

Maintaining Competitiveness through Employee Ownership in the Forest Products Industry

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About the ESOP Association

The ESOP Association, founded in 1978, is a national non-profit membership organization, with 18 local Chapters, serving approximately 2,500 employee stock ownership plan (ESOP) companies, professionals with a commitment to ESOPs, and companies considering the implementation of an ESOP. The Association is the only association devoted solely to ESOPs. Promoting and enhancing laws before Congress and regulatory agencies that govern ESOPs and providing its members with expert educational ESOP programming and information are its main focuses. For more information regarding The ESOP Association, email membership@esopassociation.org or call toll-free **1-866-366-3832**.

Resources: ESOP Experts by Specialty

www.esopassociation.org/pdfs/2008_esop_experts.pdf

The information provided within this publication does not constitute legal or financial advice. Before pursuing an ESOP structure, legal and financial council should be retained.

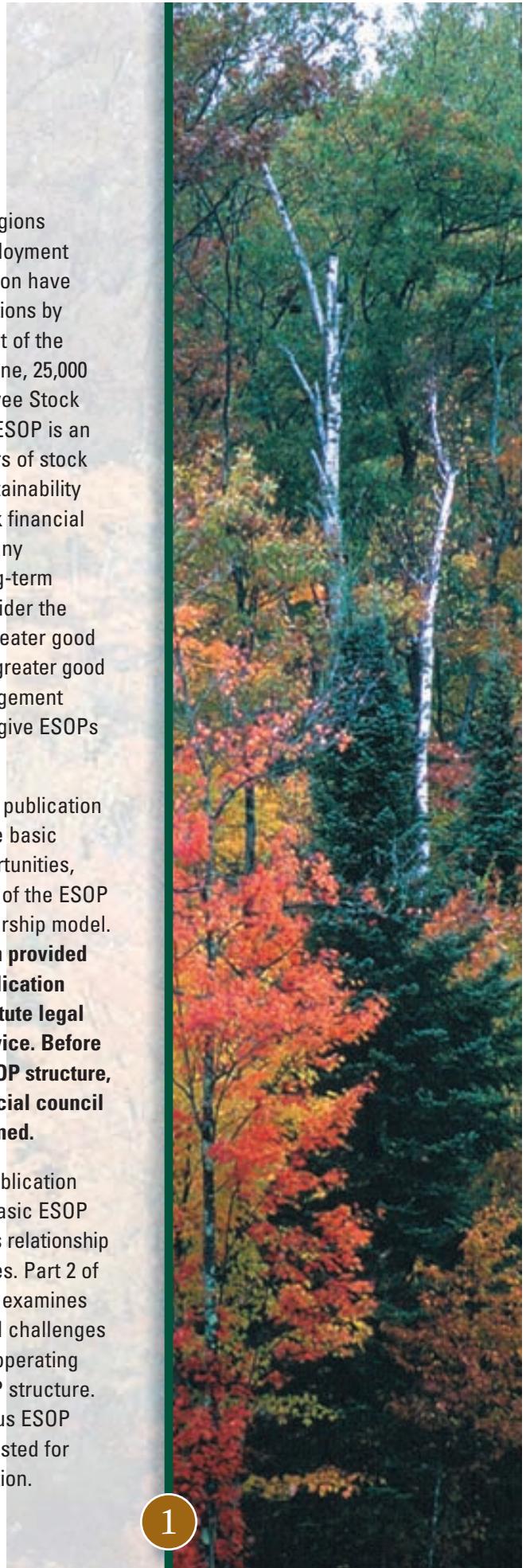
Introduction

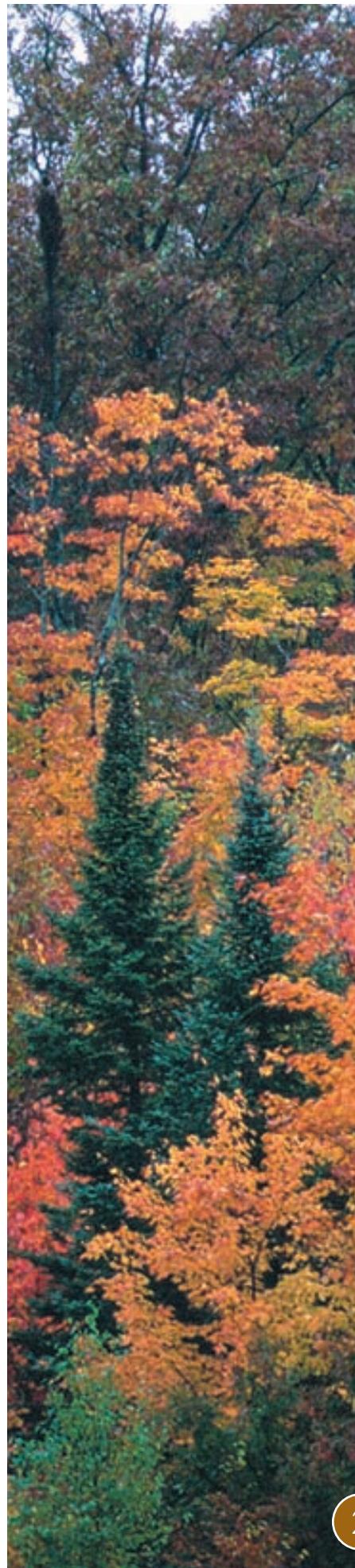
There is a growing need to provide stable employment in rural forested regions of the United States. The forest products industry has provided these employment opportunities for many years; however, globalization and foreign competition have disrupted many rural communities. In many cases, mergers and consolidations by large and often foreign owned forest products companies place the interest of the shareholders above the interests of the local community. In Wisconsin alone, 25,000 forest products manufacturing jobs have been lost since 2000. The Employee Stock Ownership Plan (ESOP) offers a more stable alternative. By definition, an ESOP is an employee benefit plan which makes the employees of the company owners of stock in that company. By its design, an ESOP is managed for the long-term sustainability of the company, thereby, serving the best interests of its employees. Quick financial gains made to please stockholders at the expense of the long-term company sustainability do not fit within the parameters of the ESOP model. This long-term management philosophy fits well within the forest products industry. Consider the following parallel: long-term sustainable forest management serves the greater good of the forest, while the long-term ESOP management philosophy serves the greater good of its employee owners. In addition to an ESOP's inherent long-term management philosophy, more tangible benefits such as tax and investment incentives give ESOPs an advantage over other non-employee owned company structures.



The goal of this publication is to explore the basic structure, opportunities, and challenges of the ESOP employee ownership model. **The information provided within this publication does not constitute legal or financial advice. Before pursuing an ESOP structure, legal and financial council should be retained.**

Part 1 of this publication examines the basic ESOP structure and its relationship to the employees. Part 2 of this publication examines advantages and challenges for companies operating within the ESOP structure. Finally, numerous ESOP resources are listed for further information.





Part 1: Understanding the ESOP Structure

What is an ESOP?

An Employee Stock Ownership Plan (ESOP) is an employee benefit plan which makes the employees of a company owners of stock in that company. Several features make ESOPs unique as compared to other employee benefit plans. First, only an ESOP is required by law to invest primarily in the securities of the sponsoring employer. Second, an ESOP is unique among qualified employee benefit plans in its ability to borrow money. As a result, leveraged ESOPs may be used as a technique of corporate finance.

How do ESOPs work?

A company which wants to set up an ESOP creates a trust to which it makes annual contributions. These contributions are allocated to individual employee accounts within the trust. A number of different formulas may be used for allocation. The most common is allocation in proportion to compensation, but formulas allocating stock according to years of service, some combination of compensation and years of service, and equally, have all been used. Typically employees might join the plan and begin receiving allocations after completing one year of service with the company, where any year in which an employee works at least 1,000 hours is counted as a year of service.

The shares of company stock and other plan assets allocated to employees' accounts must vest before employees are entitled to receive them. Vesting is a process whereby employees become entitled to an increasing percentage of their accounts over time. The least liberal vesting schedule allowed by law is 20 percent per year until employees are fully vested after seven years of service. Some companies, however, vest employees' entire accounts right away.

When an ESOP employee who has at least ten years of participation in the ESOP reaches age 55, he or she must be given the option of diversifying his or her ESOP account up to 25 percent of the value. This option continues until age sixty, at which time the employee has a one-time option to diversify up to 50 percent of his/her account. This requirement is applicable to ESOP shares allocated to employee's accounts after December 31, 1986.

Employees receive the vested portion of their accounts at either termination, disability, death, or retirement. These distributions may be made in a lump sum or in installments over a period of years. If employees become disabled or die, they or their beneficiaries receive the vested portion of their ESOP accounts right away.

In a publicly-traded company employees may sell their distributed shares on the market. In a privately held firm, the company must give the employees a put option on the stock for 60 days after the distribution. If the employee chooses not to sell at that time, the company must offer another put option for a second sixty day period starting one year after the distribution date. After this period the company has no further obligation to repurchase the shares.

An ESOP company may make an "installment distribution," provided that it makes the payments in substantially equal amounts, and over a period to start within one year for a retirement distribution, within five years for a pre-retirement distribution, and not to exceed five years in duration in either case. The company must provide "adequate security" and pay interest to the ESOP participant on the unpaid balance of an installment distribution.

How to Establish an ESOP

A company interested in establishing an ESOP has a wide range of options in tailoring a plan that is best suited to its particular needs and goals. A large, publicly traded company, for example, would handle the creation of its ESOP somewhat differently than would a smaller firm. Presented below, therefore, is only a basic guideline summarizing the steps a company might take in designing its ESOP and bringing it into being.

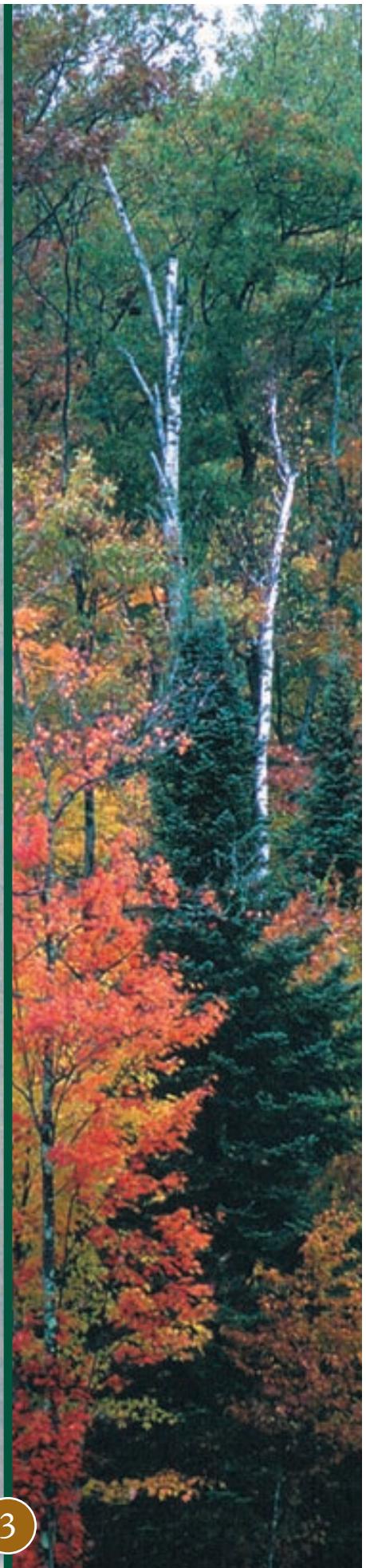
Exploring the ESOP Concept

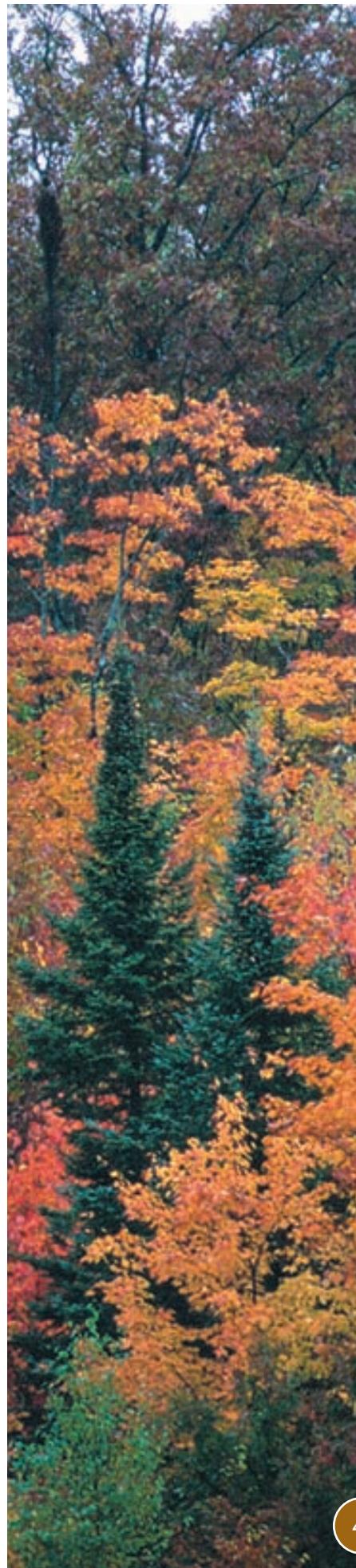
The first step in the process of establishing an ESOP is to develop an idea of the type of plan that will best serve the company's interests. Companies have created ESOPs as an employee retirement plan, for purposes of business continuity, financing, enhanced employee motivation or as a combination.

Designing the Specifics

Once you have a general picture of the kind of ESOP you want, it is wise to hire a qualified consultant to work with you to design the specifics of the ESOP. The actual feasibility of an ESOP needs to be established. Who will participate in the plan? How will stock be allocated to participants? What vesting schedule will be adopted and how will distributions of ESOP accounts be handled? How will voting rights be handled? The consultant will work to integrate the ESOP goals with applicable laws and regulations and will conduct a financial analysis to assure that any financial commitments posed by the ESOP will not exceed the ability of the firm to meet such obligations. He or she may also offer possibilities previously overlooked. The consultant may also arrange to bring in other professionals, such as an appraiser, or a lending institution as appropriate.

In the case of a privately held company, the feasibility and design phase of the process is not usually complete until three additional points have been addressed. First, the firm's stock must be valued by an independent appraiser before shares are put into the ESOP. Initially, a careful estimate will be prepared for use as a working figure in the feasibility and design process. This initial appraisal will likely take several weeks or longer, since a significant amount of business data must be collected and analyzed. Only when the design process is completed and ready for implementation will a final and formal valuation report be prepared.





Second, the ESOP's effect on existing stockholders should be estimated. Stockholders will want to know how the ESOP will affect the value of their stock and the company's financial condition. Often an ESOP will cause a dilution of their equity interest in the corporation.

Finally, while not a requirement for establishing an ESOP, a plan for meeting the private closely held company's obligations to repurchase the stock of departing employees should be projected. This "repurchase obligation" arises from the fact that in privately held companies, ESOP participants have a put option when leaving the company. The repurchase obligation and its growth over time may be affected by factors like the size of the annual ESOP contributions, the change in the value of shares between the dates of contribution and repurchase, the vesting and distribution provisions of the ESOP, employee turnover and, for shares contributed after December 31, 1986, the choices eligible employees make about their diversification option.

Companies may plan for and meet their ESOP repurchase obligation in a variety of ways, including making substantial cash contributions on an annual basis, and buying insurance to cover the plan's obligations. If the likely growth of repurchase obligation over time is projected at the outset, however, the company is in the best possible position to plan for it and design the ESOP accordingly.

The Plan: Putting the ESOP in Place

When the process of analyzing and designing the ESOP is complete, the company will typically have an attorney prepare a formal plan document, which will set forth the specific terms and features of the ESOP. An appraiser will then prepare a finished and formal evaluation report, based on data preferably no more than 60 days old at the date the ESOP is created.

The plan document should include language addressing the plan's purpose and operation, eligibility requirements, participation requirements, company contributions, investment of plan assets, account allocation formulas, vesting and forfeitures, voting rights and fiduciary responsibilities, distribution rules and put options, employee disclosures, and provisions for plan amendments. Depending on the particular circumstances of the establishment of the ESOP, it may be prudent to address any future contingencies in the plan document.



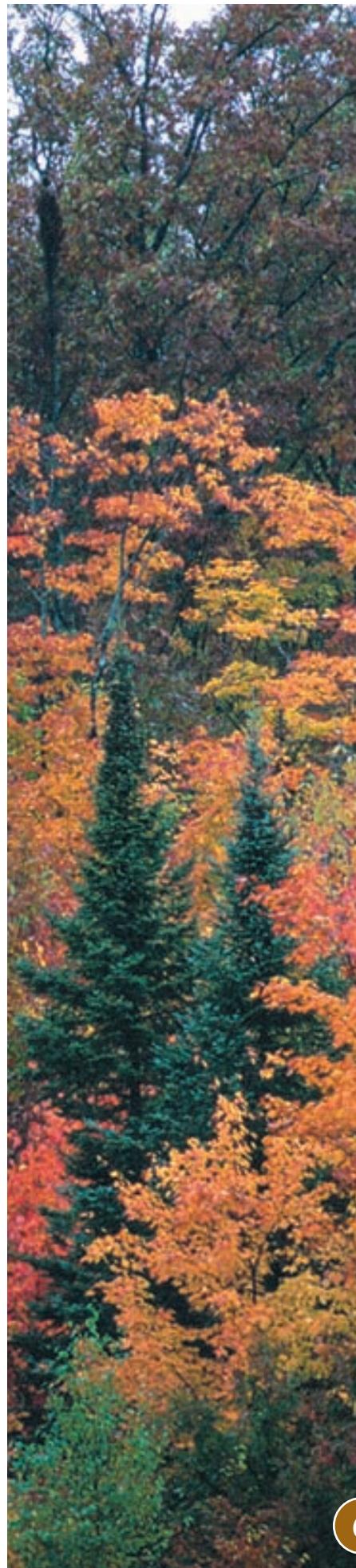
Other key decisions are who will serve as the ESOP's trustee and who will assume the functions of administering the ESOP? The stock (as well as any other assets) held by the ESOP must actually be held in the name of the trustee, who usually has fiduciary responsibility for the plan's assets. Increasingly, plan sponsors are turning to professional trustees, such as a bank or trust company, although companies sponsoring an ESOP can and do handle this role in-house. The job of ESOP administration is likewise a function which may be given to a professional administration firm or handled by the sponsor. The administrator is responsible for maintaining all the individual records of the plan in order to keep track of exactly who are the current participants in the plan, what percent is each participant vested, what is the content and value of each participant's account, etc.

In the case of leveraged ESOPs (an ESOP which used borrowed funds to acquire employer securities), arrangements must be made for securing the financing needed to complete the transaction. Banks, savings and loans, investment banking firms, mutual funds, and insurance companies in the business of lending money may all qualify as ESOP lenders. Lending institutions are becoming increasingly familiar with how ESOP loans are structured.

The company must formally adopt the plan and trust documents which establish the ESOP and its attendant trust. Also, the company usually submits a copy of these documents to the Internal Revenue Service with an application for confirmation (called "determination") of the plan's tax-qualified status (Form 5300). The plan must be a qualified ESOP under sections 401 (a) and 4975 (e)(7) of the Internal Revenue Code in order to be eligible for the various tax benefits associated with ESOPs. It is not normally necessary, however, to wait for a letter of determination from the IRS to begin the plan. If there is nothing unusual in the plan's design, any required changes will almost certainly be small ones, which can be made after the plan has begun operation.

A company must adopt an ESOP by the end of its fiscal year to claim a deduction for its contribution for that year. Contributions and leveraging for a given year, however, may occur up until the company files its corporate tax return, including extensions.

The process of setting up an ESOP is complicated, but that should not discourage interested firms from investigating employee ownership. The process is understandable and manageable, and the many benefits which flow from ESOPs, such as increased employee motivation, a market for existing shareholders shares, and tax and financial advantages, are substantial.



What is a leveraged ESOP?

In a leveraged ESOP, the ESOP or its corporate sponsor borrows money from a bank or other qualified lender. The company usually gives the lender a guarantee that it will make contributions to the trust which enable the trust to amortize the loan on schedule; or, if the lender prefers, the company may borrow directly and make a loan back to the ESOP. If the leveraging is meant to provide new capital for expansion or capital improvements, the company will use the cash to buy new shares of stock in the company. If the leveraging is being used to buy out the stock of a retiring owner, the ESOP will acquire those existing shares. If the leveraging is being used to divest a division, the ESOP will buy the shares of a newly created shell company, which will in turn purchase the division and its assets. ESOP financing can also be used to make acquisitions, buy back publicly-traded stock, or for any other corporate purpose (see Figures 1 and 2 on page 7 detailing leveraged and non-leveraged ESOP structures).

Two tax incentives make borrowing through an ESOP extremely attractive to companies which might otherwise never consider financing their employees acquisition of stock. First, since ESOP contributions are tax deductible, a corporation which repays an ESOP loan in effect gets to deduct principal as well as interest from taxes. This can cut the cost of financing to the company significantly, by reducing the number of pre-tax dollars needed to repay the principal by as much as 34 percent, depending on the company's tax bracket. Two, dividends paid on ESOP stock passed through to employees or used to repay the ESOP loan are tax deductible. This provision of federal tax law may increase the amount of cash available to a company compared to one utilizing conventional financing.



NON-LEVERAGED ESOP

- 1Each year, company contributes stock or
- 2Cash to the ESOP to buy stock. Employees pay nothing. ESOP holds stock for employees and periodically notifies them how much they own and how much it is worth.
- 3Employees receive stock or cash when they retire or otherwise leave the company according to vesting schedule.

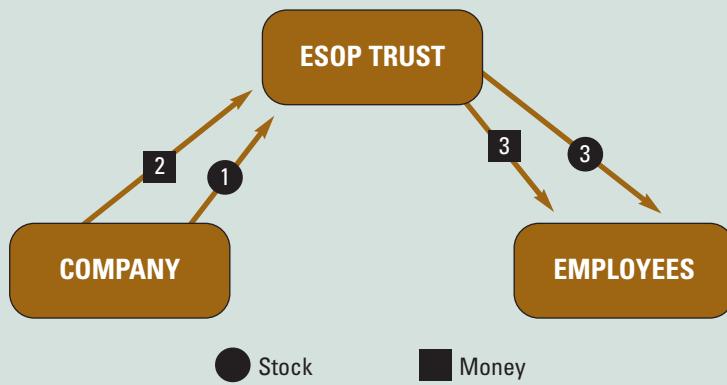


Figure 1: Non-leveraged ESOP structure.

LEVERAGED ESOP

- 1Bank lends money to ESOP with company guarantee.
- 2ESOP buys stock from company or
2AFrom existing shareholders.
- 3Company makes annual tax deductible contributions to ESOP which in turn pays bank.
- 4Employees receive stock or cash when they retire or leave the company.

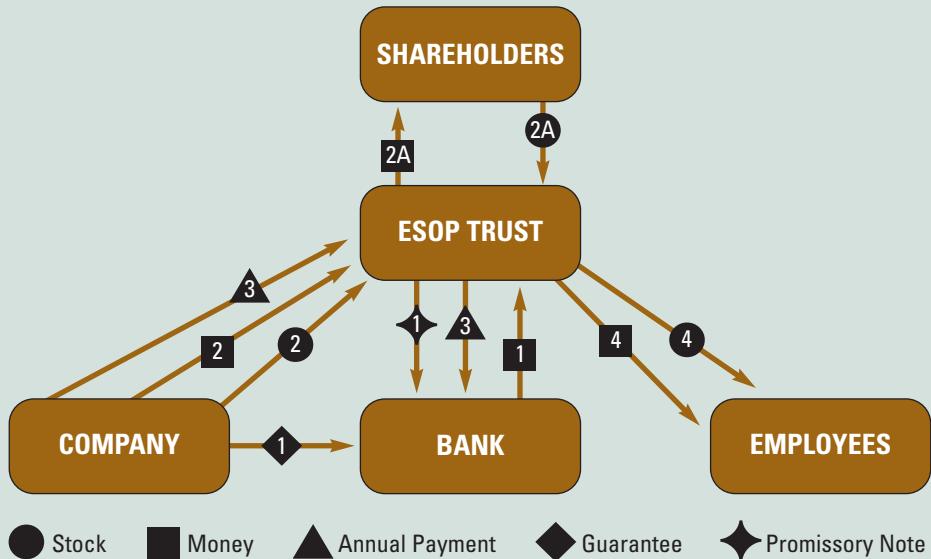
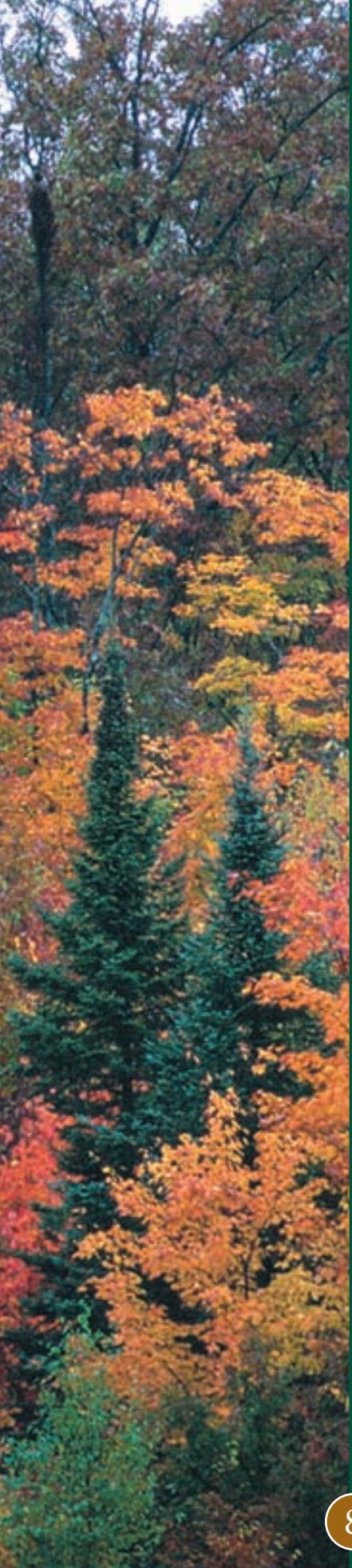


Figure 2: Leveraged ESOP structure.



Part 2: Opportunities and Challenges Within the ESOP Structure

Many people view the tax and financial advantages as the primary driver of the ESOP structure; however, the two most common uses of ESOPs are to buy the stock of a retiring owner in a closely held company, and as an extra employee benefit or incentive plan. These two uses probably account for over two thirds of all the ESOPs now in existence. Let's examine these three benefits as well as some of the challenges of the ESOP structure in more detail.

Tax Advantages of ESOPs

Introduction

In order to broaden the ownership of capital to provide employees with a stake in the ownership of their employing corporation and to provide a unique means of financing to corporations, Congress has granted a number of specific incentives meant to promote increased use of the ESOP concept. This is especially true for leveraged ESOPs, which through the use of borrowed funds provide a more accelerated transfer of stock to employees. These ESOP incentives provide numerous advantages to the sponsoring employer and can significantly improve corporate financial transactions.

Deductibility of ESOP Contributions

As with all tax-qualified employee benefit plans, contributions to ESOPs are tax deductible to the sponsoring corporation up to certain limits. These contributions can be either in cash (which is then used by the ESOP to buy employer securities) or directly in the form of employer securities. Where employer securities are contributed directly, the employer may take a deduction for the full value of the stock contributed. By doing so, the employer actually increases its cash profits by the value of the taxes saved through the deduction.

The deductibility of contributions to an ESOP becomes even more attractive in the case of a leveraged ESOP. Under this arrangement, an ESOP takes out a cash loan from a bank or other lender, with the borrowed funds being paid to the sponsoring employer in exchange for employer securities. Since contributions to a tax-qualified employee benefit plan are tax deductible, the employer may thereafter deduct contributions to the ESOP which are used to repay not only the interest on the loan, but principal as well. This makes the ESOP an attractive form of debt financing for the employer from a cash flow perspective. Each year, the company can deduct contributions of amounts up to 25 percent of covered payroll, plus any dividends on ESOP stock (see "Deductibility of Dividends" below) which are used to repay the loan. Further, any contributed amounts used to repay the interest on the loan are deductible without any limit at all.

ESOP Rollover

An additional ESOP incentive allows a shareholder, or shareholders, of a closely held company to sell stock in the company to the firm's ESOP and defer federal income taxes on the gain from the sale. In order to qualify for this "rollover," the ESOP must own at least 30 percent of the company's stock immediately after the sale, and the seller(s) must reinvest the proceeds from the sale in the securities of domestic operating corporations within fifteen months, either three months before, or 12 months after the sale. The seller, certain relatives of the seller, and 25 percent shareholders in the company are prohibited from receiving allocations of stock acquired by the ESOP through a rollover. Generally, the ESOP may not sell the stock acquired through a rollover transaction for three years.

The ESOP rollover provides a substantial tax advantage that might otherwise be unavailable to current or retiring owners. Normally, a direct shareholder's options would be to sell shares back to the company, if such a transaction is feasible, or to sell out to another company, either for cash or for a block of shares in the other company. Selling to an ESOP, on the other hand, allows the seller to exchange interest in the company for a safely diversified portfolio of securities – or the stock of a single new company – without paying any taxes on the transaction. The seller's tax basis in the employer stock which were sold will be carried over to the replacement property. If the replacement property is held until death, however, a stepped-up basis for those securities is provided under current established tax laws.

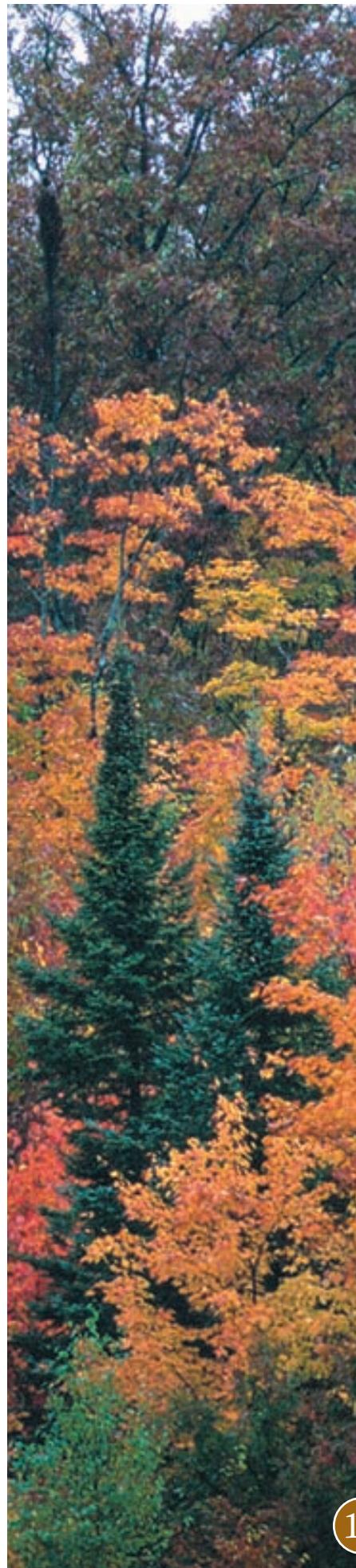
In addition to the substantial tax advantages, selling to the ESOP preserves the company's independent identity. A sale to an ESOP also provides a significant financial benefit to valued employees and can assure the continuation of jobs. Moreover, selling to an ESOP allows the seller to sell all or just a part interest in the company, and to do this gradually or all at once.

To qualify for rollover treatment, the stock sold to the ESOP must be common or convertible preferred stock of a closely held domestic corporation and must have been owned by the seller for at least three years.

Deductibility of Dividends

Employers are also permitted a tax deduction for cash dividends paid on stock which has been purchased with an ESOP securities acquisition loan, to the extent that the dividends are passed through to the employees. This provision allows companies to share current benefits of stock ownership with their employees to compliment the long-term benefits of capital ownership. The dividends are taxable as current ordinary income to employees.

A deduction is also available for dividends paid on ESOP leveraged stock to the extent that the dividends are used to reduce the principal or pay interest on an ESOP loan incurred to buy that stock. Dividends used in this manner are not counted towards the 25 percent contribution limit for leveraged ESOPs. Some ESOPs have purchased convertible preferred stock rather than common stock to assure a relatively reliable stream of dividend income to be used in servicing the loan.



Buying the Stock of a Retiring Owner

Many closely held companies have no plans, or incomplete plans, for business continuity after the departure or retirement of the founder or major shareholder. If the company repurchases a retiring or departing owner's shares, the departing owner sells his or her stock to another company, the proceeds will be taxed as ordinary income, or as capital gains if certain requirements are met, and, finding a buyer is not always easy even for a profitable closely-held company. Even if possible, it is not always desirable; furthermore in a family business, a retiring owner may face an unpleasant choice between selling to a competitor or conglomerate, or liquidating.

An ESOP can provide a market for the equity of a retiring owner – or any interested major shareholder – of a closely held company, and provide a benefit and job security for employees in the process. Retiring owners of closely held companies incur no taxable gain on a sale of stock to an ESOP, provided that the ESOP owns at least 30 percent of the company immediately after the sale (sales by two or more stockholders may be counted in this 30 percent if these sales are part of an integrated transaction), and that the sale's proceeds are reinvested in qualified securities within a fifteen month period beginning three months before the date of the sale. This tax-deferred rollover is a most tax favored way for an owner of a closely held company to sell his or her stock.

Motivation Benefits of ESOPs

Most ESOP companies had the desire to set up an employee benefit or incentive as one reason for starting their plan, but for many companies that's the only reason. Some companies hope that by making employees owners they will increase their dedication to the firm, improve work effort, reduce turnover, and generally bring a more harmonious atmosphere to the company. Research has shown that giving workers a significant stake in their companies can improve employees' attitudes towards their companies, and that these improved attitudes towards their companies can translate into bottom line improvements. Other companies want to set up some kind of benefit plan, and find that an ESOP is the best choice.

A 1993 ESOP Association study found that 54 percent of member companies cite an overall productivity increase due to their ESOP. Eighty-one percent of those surveyed believed the ESOP was a "good decision" that helped the company; only two percent responded that it was a "bad decision." A 1993 study by the Northeast Ohio Center on Employee Ownership found that 49 percent of Ohio ESOP companies reported outperforming their industry in job creation and retention during the previous three years; 50 percent said they were the same as their industry; and one percent fared worse.

A study of publicly-traded companies by Joseph Blasi and Douglas Kruse of Rutgers University and Michael Conte of the University of Baltimore found a positive relationship between employee ownership and stock performance. The un-weighted Employee Ownership Stock Ownership Index reflects the average stock price of the 355 companies listed on the NYSE, AMEX, and NASDAQ exchanges with more than 10 percent of stock owned by employees. In 1991, the index was up 35.9 percent compared to increases of 26.3 percent for the Standard & Poor's 500-index and 20.3 percent for the Dow Jones industrial average. In 1992, the Employee Ownership Stock Ownership Index increased 22.9 percent versus gains of less than 4.5 percent for the other two indices.

In addition to other empirical studies that yield a similar positive correlation between ESOPs and company performance, much anecdotal evidence lends itself favorably to ESOPs. In the landmark business book *The 100 Best Companies to Work for in America* (by Robert Levering and Milton Moskowitz, published by Doubleday, 1993) 30 of the "best" corporations had ESOPs of 10 percent or greater. In 1992, all of the finalists for Inc. Magazine's "Entrepreneurs of the Year Award" were ESOP companies.

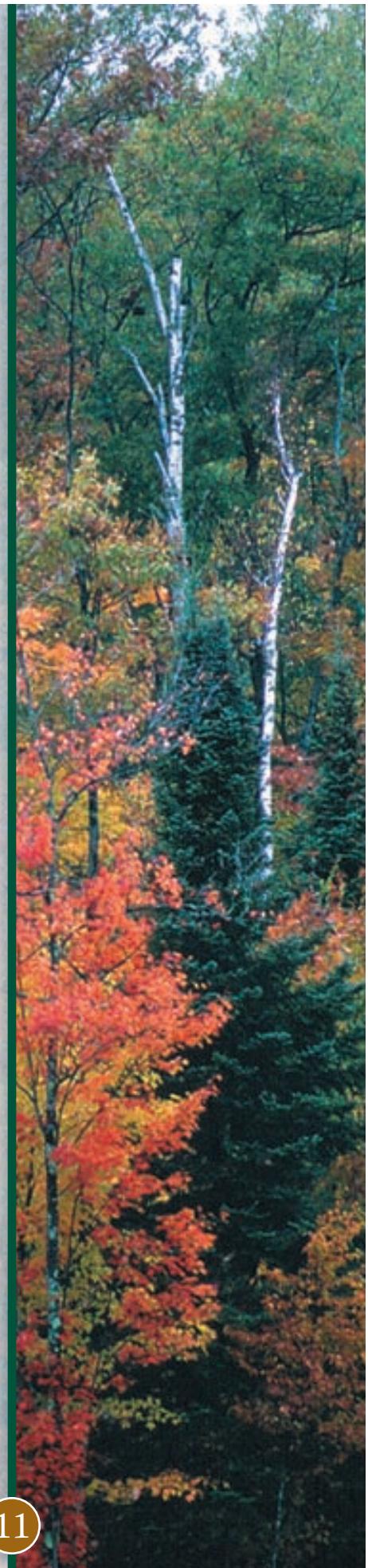
Challenges within ESOPs

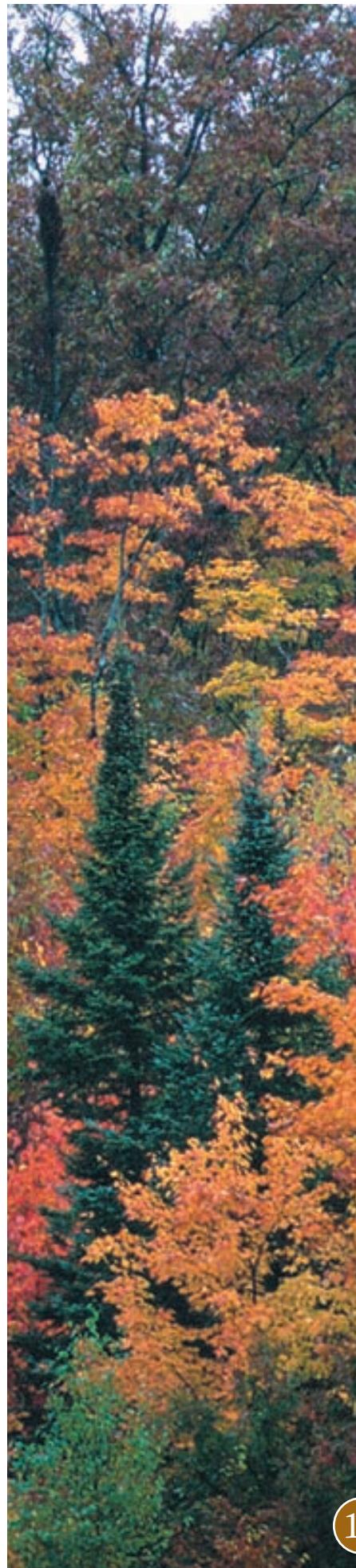
With respect to human resource issues, an ESOP is not all that different than other ownership structures. Communication is key for dealing with management and personnel issues. One challenge for a new ESOP is building the ESOP culture. It is important to demonstrate to the employee owners how they can work together for the common good of the company. The same holds true for existing ESOPs. Management and employees alike must work together to maintain and strengthen communication.

A second challenge presented to ESOP participants is fundamental to its structure. When an employee's retirement is invested in the ESOP's stock, their retirement suffers when the stock does poorly. Of course this is not limited to the ESOP structure. We all remember non-ESOP companies, such as Enron, where employee retirement was heavily invested within the company stock and entire retirements were lost when the company went bankrupt. As explained earlier, by law, an ESOP employee can limit this risk by diversifying his or her company stock as they approach retirement. In addition, a majority of ESOP companies have other retirement plans, such as defined benefit pension plans or 401(k) plans, to supplement their ESOP.

An additional challenge for the ESOP structure is that in some cases, the company has to be purchased twice. It must first be purchased from the original owner. It is purchased a second time from the employee owner when he or she retires.

As with any ownership structure, there is no free lunch. ESOPs provide a number of tax advantages and a structure to keep local forest products businesses local, but ESOPs face the same raw material challenges and globalization challenges as other non-ESOP forest products companies.





Resources: Frequently Asked Questions

What is an ESOP?

An ESOP, or employee stock ownership plan, is a tax qualified deferred compensation employee benefit which makes the employees of that company beneficial owners of stock in that company.

ESOPs are unique in that only ESOPs are required under U.S. tax and labor laws to invest primarily in the securities of the sponsoring employer and the only employee retirement savings plan that law permits that may use borrowed funds to acquire its asset, the employer securities.

How are ESOPs used?

The most common uses of ESOPs are to buy the stock of a retiring owner in a closely held company and as an extra employee benefit or incentive.

Other companies have used ESOPs as a technique of corporate finance to help finance an expansion, make an acquisition, spin off a division, or take a company private.

In a very small percentage, approximately two percent, ESOPs have been used to buy out an existing firm that would have otherwise closed.

What is a leveraged ESOP?

In a leveraged ESOP, the ESOP or its corporate sponsor, borrows money from a bank or other qualified lender. The company usually gives the lender a guarantee that it will make contributions to the trust which enables the trust to amortize the loan on schedule; or, if the lender prefers, the company may borrow directly and make a loan back to the ESOP. If the leveraging is meant to provide new capital for expansion or capital improvements, the company will use the cash to buy new shares of stock in the company. If the leveraging is being used to buy out the stock of a retiring owner, the ESOP will acquire those existing shares. If the leveraging is being used to divest a division, the ESOP will buy the shares of a newly created shell company, which will in turn purchase the division and its assets. ESOP financing can also be used to make acquisitions, buy back publicly-traded stock, or for any other corporate purpose.



ESOP Statistics

There are approximately 11,500 ESOPs in place in the U.S., covering 10 million employees (10 percent of the private sector workforce).

These employees draw in excess of three percent of their total compensation from ESOP contributions.

The growth of ESOP formation has been influenced by federal legislation. While the rapid increase in new ESOPs in the late 1980s subsided after Congress removed certain tax incentives in 1989, the overall number has remained steady with new plans replacing terminated ESOPs.

Currently, it is estimated that there are approximately 11,500 ESOPs in place in the U.S. However, there is no precise way to measure this figure accurately since the overwhelming majority of ESOP companies are privately held and do not file public reports with the Securities and Exchange Commission.

About 330 ESOPs – three percent – are in publicly-traded companies. However, these companies employ just under 50 percent of the nation's 10 million employee owners.

An estimated 7,000 of the 11,500 companies have ESOPs that are large enough to be a major factor in the corporation's strategy and culture.

Approximately 4,000 ESOP companies are majority-owned by the ESOP.

Approximately 2,500 are 100 percent owned by the ESOP.

About two percent of ESOP companies are unionized.

While ESOPs are found in all industries, more than 25 percent of them are in the manufacturing sector.

At least 75 percent of ESOP companies are or were leveraged, meaning they used borrowed funds to acquire the employer securities held by the ESOP trustee.

A majority of ESOP companies have other retirement plans, such as defined benefit pension plans or 401(k) plans, to supplement their ESOP.

Of the 11,500 employee-owned companies nationwide, fewer than two percent were financially distressed when they established their ESOP.

Total assets owned by U.S. ESOPs was estimated to be \$800 billion at the end of 2006.



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