

Providence Business News

Serving Southern New England

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June 2-8, 2003

Companies see benefits of employee ownership

By **Mike Colias**
Staff Writer

Peter Hallock wasn't about to abandon his "baby."

Hallock and his wife founded Gripnail Corp. in East Providence in 1966. A few years ago, staring down age 70, Hallock's thoughts turned to what would become of the manufacturing business when he retired.

"When you build a business, it's your baby, and you want to be careful about what happens to it when you let go," Hallock said. "I've seen so many times in Rhode Island somebody sell out, and the employees who helped build the business are left standing on the sidewalk."

After a little soul searching and a lot of research, Hallock reached his decision: The company in 2000 started an "employee stock ownership plan," or ESOP, a benefit plan that buys and holds company stock for its employees.

Hallock says the move was a winner all the way around: It enabled him to keep majority ownership in the company while also creating some liquidity. And the business's 50 employees are building equity without contributing a dime of their own money.

Congress passed legislation in 1974 creating ESOPs. There now are more than 11,000 such plans covering about 8.5 million workers. About 10 percent of the plans are of publicly traded companies, including consumer-products giant Procter & Gamble and West Kingston-based American Power Conversion Corp.

An ESOP works like this: A company sets up a trust fund and, using profits, makes tax-deductible contributions to buy shares of company stock for individual employee accounts. When employees leave or retire, the company is obligated to buy back the stock. (Shares usually become fully vested in five to seven years).

The plans have garnered much negative media attention recently in connection with United Airlines.

The company created the country's largest ESOP in 1994 as a means of averting a financial meltdown. Now, with United expected to emerge from bankruptcy later this year, the plan likely will be wiped out, according to analysts.

But examples like United are rare, according to the National Center for Employee Ownership. Most commonly, ESOPs are started to create a market for the shares of departing owners of profitable, closely held companies who want to either leave the business or create liquidity.

The Gripnail plan is an example of a "leveraged ESOP." The company took out a bank loan in order to pay Hallock for a share of the business. Gripnail now is in the midst of repaying the loan over five years through regular, tax-deductible contributions.

Gripnail employees now own 30 percent of the business. And although Hallock hasn't retired yet, he says he'll have peace of mind when it comes time.

"I could leave and feel pretty good knowing the company would

Harbor Corp., which started an ESOP in 1995.

Newport Harbor owns a number of tourist-related businesses, including Newport Yachting Center, the Mooring Restaurant, Admiral Fitzroy Inn and the Newport Boat Show. It formed its employee-stock program to allow its 75 or so shareholders to liquidate some of their shares for estate-planning purposes, O'Reilly said.

Since then the company has worked to promote an "ownership culture," O'Reilly said. About 125 employees who participate in the ESOP now feel and act more like owners, he said, which is critical in a tourism industry traditionally dependent on seasonal, often ambiguous help.

"I feel like we get an unusually high level of customer service from our employees," O'Reilly said. The company now is 42 percent employee owned.

While many companies tout ESOPs as a win-win arrangement that benefits both owners and employees, the national association does offer a few caveats.

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stay in Rhode Island and be run by the same people who run it now," he said. "And the employees have benefited because they've gotten something that didn't cost them anything."

Research consistently has shown that an ESOP serves as a motivating force by instilling a sense of ownership in employees. Companies with employee-ownership plans grow roughly 2.4 percent faster than companies that don't have such programs, according to a 2000 study by two researchers at Rutgers University.

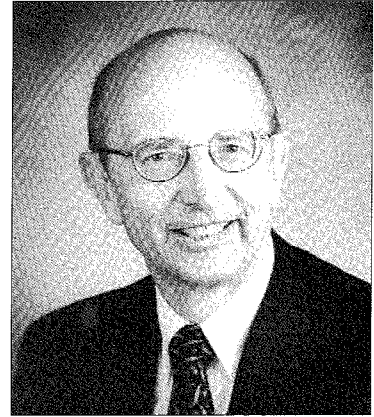
"We have definitely seen an increase in productivity," said J. Timothy O'Reilly, president and chief executive officer of Newport

Setting up even a simple ESOP at a small company can cost \$20,000 in administrative fees and appraisal expenses, the center says. For private companies, annual appraisals are required to determine the fair-market value of the company's shares.

A leveraged ESOP, which requires a bank loan, will cost even more after tacking on loan fees and legal and consulting costs.

Because of the costs involved, ESOPs generally work best for companies with at least 20 employees, the national center says.

Compensation expenses can be another downside to ESOPs,



Robert W. Edwards Jr.

because a company agrees to repurchase stock every time an employee leaves.

For that reason, companies with ESOP plans that decide to go public are in an ideal position because it reduces their "repurchase liability," according to Robert W. Edwards Jr., a partner at Nixon Peabody LLP's Providence office who specializes in ESOPs.

Instead of being obligated to buy back employees' shares, those shares instead can be sold on the open market — thus reducing the company's compensation expense, said Edwards, who advised Gripnail in setting up its ESOP.

Edwards said there is a growing interest in ESOPs in New England and nationally, partly due to a difficult credit environment and a slowdown in merger and acquisition activity.

He said one of the driving forces behind ESOP formation is the tax advantage. Founding owners looking to sell their business often face huge capital-gains tax. A leveraged ESOP can shelter the owner from taxes he would incur through an outright sale.

Robert W. Edwards, a former partner at Nixon Peabody, is currently a partner in Shared Equity Strategies and Steiker, Fischer, Edwards and Greenapple's Providence Office.

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