7e. The European Employee Stock Ownership Plan (ESOP): A Vehicle for Sustainable Employee Ownership and Business Succession

Strategic employee shareholding via an intermediary entity

Employee ownership can give employees a voice, which further strengthens the relationship between them and their firm. Employee shareholders are concerned with the long-term performance of the business, not just short-term movement of share prices. This focus on the long-term interests of the firm can help shift executive remuneration policy towards long-term incentives. This is an important potential for better corporate governance and thus directly relevant to the 2012 Commission Action Plan to modernise EU company law and corporate governance.

There is a European trend towards using intermediary entities as a vehicle for share transfer in employee share ownership plans (ESOP schemes) because they limit risk of investment for employee shareholders, allow to implement leveraged investment and to pool voting rights after the shares are acquired. On the macroeconomic level, ESOPs support productivity and growth as well as strategic stabilisation of ownership contributing to the aims of the Europe 2020 strategy.

Contributing to resolving the business succession problem

A Commission Communication from 2006[1] stated that with the aging of Europe's population, "one third of EU entrepreneurs, mainly those running family enterprises, will withdraw within the next ten years". This portends an enormous increase in business transfer activity, which could affect up to 450,000 small and medium-sized enterprises and 2 million jobs *every year*. Every year, there is a **risk of losing approximately 150,000 firms and 600,000 jobs** due to inefficiency in transferring businesses.[2] It is anticipated that as a consequence of the new forms of business finance now coming into use, transfers within the family will decrease, while sales to outside buyers will rise. The entrance of international investors into what used to be primarily domestic markets will broaden the range of potential buyers for European small and medium-sized enterprises and is likely to threaten the successful regional structure of European (family-owned) businesses.

A full or partial ESOP buy-out provides an ideal vehicle to facilitate transitions in ownership and management of **closely-held companies**. An ESOP usually involves a loan to an employee benefit trust, which acquires company stock and allocates it through periodic contributions to each employee's ESOP account. The loan is serviced by payments from the company out of company profits and out of dividends paid on the stock held by the ESOP. This field of action has been highlighted as one of the main objectives of the Council Recommendation of 7 December 1994 and recently by the European Commission, explicitly stressing the importance of ownership transfers to employees as a specific measure for facilitating business succession in SMEs.

Creating a market for retiring shareholders' shares

ESOPs may easily buy-out one or more shareholders while permitting other shareholders to retain their equity position. Furthermore, there is no dilution in equity per share of current stockholders since no new shares are issued and all shares are bought at fair market value. In this way the ESOP creates a market for retiring shareholders' shares at a price acceptable to the owner - a market which otherwise might not exist. At the same time, when a change of control is appropriate, ownership is transferred to motivated employees who have a vital interest in the company's long-term success.

Thus the ESOP may be an attractive alternative to selling the business to outsiders, especially when there is a desire to keep control of the business within a family or a key-employee group. **As a trusteed plan,** the ESOP is designed to pool employee's voting rights. The trustee exercises the voting rights while the employees are the financial beneficiaries of the trust. Of course, most ESOPs make some arrangement for the presence of employee representatives on the plan committee.

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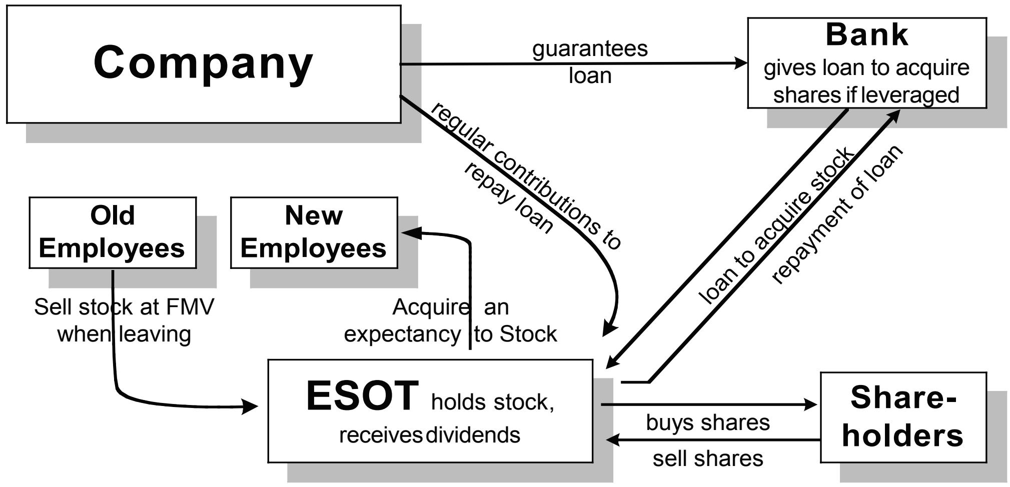
[1] Implementing the Lisbon Community Programme for Growth and Jobs, on the Transfer of Businesses – Continuity through a new beginning, from 14.03.2006 COM (2006) 117 final.

[2] See „Business Dynamics: Start-ups, Business Transfers and Bankruptcy" *(2011)*, final report for DG Enterprise, p. 95, 96 and 100.



Avoiding additional risk while increasing motivation and competitiveness

While share ownership generally involves additional risk for employees, the ESOP avoids this consequence. Although employees, as in other share ownership schemes, are encouraged to allot part of their wealth into the shares of their own companies rather than those of other companies, resulting in concentrated rather than diversified risk, there is this fundamental difference: ESOP debt is funded by appropriately timed contributions from the company to an employee trust (ESOT). Thus the scheme provides an additional benefit to basic wages. The employee's salary remains unaffected.

Furthermore, ESOPs make employees more motivated and productive while at the same time making enterprises more competitive.[3] Finally, there is an additional advantage to the company: shares are not sold to outsiders; thus there is no risk of loss of control and the company remains local. As such ESOPs could **strengthen bonds between enterprise and community**, while keeping jobs local and more wage income spent at home.

Boosting SME lending to finance business successions in SMEs

A public bank such as the European Investment Bank (EIB) could step in focussing its efforts more on providing senior and/or mezzanine capital for the transmission (buyout) of established mature companies. Providing loans to established mature companies is by definition less risky than for example providing loans for start-ups and newer SMEs. Further, providing loans for the transmission of established mature companies would enable the EIB to invest larger sums of money. As the experience from the U.S.—where this type of lending has become part of the texture of corporate America—shows, loans made for ESOP buyouts have a much lower default rate than is the case with other types of loans. A related SME loan facility could be embedded, for example in the EIB's JEREMY programme.

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3 For a recent, comprehensive overview of the positive economic evidence (esp. for ESOPs) see *J. R. Blasi, D. Kruse, A.* Bernstein, "In the Company of Owners", Basic Books, New York 2003; they find an average increase of productivity level by about 4%, of total shareholder returns by about 2% and of profit levels by about 14% compared to firms without PEPPER schemes.