 companies, the employees own 50% of the stock or less, and in 24 companies the employees own 51% to 100% of the stock.

- On a scale of 1 to 10 with 10 being the highest, the survey asked to what extent the ESOP has been a positive motivational factor. Thirty-four (34) of the companies, or 71%, ranked the positive motivational factor as a 7 or above.

- The four highest reasons why their ESOPs were established are: employee motivation; perpetuation of the business; reward loyal long-term employees; and improve employee productivity.

In evaluating the decision to establish an ESOP, 39 of the companies stated that the decision had a positive effect on company performance and productivity. Nine reported no change, and only 2 companies indicated that their ESOPs were bad decisions.

- In addition to their ESOPs, 44 of the 48 companies have either 401(k) plans, profit-sharing plans, pension plans, or a combination of these plans.

- Thirty-eight (38) of the companies stated that if a Virginia governmental entity or function is to privatized, employee ownership of at least 25% to 75% is necessary to make the new ESOP succeed. Ten companies were not sure of the percentage[1] .

- In asking if their companies support the concept of converting certain governmental services to an ESOP, the responses were:

  ➔ 35 said yes

  ➔ 4 said no

  ➔ 9 were not sure

[1] It should be noted that the percentage of ownership is less important than the percentage of employee compensation contributed to the ESOP.

IX. ESOPs IN OTHER COUNTRIES

United Kingdom

The laws in the United Kingdom have been to accommodate the use of leveraged ESOPs similar to the United States. Leveraged ESOPs have played a significant role in both government and private sector privatization transactions. The United Kingdom's government privatization program includes a goal of providing employees of privatized companies opportunities to purchase discounted shares. The success of this program was a key to building political support for privatization and contributed in large measure to the government's claim to have quadrupled the number of shareholders in the country.

Hungary

The Hungarian privatization legislation gives strong preference to the use of leveraged ESOPs based on the United States and United Kingdom models. Employee groups that organize themselves into ESOP companies are allowed to purchase a company's shares with payments spread over 15 years, with an optional 3-year grace period of interest payments only. ESOP companies qualify for a tax deduction for up to 20 percent of their pre-tax profits to fund an ESOP or to repay ESOP-related debt. ESOPs have played a significant role in approximately 150 privatization transactions.

Lithuania

Employee stock ownership of some form exists in virtually all privatized Lithuania companies, and employees currently constitute the single largest group of shareholders. Employee ownership is obtained through a number of different means under a variety of legislative programs and employees directly hold shares that they buy or are given.

Slovenia

Most management employee buy-outs in Slovenia are structured with the assistance of a holding company which acts as the seller. Typically, the state company transfers the assets into one or more new companies and becomes the holding company with 100 percent ownership of the subsidiaries. The state-owned company then sells shares to employees by providing long-term financing on favorable terms.

Poland

For larger companies slated for privatization, employees are limited to a maximum ownership stake of 20 percent, with the shares offered at a 50 percent discount. National mutual funds acquire the remaining shares.

For smaller firms a "liquidation" option enables employee groups to structure a management-employee buyout if at least 50 percent of the employees agree to participate. This option has proven to be the most popular and most successful form of privatization and has resulted in over 1,000 new employee-owned companies.

Chile

Chile developed a strategy for "labor capitalism" in order to build support for its privatization program. As a general rule, government workers are offered 5-10 percent of a privatized company's shares at a discount price. To pay for the shares, workers are allowed to borrow up to 50 percent of their severance pay, with the company promising to repurchase the shares at retirement at a value at least equal to the foregone severance payments. Thus, employees can buy shares at below market price with no cash outlay, with no risk of loss, and a potential for gain if the shares increase in value. This plan has proved to be quite attractive and approximately 15 privatized companies have been created with significant levels of employee ownership.

Russia

Russia can claim to have one of the largest number of employee-owned companies in the world. Of the approximately 12,000 medium and large scale enterprises privatized after 1992, about two-thirds were majority owned by their employees following privatization.

Canada

Over the last decade or so, the privatization of many activities and enterprises formerly owned by the government has been a popular and common practice in Canada. Employee ownership has also been a popular and rapidly expanding phenomenon. Unlike the United States, Canadian employee owners generally purchase and hold shares directly. Two provincial governments, British Columbia and Saskatchewan, have experimented with a different approach, under which entire units of government departments are sold to their employees.

These provinces have governments that are philosophically predisposed towards the concepts of smaller government, privatization, and employee ownership, and who see a connection among these concepts.

Other Countries

The Foundation for Enterprise Development reports that more than 50 other countries have included employee ownership as part of their privatization programs.

X. THE PROCESS TO IMPLEMENT AN ESOP

The process described below are recommended steps to implement an ESOP privatization of a governmental entity, function, or service.

- **Request for Proposals and Execute a Contract for a Pre-Feasibility Analysis:**

  (1) Determine if the entity, function, or service can be privatized and establish the financial parameters of the potential ESOP opportunity.
  (2) Discuss potential ESOP cost-benefit analysis and key issues with key interest groups and decision-makers to streamline the privatization process.
  (3) Identify potential problem areas and conflicts of interests, analyze potential financial transaction structures, and prepare necessary communications channels between government, employees and the public.

- **Request for Proposals and Execute a Contract to Conduct a Feasibility Study to determine:**

  (1) Determine what action must be taken to ensure that the new enterprise will be able to operate successfully in the competitive marketplace.
  (2) Analyze current program financial operations.
  (3) Identify opportunities to reduce costs.
  (4) Develop capitalization requirements for the new enterprise.
  (5) Identify whether current program customers will continue to do business with the new enterprise.
  (6) Assess capital equipment and facilities needs.
  (7) If applicable, identify legislation to effect the transition.
  (8) Create guidelines for involvement of program employees, to include representation of appropriate employee groups.
  (9) Develop procedures for protecting the benefits of current employees.
  (10) Develop model for the structure of the new enterprise to facilitate effective competition in the private sector.
  (11) Provide revenue and cost projections for the new enterprise for at least five (5) years.

  If the feasibility study indicates that the new enterprise can compete and succeed, the next step is to:

- **Issue a Request for Proposals and Execute a Contract to Implement the Employee Stock Ownership Plan**

  The Request for Proposals would require that the proposals shall include a team consisting of ESOP consultants, an ESOP trustee, financial advisors, investment banker (if applicable), and a legal advisor. The scope of work would include:

(1) Establish the ESOP Committee including employee representatives.
(2) Establish the Employee Stock Ownership Plan and Trust.
(3) Incorporate the new company.
(4) Conduct general education sessions with the employees.
(5) Develop a detailed financial model for the ESOP company.
(6) Develop the marketing plan.
(7) Prepare a financing and business plan.
(8) Obtain financing if necessary.
(9) Develop employee compensation and benefit plans.
(10) Recruit senior management for the new enterprise.
(11) Engage an ESOP valuation company.
(12) Engage an ESOP plan administrator for all record keeping.
(13) Negotiate the sale of the asset and/or the "franchise" fee to be paid to the state.

Depending on the size and the nature of the privatization, an independent cost-benefit analysis might be required. The last step is to:

- **Issue a Request for Proposals and Execute a Contract for the New Enterprise to Conduct Business with the Government**

This would be essentially a sole source procurement for the new enterprise pursuant to the Virginia Public Procurement Act. The request for proposals and contract is necessary to satisfy specific government terms of the contract. Initial contract terms should not exceed three to five years. Thereafter, a new request for proposals is issued and the new contract is open to all competitors.

XI. SUMMARY

This study did not reveal any current Commonwealth of Virginia rules, procedures, policies or limitations that would preclude an ESOP privatization of a government unit or service. Moreover, there is no current recognition or implementing regulations in the Code of Virginia pertaining to ESOPs.

At the federal and local government level, there presently exists, or are underway, innovative ESOPs generated from former government functions. It will be necessary for the Commonwealth to make an initial investment in funding a pre-assessment analysis and feasibility study in promoting ESOPs. The original investment is recoverable through cost savings or a favorable repayment contract provision with the newly created ESOP company/s performing the government service.

XII. CONCLUSION

An ESOP is an excellent privatization method for performing government services. It gives employees a voice in the action and they gain a direct stake in the equity growth of the privatized company. Employees will have an incentive to support the privatization process since job displacement concerns will be reduced.

The employees can achieve greater financial rewards when the ESOP is combined with other retirement plans, such as a 401(k) plan, which can provide substantially higher retirement benefits than under the state system. The rewards are predicated upon the success of the new privatized company. Experience in the private sector has demonstrated that once employees understand the potential for financial accumulation in the ESOP, many will become enthusiastic supporters of the privatization process.

In the ESOP privatization process, the opportunities for everyone to gain is present. The state can realize a fair selling price from the privatized entity to perform the service, taxpayers can look forward to a reduced cost of providing the service, and the privatized entity can offer the potential of significant financial rewards to the former government employees that have become employee owners. The reduction in the capital gains tax in the 1997 Tax Act will provide a strong motivation for substantial growth in ESOP formation.

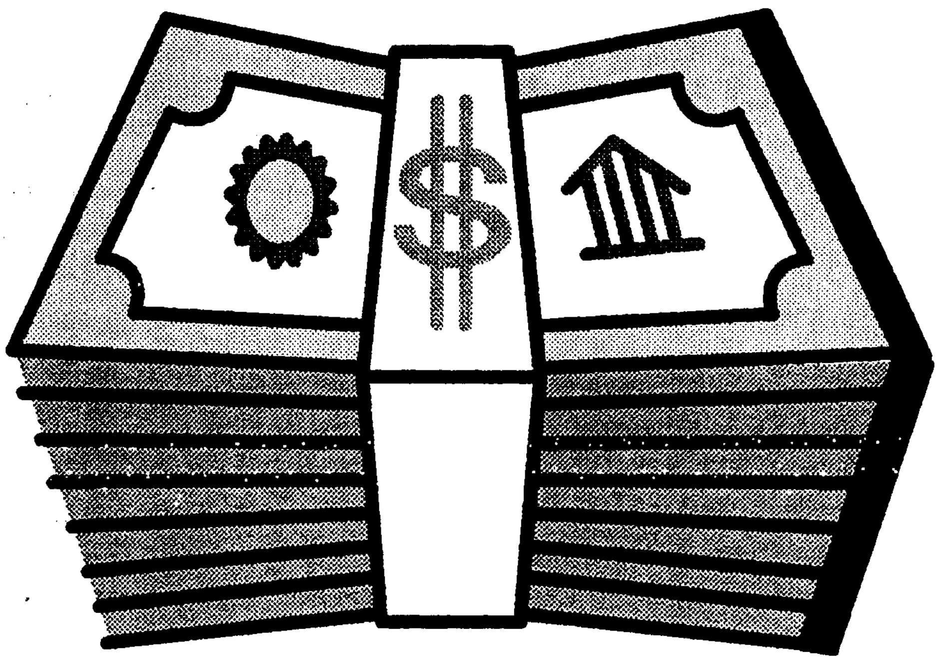
An ESOP privatization of a government function can produce multiple results: more cost-effective and efficient services; reduced government payroll with little or no job displacement; employee support for the privatization process; private sector job creation; increased tax revenues; and promotion of economic development.

XIII. RECOMMENDATIONS

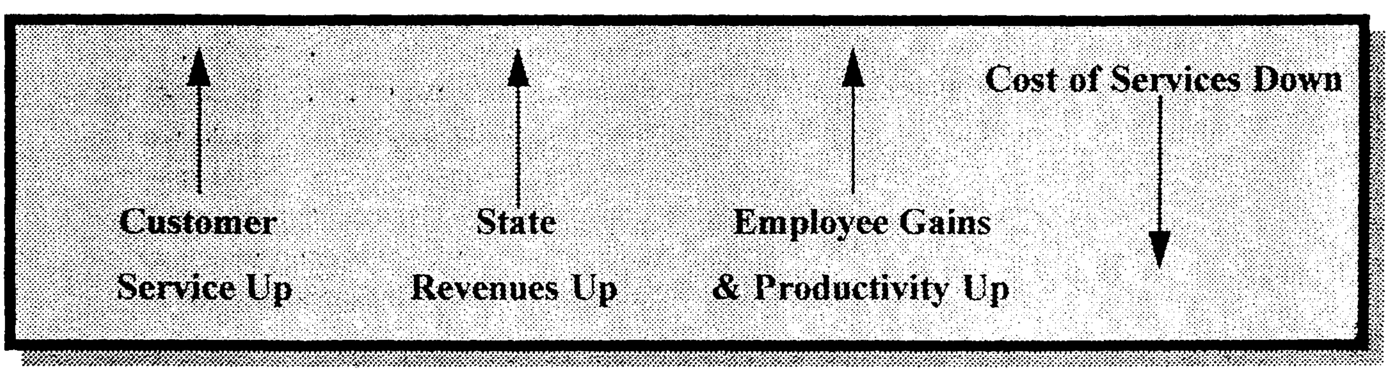
Consideration should be given by the Governor and the General Assembly to enact legislation for funding to support and assist current ESOP companies and to promote the creation of new ESOP companies in both the private and public sectors. This ownership transition service function should be assigned to an appropriate state agency. The mission of this service and state agency should be to promote employee participation and stock ownership by providing information, education, and technical services to employee groups and business owners and to generate awareness of the concept with the general public.

By providing practical information and assistance to help organizations implement equity-based compensation and broad-based participation programs, this service and agency will enhance economic and social development through broader ownership and involvement in the free enterprise system.

It is further recommended that funding be provided in the 1998-2000 budget to conduct a pre-assessment analysis and feasibility study on selected state functions that may be candidates for an ESOP privatization.



THE POTENTIAL WINNERS



APPENDICES

SENATE JOINT RESOLUTION NO. 284

Requesting the Secretary of Administration, in cooperation with the Commonwealth Competition Council, to study methods to privatize appropriate state government functions through the development and promotion of employee-owned companies.

Agreed to by the Senate, January 30, 1997
Agreed to by the House of Delegates, February 20, 1997

WHEREAS, the Commonwealth of Virginia desires to provide the citizens of the Commonwealth with services that are of high quality at an efficient cost; and

WHEREAS, the Commonwealth Competition Council is charged by § 9-342 of the Code of Virginia to review possible alterations in the Commonwealth's delivery of services to its citizens in order to ensure cost effective, high quality services; and

WHEREAS, it may be beneficial to convert some units of the Commonwealth's current government structure to the private, for-profit sector, by either converting the unit to a privately owned for-profit corporation, or by contracting with a privately owned corporation to perform the unit's tasks; and

WHEREAS, there are approximately ten thousand employee-owned corporations in the United States, which most frequently evolved through employee stock ownership plans; and

WHEREAS, there is ample evidence that employee-owned corporations often outperform traditional corporations by involving employees as owners in the decision making, providing additional performance incentives, and fostering entrepreneurial skills; and

WHEREAS, the use of an employee stock ownership plan in combination with the transfer of appropriate government functions from the public sector to the private sector may serve to minimize the loss of jobs for the public employees who are affected by such a transfer; now, therefore, be it

RESOLVED by the Senate, the House of Delegates concurring, That the Secretary of Administration, in cooperation with the Commonwealth Competition Council, be requested to study methods to privatize appropriate state government functions through the development and promotion of employee-owned companies. The study shall (i) examine the current rules, procedures, policies, and limitations of employee stock ownership plans in Virginia; (ii) examine current and innovative employee stock ownership plans in other states; and (iii) determine the necessary level of state financial support for such plans.

The Secretary shall complete his work in time to submit his findings and recommendations to the Governor and the 1998 Session of the General Assembly as provided in the procedures of the Division of Legislative Automated Systems for the processing of legislative documents.

THE EMPLOYEE OWNERSHIP 100

COMPANY	LOCATION	PLAN	BUSINESS	% OWNED	# EMP
Kroger Co.	Cincinnati, OH	ESOP	supermarkets	min	200,000
Publix Supermarkets	Lakeland, FL	ESOP, st purch.	supermarkets	maj	95,000
Rockwell International	Seal Beach, CA	ESOP	conglomerate	min	82,670
United Airlines	Chicago, IL	ESOP	airline	maj	77,900
McDonnell Douglas Corp	St Louis, MO	401(k)/ESOP	aerospace	min	67,500
Tandy Corp.	Ft. Worth, TX	ESOP	electronics	min	47,500
Hy-Vee Stores	Chariton, IA	ESOP	supermarkets	min	30,000
Hallmark Cards, Inc.	Kansas City, MO	profit sharing	greeting cards	min	28,500
TTC Inc.	Kankakee, IL	ESOP	employee leasing	min	25,000
Science Applications Int'l	San Diego, CA	ESOP & others	R&D & computer systems	maj	21,000
Ruddick Corporation	Charlotte, NC	ESOP	holding co.	min	20,100
Dyncorp	Reston, VA	ESOP	technical svcs.	min	18,000
Avis Inc.	Westbury, NY	ESOP	car rental	maj	12,500
Lifetouch	Minneapolis, MN	ESOP	photograph studios	maj	12,000
Price Chopper	Schenectady, NY	ESOP	supermarkets	maj	12,000
Parsons Corp.	Pasadena, CA	ESOP	engrng., mining, construction	maj	10,000
Armsted Industries	Chicago, IL	ESOP	manufacture industrial prod.	maj	9,000
Int'l Data Group	Framingham, MA	ESOP	computer magazines	min	7,500
AECOM	Los Angeles, CA	ESOP	energy technology	maj	7,000
Journal Communications	Milwaukee, WI	stock purchase	media/printing	maj	6,200
Avondale Shipyards	Westwego, LA	ESOP	shipbuilding	maj	6,200
Quad/Graphics	Pewaukee, WI	ESOP	printing	maj	6,000
Fiesta Mart	Houston, TX	ESOP	grocery chain	min	6,000
Figgie International, Inc.	Willoughby, OH	ESOP	fire protection	min	6,000
W.L. Gore Associates	Newark, DE	ESOP	"Gore-Tex"	maj	5,600
Austin Industries	Dallas, TX	ESOP	construction	maj	5,500
Pamida	Omaha, NE	ESOP	discount retail	min	5,400
Rural/Metro Corporation	Scottsdale, AZ	ESOP	fire & emergency	maj	5,200
Davey Tree Expert Co.	Kent, OH	ESOP	tree service	maj	5,200
Justin Industries	Ft. Worth, TX	ESOP	conglomerate	min	5,000
Herberger's	St. Cloud, MN	ESOP	retail	maj	5,000
Nat'l Steel & Shipbuilding	San Diego, CA	ESOP	shipbuilding	maj	5,000
Republic Engineered Steels	Massillon, OH	ESOP	steel mfr.	maj	4,900
Graybar Electric	St. Louis, MO	stock trust	electrical equipment	maj	4,800
Dentsply International	York, PA	ESOP	dental supplies	maj	4,500
King Kullen	Westbury, NY	ESOP	supermarkets	maj	4,300
American Bus. Prod. Inc.	Atlanta, GA	prof. sharing	paper products	min	4,034
Everen Securities	Chicago, IL	ESOP	brokerage	maj	4,000
CH2M Hill, Inc.	Corvallis, OR	stock purchase	engnrng., arch., & surveying	maj	4,000
Tyler Corp.	Dallas, TX	ESOP	divers. holding	min	4,000
Tandycrafts	Ft. Worth, TX	ESOP	crafts	min	3,633
Andersen Corp.	Bayport, MN	ESOP	window mfr.	min	3,600
Michael Baker Corp.	Pittsburgh, PA	ESOP	engineering	min	3,100
Allied Group	Des Moines, IA	ESOP	insurance	min	3,050
Waremart	Boise, ID	ESOP	supermarket chain	maj	3,000
Houchens Food Store	Bowling Green, KY	ESOP	supermarkets	maj	3,000
Herff Jones	Indianapolis, IN	ESOP	mfr. of awards and gifts	maj	3,000

COMPANY	LOCATION	PLAN	BUSINESS	% OWNED	# EMP
Century Tel. Enterprise	Monroe, LA	ESOP	telecommcts.	min	3,000
Capital Mercury Shirt Co.	NYC, NY	ESOP	shirt manufacturer	maj	3,000
Treasurer Chest Adver.	Glendora, CA	ESOP	printing	maj	3,000
Piper Jaffray Co. Inc.	Minneapolis, MN	profit sharing	investment firm	min	2,763
U.S. Sugar	Clewiston, FL	ESOP	sugar processor	min	2,700
Inter-Regional Fin. Group	Minneapolis, MN	ESOP	brokers	min	2,700
American Cast Iron Pipe	Birmingham, AL	stock trust	iron pipe and fittings mfr.	maj	2,600
Arthur D. Little	Cambridge, MA	profit sharing	consulting	maj	2,600
Norcal Waste Systems	SF, CA	ESOP	waste disposal	maj	2,500
General Medical Group	Richmond, VA	ESOP	medical equipment	min	2,500
Owen Healthcare Inc.	Houston, TX	ESOP	hosp phar suppl	min	2,300
Swank Inc.	Attleboro, MA	ESOP	leather goods	maj	2,200
Kysor Industrial	Cadillac, MI	ESOP	indus. machines	min	2,100
Butera Finer Foods	Elgin, IL	ESOP	supermarkets	maj	2,100
Phelps Inc.	Greeley, CO	ESOP	construction	maj	2,000
Crucible Materials Corp.	Syracuse, NY	ESOP	specialty steel	min	2,000
Redner's	Reading, PA	ESOP	supermarkets	min	2,000
Bureau of Natl. Affairs Inc.	Washington, DC	direct purchase	bus.inform. publisher	maj	1,830
Guckenheimer Enterprises	Redwood City, CA	ESOP	food distributor	min	1,800
Cranston Print Works	Cranston, RI	ESOP	textile printer	maj	1,700
Cal-Maine Foods	Jackson, MS	ESOP	eggs	min	1,600
Angeles Corp.	Los Angeles, CA	401(k)	holding company	min	1,600
North American Rayon	Elizabethton, TN	ESOP	rayon manufacturer	maj	1,500
Cianbro Corp.	Pittsfield, ME	ESOP	heavy construct	min	1,500
Dillingham Construction	Pleasanton, CA	ESOP	construction	maj	1,500
Seton Corporation	Troy, NY	ESOP	leather tanning	min	1,400
Erickson's	Hudson, WI	ESOP	supermarkets	maj	1,400
Alma Desk Co.	High Point, NC	ESOP	furniture mfr.	min	1,300
Sundt Corp.	Tucson, AZ	ESOP	construction	min	1,300
Rosauer's Supermarkets	Spokane, WA	ESOP	supermarkets	maj	1,300
Physician Sales & Services	Jacksonville, FL	ESOP/dir purch	medical supply	min	1,300
Kolbe and Kolbe	Wausau, WI	stock bonus	window manufacturing	maj	1,300
Dahl's Inc.	Des Moines, IA	ESOP	supermarkets	maj	1,200
Ruiz Foods	Dinuba, CA	ESOP	frozen food	maj	1,200
Aspen Systems Corp.	Rockville, MD	ESOP	computer services	maj	1,200
Tidyman's Warehouse Foods	Spokane, WA	ESOP	grocery retail	maj	1,200
Performance Food Group	Nashville, TN	ESOP	food dist.	min	1,150
Hot Dog on a Stick	Solano Beach, CA	ESOP	fast food outlets	maj	1,100
Scolaris Food & Drug	Reno, NC	ESOP	supermarkets	maj	1,100
Merkert Enterprises	Canton, MA	ESOP	food broker	maj	1,100
Topps Co. Inc.	Brooklyn, NY	ESOP	chewing gum	min	1,100
Burns & McDonnell Engr. Co	Kansas City, MO	ESOP	engnrs. archtct. consulnts.	maj	1,050
Mutual Savings Life	Decatur, AL	ESOP	insurance	maj	1,050
STV Engineers	Pottstown, PA	ESOP	engr,arch serv	min	1,023
Reliable Stores	Columbia, MD	ESOP	dept. store chain	maj	1,000
Kiwi International Airlines	Newark, NJ	direct purchase	airline	maj	1,000
Okonite Company	Ramsey, NJ	ESOP	wire & cable manufacturer	maj	1,000
Springfield Remanufacturing	Springfield, MO	ESOP	engine remfr.	min	1,000
Ecker Enterprises	Chicago, IL	ESOP	constructuion	min	1,000
Rockford Products	Rockford, IL	ESOP	fasteners	maj	1,000
Foster and Gallagher	Peoria, IL	ESOP	direct mail	maj	1,000
				Total Employees:	1,634,000

MAJOR ESOP FEDERAL LAWS

1. **Regional Rail Reorganization Act of 1973:** This was the first statute to mention "ESOPs". It required a feasibility study of the use of an ESOP for the reorganization of the Northeast freight rail system into Conrail.

2. **Employee Retirement and Income Security Act of 1974 (ERISA):** This law created a specific statutory framework for ESOPs and carefully exempted them from certain requirements applicable to other benefit plans. The act thereby provided ESOPs with the unique authority among employee benefit plans to borrow money. It required ESOPs to invest primarily in employer securities. ESOPs were defined as "qualified employee benefit plans," meaning that contributions to them are tax-deductible and that they must abide by the allocations, vesting, and other rules ERISA applies to qualified benefit plans.

3. **Small Business Employee Ownership Act of 1980:** Prior to this Act, the SBA would not guarantee loans to ESOPs. This Act provided statutory authority for the SBA to make loan guarantees to ESOPs and made their rules for loans to employee situations more liberal.

4. **Economic Recovery Tax Act of 1981:** This Act contained several provisions. First, it authorized payroll-based stock ownership plans. Second, the Act raised limits on how much could be deducted for contributions to a leveraged ESOP. This new law raised the limits from 15 percent to 25 percent of payroll to cover the principal part of the repayment and an unlimited amount of the interest portion. Third, the Act allowed companies that are substantially employee-owned to require that departing employees take cash for the fair market value of their stock, rather than the stock itself when receiving their ESOP distribution.

5. **Deficit Reduction Act of 1984:** This Act contains the most significant incentives for employee ownership. They include:

   a) A provision allowing an owner of an independent business to defer taxation on the gains made by a sale of stock to an ESOP by reinvesting the gains within 12 months in the stock or stocks of other domestic companies. When that new stock is sold, taxes would be due. At least 30 percent of the ownership of the firm must be held by the ESOP after the transaction for the provision to be effective;
   b) A provision allowing commercial lending institutions to deduct 50 percent of the interest income they receive from a loan to a company for the purchase of acquiring stock through an ESOP;

c) A provision allowing an ESOP company to deduct dividends paid directly to ESOP participants.

6. **Tax Reform Act of 1986:** This Act made a number of technical changes in ESOP law, as well as adding several new incentives for ESOPs and a number of new regulations.

New Incentives:
-Dividends contributed to an ESOP can be used to repay an ESOP loan.
-Dividends do not count against the 25 percent of covered compensation limit that normally can be deducted to repay the principal part of and ESOP loan.

New Regulations:
-If requested by the employee, ESOPs are required to distribute up to 25 percent of account balances to employees over age 55 with 10 years ESOP participation and up to 50 percent for employees age 60 with 10 years ESOP participation;
-Independent, outside appraisals must be performed for all ESOP companies at least annually;
-After 1989, employees receiving their ESOP distribution before age 59 ½ must pay a 10 excise tax on the amount unless they roll it over into an IRA or have it paid in a life annuity;
-Vesting must be complete in seven years if gradual or five years if vesting does not start until the fifth year;
-Rules were tightened to prevent discrimination on employee participation.

7. **Small Business Job Protection Act of 1996:** This legislation made a number of important changes in laws governing ESOPs and employee benefit plans:

a) It repealed Section 133 of the IRS Code, which had provided that qualified lenders to ESOPs could exclude 50 percent of the interest income from ESOP loans;
b) ESOPs will be allowed to own stock in Subchapter S corporations effective tax years after December 31,1997;
c) Contributions to defined benefit pension plans will no longer have to be combined with contributions to defined contribution plans when calculating whether a company is exceeding contribution limits for all ERISA plans. This change is effective after December 31,1999;
d) Employee deferrals to tax-qualifed plans, such as 401(k) plans and cafeteria plans, will no longer reduce the definition of eligible pay for purposes of determining whether an individual plan participant received an excess contribution.

8. **The Taxpayer Relief Act of 1997:** This Act, signed into law on August 5, 1997, contains provisions that permit Subchapter S corporations to sponsor an ESOP, with certain characteristics different from the treatment of C corporations sponsoring an ESOP. The "ESOP rollover" will not apply, contribution limits will be 15 percent of pay in all plans, interest payments on ESOP loans will count towards the contribution limits, and dividends will not be deductible. "TRA '97" also makes important technical corrections to the provisions of the Small Business Job Protection Act of 1996 that allows S corporation stock to be owned by ESOPs beginning in 1998.

An S corporation will not be required to offer participants the right to receive distributions in the form of employer stock. These plans may make all distributions in cash. Finally, an S corporation ESOP will not be subject to income tax on its share of the net income of the S corporation or on gains realized upon the disposition of employer stock.

"TRA '97" also reduces the maximum rate of tax on long-term capital gains and thereby creates opportunities for increased tax savings for certain lump sum distributions of plan benefits in the form of employer stock.

APPENDIX D

MAJOR ESOP STATE LAWS

State Cooperative Statutes

Connecticut, Maine, Massachusetts, New Hampshire, New York, Washington, and Vermont have each passed identical legislation establishing a state worker cooperative incorporation statute. The laws make it clear that companies can incorporate as worker cooperatives, use an internal accounting system similar to profit sharing, be based on the membership of workers, follow one-member, one-vote rules, and use the word cooperative in their corporate name.

Laws and Programs Providing Financial and Technical Assistance Support

Connecticut, Hawaii, Illinois, Massachusetts, Michigan, Montana, New Jersey, New York, Ohio, Oregon, Pennsylvania, Washington, and Wisconsin have each passed laws providing loans and/or loan guarantees for worker buyout efforts, funds for technical assistance buyouts, or programs for general outreach on employee ownership. A short synopsis of some of these state laws is described below.

Connecticut's law directs the Department of Economic Development to help fund both feasibility studies and provide financing for employee buyouts of plants that would otherwise be closed or sold to out-of-state companies.

Hawaii reinstated legislation in 1996 to actively promote and support expanded ownership and participation in Hawaii businesses.

Illinois law provides authority for the Department of Commerce and the Employee-Owned Enterprise Advisory Council to assist buyouts. Bond-backed financing can be used for low-interest loans with a limit of $250,000 or 25 percent of the purchase price, whichever is lower. The Department can also conduct outreach programs and provide technical assistance for buyout efforts.

Massachusetts, in 1989, passed "An Act Providing For Employee Involvement and Ownership Projects." The law created the Massachusetts Office of Employee Involvement and Ownership to provide technical assistance, education, and training for employee ownership and participation programs.

Michigan has passed six laws similar to the concept in Massachusetts.

A **Montana** law passed in 1989 directs the Department of Commerce to spread information about employee ownership and exempts ESOPs from securities registration.

New Jersey's 1983 law directs the Commissioner of Commerce and Economic Development to provide information on employee stock ownership plans and assist employee buyouts in cases in which substantially higher unemployment will result.

New York's "Employment Ownership Assistance Act" of 1983 provides the Department of Commerce with authority to promote the idea of employee ownership. Through a 1987 executive order, New York also created the New York Center for Employee Ownership and Participation to provide training and assistance to employee ownership programs and to assist new potential ESOPs. This function is now called "Ownership Transition Services" and is part of the Empire State Development Corporation.

Ohio's law assists persons seeking employee ownership as an alternative to closing or relocating a firms's operation. In addition, the Ohio Employee Ownership Center provides information and presentations on employee ownership, as well as prefeasibility studies for those considering it.

Oregon's 1985 law created the Oregon Stabilization and Conversion Fund to provide studies for troubled companies.

Pennsylvania's "Employee Ownership Assistance Program", passed in 1984, provides funding for feasibility studies and professional services assistance.

Washington's "Employee Cooperative Corporations Act", passed in 1987, directed the Washington Department of Community Development to conduct education and provide technical assistance for employee ownership companies. The department can loan up to $700,000 in state development loans to employee ownership companies.

Wisconsin's "Employee Ownership Act", passed in 1983, provides a $25,000 grant to companies considering employee ownership. The grant is forgiven if the plan goes through.

APPENDIX E

KEY ORGANIZATIONS

1. **The ESOP Association, Washington, D.C.**

   Trade organization for ESOP firms.

2. **Foundation for Enterprise Development, Washington, D.C.**

   Organization promoting entrepreneurship and employee ownership.

3. **Massachusetts Corporation for Business, Work, and Learning, Office of Employee Involvement and Ownership, Boston, Massachusetts**

   Information, technical assistance, and funding for feasibility studies.

4. **Empire State Development Corporation, Office of Ownership Transition Services, New York, New York**

   State-funded organization providing education, research, technical assistance and funding for employee ownership efforts.

5. **Ohio Employee Ownership Center, Kent State University, Kent, Ohio**

   Non-profit organization providing information and preliminary technical assistance for employee ownership efforts in Ohio.

6. **The National Center for Employee Ownership, Oakland, California**

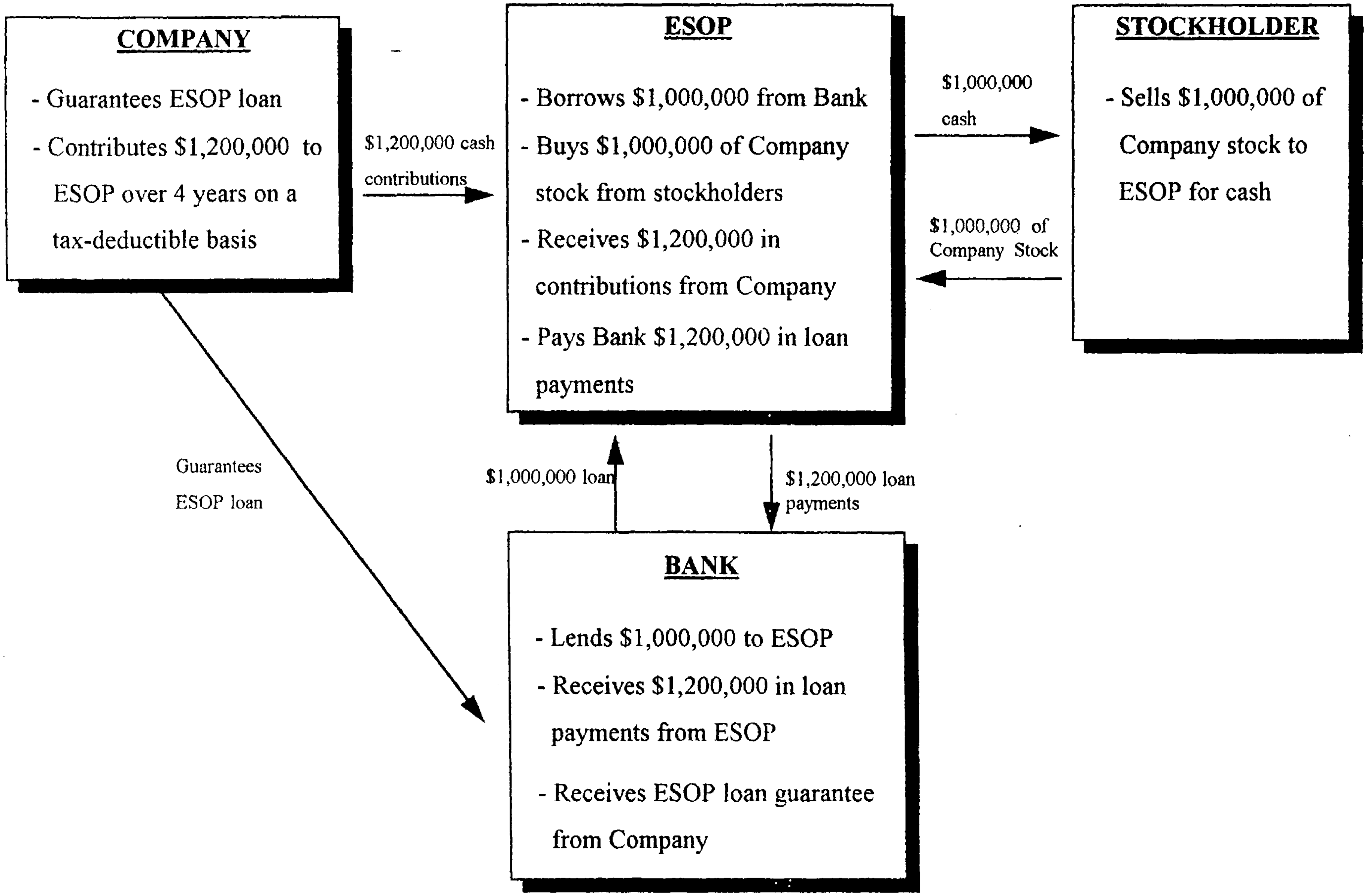
   Non-profit organization providing research and technical assistance to employee-owned companies.

7. **Washington Department of Community, Trade and Economic Development, Employee Ownership Program, Olympia, Washington**

   State-funded organization providing education, research, technical assistance and funding for employee ownership efforts.

SCHEDULE 1

Step 1 - ESOP Loan, Stock Purchase, Company Contributions and Loan Payments



SCHEDULE 2

Step 2 - Benefit Distributions and Redemption by Company

COMPANY

- Purchase of Company stock at current market value
- Payment for purchased Company stock with after-tax dollars

ESOP

- Distribution of Company stock to participant

Company stock

Company stock

Cash or
5-year note
with security
(Company option)

PARTICIPANT

- Receipt of Company stock from ESOP
- Redemption of Company stock to Company

Note that the redemption of stock is at **current fair market value** and that the Company purchase is with after-tax dollars

ACCOUNTING ENTRIES FOR LEVERAGED ESOPS

Assumptions.

- Annual covered compensation of participants - At least $1,000,000. Reason is that maximum deductible employer contribution is 25% of covered payroll to pay principal on an ESOP loan plus interest used to carry the ESOP loan.

- Employer has only one class of stock - common stock - and has 172,500 shares issued and outstanding.

- $1,000,000 "direct loan" from unrelated bank to ESOP under following terms:

    - 4 equal principal payments of $250,000 paid at end of each year.
    - Stock acquired by ESOP with loan proceeds pledged as security for bank loan. Note stock must be released from pledge as same stock in ESOP loan "suspense account" is released and allocated to participants' accounts in the ESOP each year (see below).
    - Employer guarantees bank's loan to ESOP. Employer gives security interest in certain of its assets.
    - Interest at 8% paid annually at end of each year on unpaid loan balance.
    - Loan payments:

Year	Principal	Interest	Total
1	250,000	80,000	330,000
2	250,000	60,000	310,000
3	250,000	40,000	290,000
4	250,000	20,000	270,000
	1,000,000	200,000	1,200,000

- Loan is used to purchase $1,000,000 of employer securities from a stockholder (100,000 shares at $10.00 per share, based on fair market value (FMV) as determined by an independent appraisal).

- Employer contributions equal amounts needed to make loan payments. Dividends on stock acquired with ESOP loan proceeds could be used to pay ESOP loan.

- Purchased shares are allocated to an ESOP loan "suspense account" and are released and allocated to participants' accounts in the ESOP each year as contributions (and any dividends) are used to make loan payments on basis of loan payments for year divided by total of current and future years' loan payments (note that the pledge agreement for the ESOP's shares must provide for a release consistent with the ESOP loan "suspense account" release):

Year	Current Year Loan Payment	Percentage of Shares Released and Allocated to Participants' Accounts	# of Shares Released and Allocated to Participants' Accounts
1	330,000	27.50%	27,500
2	310,000	25.83%	25,830
3	290,000	24.17%	24,170
4	270,000	22.50%	22,500

- Assume the FMV per share is as follows at the end of each year:

Year	FMV Per Share	FMV of Shares Released and Allocated to Participants' Accounts
1	11.00	302,500
2	10.00	258,300
3	12.50	302,125
4	14.00	315,000

Employer's Balance Sheet Reporting

Pre-Leveraged ESOP Balance Sheet

	Assets		Liabilities
Assets	3,500,000	Total Liabilities	2,000,000
		Stockholders' Equity	1,500,000
Total Assets	3,500,000	Total Liabilities & Stockholders' Equity	3,500,000

Post-Leveraged ESOP Balance Sheet

	Assets		Liabilities
Assets	3,500,000	Liabilities:	
		Other Liabilities	2,000,000
		ESOP Debt	1,000,000
		Total Liabilities	3,000,000
		Stockholders' Equity:	
		Unearned ESOP Shares	(1,000,000)
		Retained Earnings & Paid-In Capital	1,500,000
		Total Stockholders' Equity	500,000
Total Assets	3,500,000	Total Liabilities & Stockholders' Equity	3,500,000

Employer's Accounting Journal Entries

Year 1 (inception):

The following are the journal entries (exclusive of entries for current and deferred taxes).

Unearned ESOP shares (contra-equity account)	1,000,000	
Debt		1,000,000

[To record ESOP loan and ESOP's purchase of 100,000 shares at $10 per share]

Interest expense	80,000	
Accrued interest payable		80,000
[To record interest expense]		

Accrued interest payable	80,000	
Debt	250,000	
Cash		330,000
[To record debt payment]		

Compensation expense	330,000	
Paid-in capital		27,500
Unearned ESOP shares		302,500

[To record release of 27,500 shares at assumed $11.00 per share value when "shares are committed to be released", which value normally will vary during the year]

Employer's Earnings Per Share

Year 1 (inception):

At the end of Year 1, 27,500 of the 100,000 shares held in the ESOP would be considered outstanding for earnings per share calculations. Thus, assuming no other changes in issued and outstanding stock, the employer would be considered to have 100,000 shares issued and outstanding stock for earnings per share calculations (that is, the 72,500 held by non-ESOP shareholders and the 27,500 "allocated" shares held in the ESOP).

Dividends. If the employer had paid dividends in Year 1 and the dividends were used to pay debt service on the ESOP loan, the journal entries would not have changed. This is because no ESOP owned shares were released from the suspense account and allocated to participants' account until year end, and dividends on shares which are not allocated to participants' accounts where the dividends are used for debt service are reported as a reduction of debt and accrued interest (and are not charged to retained earnings).

COMMONWEALTH COMPETITION COUNCIL PROCESS

Step One

INPUT

- Public Hearings
- Business Interests
- Government Input
- Opportunity Inventory

Step Two

SELECTION

- Public or Private Performance Analysis

Step Three

COMPETITION

- Virginia Public Procurement Act
- Request for Proposals
- Invitation for Bid
- Evaluation

Step Four

AWARD

- Cost Comparison
- Independent Audit
- Appeal Process

Step Five

MONITOR

- Quality Assurance
- Post Performance Review

Process approved by the Commonwealth Competition Council on May 15, 1996.

State Employee Benefits

TYPE OF BENEFIT		PROVISIONS	LEGAL REQUIREMENT	
			(STATE)	PRIVATE)
LEAVE				
	ANNUAL	12-21 DAYS PER YEAR, BASED ON SERVICE CARRYOVER UP TO 2X ACCRUAL PAID ON SEPARATION		
	SICK	15 DAYS PER YEAR NO MAXIMUM ACCRUAL 1/4, TO $5000, PAID ON SEPARATION		
	MILITARY	15 DAYS PAID PER YEAR UP TO 5 YEARS UNPAID	X	X
	FAMILY/MEDICAL	UP TO 12 WEEKS UNPAID OR USING OTHER PAID LEAVE WITH 12 MOS, 1250 HOURS	X	IF 50 EMPLOYEES
	EDUCATIONAL	WITH FULL, PARTIAL, OR NO PAY UP TO 2 YEARS COSTS MAY BE PAID		
	ADMINISTRATIVE	WITH PAY FOR JURY DUTY, COURT APPEARANCE, STATE JOB APPL. GRIEVANCE HEARINGS, DISASTER ASSISTANCE		X PAY NOT REQUIRED
	OVERTIME	FLSA NON-EXEMPT ALTERNATIVE TO 1.5X PAY		NOT YET ALLOWED
	COMPENSATORY	NON-EXEMPT FOR EXTRA HRS <40; SOME EXEMPT >40; BOTH FOR HOLIDAYS, EMERGENCY CLOSINGS		
	SCHOOL	8 HOURS PAID LEAVE PER YEAR TO ASSIST SCHOOLS		
	HOLIDAYS	11 PAID, PLUS ANY DESIGNATED BY GOVERNOR	X	
	LEAVE-SHARING	EMPLOYEES MAY DONATE ANNUAL LEAVE TO SICK EMPLOYEES ON UNPAID LEAVE		

TYPE OF BENEFIT		PROVISIONS	LEGAL REQUIREMENT (STATE)	PRIVATE)
INSURANCE				
	LIFE	2X SALARY PLUS OPTIONAL AT EMPLOYEE COST	X	
	AD&D	2X LIFE BENEFIT FOR DEATH PAYMENT FOR DISMEMBERMENT	X	
	S-T DISABILITY	UNDER CONSIDERATION NOT OFFERED NOW		
	L-T DISABILITY	>=50% SALARY W/O SOC.SEC.' PART OF RETIREMENT PLAN	X	
	WORKERS' COMP	SELF-INSURED FULL PAY 1ST 92 DAYS OTHER LEAVE MAY SUPPL 2/3 WC BENEFIT AFTER 92ND.	X	X
	SOCIAL SECURITY		X	X
	UNEMPLOYMENT COMPENSATION		X	X
	HEALTH	POS,PPO,HMO'S INCLUDES DENTAL EMPLOYEE & FAMILY COVERAGE EMPLOYEE CONTRIBUTES OPTIONAL COVERAGE AVAIL. PREMIUM CONVERSION, MED. & CHILD CARE ACCTS.	X	
SALARY ADMINISTRATION				
	SUPPLEMENTS	SOME ARE PAID FOR SHIFT, ON-CALL, CALL-BACK, & ACTING ASSIGNMENTS		
	FLSA OVERTIME	1.5X FOR NON-EXEMPT	X	X
	OTHER OVERTIME	1X OR 1.5 X FOR SOME EXEMPT EMPLOYEES		
	SALARY RANGE ADJUSTMENTS	EMPLOYEES ARE USUALLY GRANTED GENL. INCR. AMOUNT	X	
	COMPETITIVE DIFFERENTIALS	UP TO 25% IN NOVA OR FOR HARD-TO-FILL JOBS		

TYPE OF BENEFIT	PROVISIONS	LEGAL REQUIREMENT (STATE)	PRIVATE)
MISCELLANEOUS			
FLEXIBLE WORK HOURS			
SERVICE AWARDS			
UNPAID LUNCH BREAK			
PAID BREAKS	OPTIONAL FOR AGENCIES TO ALLOW 2 15-MIN. EACH		X
LAYOFF	BY SENIORITY W/IN UNIT, LOCATION, JOB CLASS; NO BUMPING		
SEVERANCE	4-36 WEEKS, 2 WEEKS PER YEAR OF SERVICE	X	
TELECOMMUTING	LIMITED SITUATIONS; STATEWIDE POLICY UNDER DEVELOPMENT		
RETIREMENT	DEFINED BENEFIT 1.5-1.65% OF SALARY PER YER OF SERVICE 55/30; 50/10 WITH REDUCED BENEFIT	X	
	DEFERRED COMPENSATION		
PROBATIONARY PERIOD	SIX MONTHS EXCEPT WHERE EXTENDED TRAINING IS REQUIRED	X	
GRIEVANCE PROCEDURE			
PARKING	EMPLOYEE PAYS $35 PER MONTH IN RICHMOND		
INCENTIVES			
PERFORMANCE INCREASES	UP TO 6.9% WHEN FUNDED	X	
SUGGESTION PROGRAM	EXTRA LEAVE OR UP TO $5000 + 1% OF SAVINGS	X	
RECOGNITION AWARDS	NON-MONETARY, $25/YEAR MAX.		
INCENTIVE PAY	ANNUAL & SPOT AWARDS, LIMITED PILOT PROGRS.		

EMPLOYEE OWNERSHIP AND CORPORATE PERFORMANCE

Courtesy of National Center for Employee Ownership
1201 Martin Luther King Jr. Way, Oakland, CA 94612 (510)272-9461

1. A 1986 NCEO study established the first definitive causal link between employee ownership and improved corporate performance. The ESOP companies had sales growth 5.40% faster than their competitors after their plans versus 1.89% per year before. The ESOP companies had employment growth 5.05% per year faster than their competitors after establishing their ESOP, versus 1.21% before their ESOPs. Both statistics have at least a 95% confidence level (i.e., there is only a 5% probability that the difference could be due to chance). Because the study analyzed ESOP companies performance via-a-vis their competitors for several years both before and after their ESOPs were installed, it is certain that most of the superior performance of ESOP companies is due to ESOPs, not due to the fact that better performing companies are more likely to set up ESOPs (although that seems to be true also).

   The study also found that companies which combined ownership with job-level participation programs did even better than companies which simply started an ownership plan. The most participative companies improved their performance by about 8-11% on various measures of growth as compared to their pre-ESOP performance, versus about 3.5% for the least participative.

2. A 1989 University of New Orleans Study found that, on average, employees in publicly traded ESOP companies receive two to three times as much income from their ESOP as other employees receive from other types of benefit plans. Because the specific value of this benefit varies with the performance of the employer's stock, the ESOP is a major financial incentive for employee performance.

3. *Employee Ownership in America: The Equity Solution*, the result of a four-year study by the NCEO of 37 ESOP companies, found that the most important factor associated with positive employee attitudes toward ownership was a large annual increase in the value of their ESOP accounts. Other important factors included management's attitude toward employee ownership and job-level participation opportunities. This study measured employee attitudes, but did not measure corporate performance directly.

4. A 1988 ESOP Association survey of member companies found that 16% of the companies believed ESOPs had "strongly improved" their productivity, while 59% believed that employee motivation and productivity had "somewhat improved".

5. A 1984 NCEO study for the New York Stock Exchange of thirteen companies that were 10% or more employee owned found that these firms outperformed 62-75% of their competitors, depending on the measure used (net operating margin, return on equity, sales growth and book value per share).

6. A 1987 study by the General Accounting Office, based on data collected between 1975-1982, found ESOPs had no statistically significant impact on productivity as measured by value added divided by compensation, or on profitability as measured by after-tax return on assets. Some analysts believe that these measures may be unequal tests for ESOP companies, since the presence of an ESOP drives up compensation (the denominator of the productivity measure) and reduces after-tax profits (the numerator of the profitability measure; ESOP contributions are an expense on the financial statements). The report also noted that it collected data on ESOP companies for three years after their ESOP was installed (i.e., plans were installed during 1976-1979), and "it may be that three years is too short a time for any effects of ESOPs to appear". This report did not analyze measures such as sales and employment growth.

7. A 1980 study reported in the *Journal of Corporation Law* found that companies with ESOPs had twice the annual productivity growth rate of comparable conventional firms during the 1975-1979 study period.

8. *The 100 Best Companies to Work For, 1984*, found that sharing ownership was one of the characteristics of desirable employers, and listed eight substantially employee owned companies among the top 100.

9. A 1984 *Savvy* magazine survey of the best companies for women to work for added nine companies to their list, five of which were substantially employee owned.

10. A 1984 McKinsey and Company study, "The Winning Performance of Mid-Sized Growth Companies" found that these successful firms tended to share ownership with employees to a greater degree than larger firms.

11. A 1983 NCEO study found that companies with a majority of their stock owned by employees generated three times more net new jobs per year as non-ESOP firms.

12. A 1984 Atlanta Federal Reserve study of 22 premier companies in the South found employee ownership to be a common thread.

13. A 1978 University of Michigan Survey Research Center study found that in a sample of 30 employee ownership companies, profits were 1.5 times as high as those in comparable conventional firms.

14. A 1989 study by MCS Associates concerning executive compensation found that ESOP plans are in place at 43% of all surveyed thrifts, up 71% since 1986.

15. A 1989 study by Hill and Knowtion concerning the effects of ESOPs on shareholders found that 85% of the professional analysts believed that ESOPs build shareholder value if the ESOP is advertised as a means to boost productivity and motivate employees.

16. A 1989 study conducted by the National Chamber Foundation of the tax costs and benefits of ESOPs found that the Treasury Department estimate of the tax cost of ESOP was $160 per person for the 20 million plan participants. This $160 per person investment is offset by productivity improvements ranging from 3 to 17 percent per year, job growth in ESOP companies of roughly twice what would otherwise be the case, new savings per employee of roughly $3,100 per year and new tax revenue on that savings.

COMMONWEALTH OF VIRGINIA
COMMONWEALTH COMPETITION COUNCIL

ESOP QUESTIONNAIRE/SURVEY

1. Company Name: ______________________________

2. Address: ______________________________

3. Phone No: ____________ FAX: ____________ E-Mail: ____________

4. Year ESOP established:__________ Number of Company Employees: __________

5. Is your ESOP now, or has it ever been leveraged? Yes___ No___

6. ESOP ownership majority percentage:__________ Minority percentage:__________

7. On a scale of 1 to 10 please indicate the extent to which the ESOP has been a positive motivational factor in your company, with 1 being no favorable impact to 10 being very strong motivational impact:

1	2	3	4	5	6	7	8	9	10
❑	❑	❑	❑	❑	❑	❑	❑	❑	❑

8. Please check the principal reason(s) why the ESOP was established. More than one reason can be checked:

❑ Employee motivation
❑ Improve employee productivity
❑ Improve customer service
❑ Reward loyal long-term employees
❑ To remain competitive
❑ Tax deduction for corporation
❑ Increase working capital
❑ Perpetuation of the business
❑ It's the way of the new world
❑ Liquidity for selling to shareholders
❑ Other: ______________________
____

9. How do you evaluate your decision to establish an ESOP?

_______ Has had a positive effect on company performance and profitability
_______ Performance, profitability, and employee motivation is the same as the pre-ESOP company
_______ A bad decision that has harmed the company

10. We also have a: 401(k) plan ___ Profit-Sharing plan ___ Pension Plan ___

11. Based on your experience with your ESOP, if a Virginia governmental entity or function was privatized, what level of employee ownership of the privatized company is necessary to make it succeed?

___ 25% to 50%
___ 50% to 75%
___ 75% to 100%

12. Is your company a current government contractor? Yes ___ No ___

13. If the answer to question 12 is *no*, would your company be interested in becoming a government contractor? Yes ___ No ___

14. Does your company support the concept of converting certain governmental services to an ESOP? Yes ___ No ___

15. If the answer is *yes* to question 14, what areas of government do you think are candidates for an ESOP:

____
____
____
____
____

The following space is provided for any additional information you wish to provide:

____
____
____
____
____

Please Print Your Name: ____________________

Signature: ____________________

Title: ____________ Phone No. ____________

Date: __________

THANK YOU VERY MUCH FOR YOUR ASSISTANCE

Please return the survey to the following address:

Mr. Otis L. Brown
Chairman
Commonwealth Competition Council
P.O. Box 1475
Richmond, VA 23218-1475