ESOPs and Preferred-Status Certification

Challenges and Opportunities for Employee Stock Ownership Plans and Business Preference Programs

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UPDATES

This document will be occasionally updated as new material becomes available. Visit www.nceo.org/r/preferred for the most recent version. It was originally published on May 24, 2017.

AUTHORSHIP

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Introduction

Programs designed to support businesses owned by minorities, women, and other historically disadvantaged groups intend to increase economic opportunities for members of those groups. Employee stock ownership plans, or ESOPs, were created by Congress to serve many goals, one of which is to transfer ownership of companies in the form of stock to working Americans, most of whom would not otherwise be likely to have it. In theory the goals of these programs are complementary. Unfortunately, in practice companies that have preferred-status certification and wish to adopt an ESOP face obstacles that are often insurmountable.

This paper outlines the core features of preferred-status certifications and of ESOPs, and then explores the reasons for the tension between the two by using case studies and excerpts from laws and certifier policy statements. It makes recommendations for companies interested in exploring simultaneous certification and ESOP ownership and separate recommendations for certifying agencies that are considering changes to their policies with regard to ESOPs.

Creating Opportunities for Disadvantaged Groups

This paper explores the compatibilities and tensions between preference programs and employee stock ownership plans (ESOPs).

In this paper, the terms "preferred status certification" and "preference programs" refer to an array of programs at governments, certifying agencies, and other entities that support selected businesses to benefit a traditionally disadvantaged group of people. These terms include businesses owned by minorities, by women, by veterans, by the disabled, those located in a disadvantaged area, and other groups.

The benefits of preferred-status certifications flow partly to owners who are members of the defined groups. The programs also have broader potential to benefit members of the groups who are non-owner employees of the certified companies. This potential rests on the premise that a woman, minority, or disabled veteran who owns and controls a business is more likely to hire other people in those categories.

ESOPs are a federally-regulated mechanism for creating employee ownership. Employees covered by ESOPs have an asset they would not typically otherwise have: stock in the companies where they work. ESOPs were not created to, and cannot substitute for, preference programs. By design, ESOPs provide an employee benefit in the form of company stock and do not limit economic value to any specific groups of employees. In theory, ESOPs would not provide an effective mechanism to offer special access to the groups supported by preference programs.

In practice, however, ESOPs benefit the same groups protected and supported by preference programs, according to recent research from the National Center for Employee Ownership. An analysis of working Americans ages 28 to 34[1] found that employee-owners in the same groups often targeted by preference programs earned higher wages and had greater net household wealth than those categories of workers in non-employee-owned companies. Employee-owners of color in the data set, for example, have 79% greater median household net worth and 30% greater median income from wages, relative to non-employee-owners of color. (See table 1 on page 3.)

This research demonstrates that ESOPs are a potential tool to advance similar policy goals to preference programs. If certification standards were designed to recognize and accommodate the existence of ESOPs, preferred-status companies would have the option of becoming substantially or entirely employee-owned without losing access to the economic benefits generated by preferred status. The result would be that employees in the target groups would not only have jobs, but better employment and a substantial opportunity to accumulate wealth.

Preference programs and ESOPs have proven to be nearly incompatible in practice, largely because of the way preference programs set standards that define ownership and control.

[1] Wiefek, Nancy, *Employee Ownership and Economic Well-Being: A Research Report on Household Wealth, Job Stability and Employment Quality among Employee-Owners Age 28 to 34, Oakland: National Center for Employee Ownership, May 15, 2017. Highlights and the full report are at* www.OwnershipEconomy.org. This research was funded by the W.K. Kellogg Foundation, as part of a $200,000 grant covering the period from May 1, 2015, to March 31, 2017. This table includes additional unpublished analysis.

Table 1: Employee-owner vs. Non-employee-owner Income and Household Net Worth

(Americans aged 28 to 34)

	MEDIAN INCOME FROM WAGES			MEDIAN HOUSEHOLD NET WORTH[2]		
	Employee-owners	Non-employee-owners	*Percent Difference*	Employee-owners	Non-employee-owners	*Percent Difference*
Workers of color	$35,000	$27,000	*30%*	$16,450	$9,175	*79%*
All women	$34,000	$29,000	*17%*	$20,950	$12,500	*68%*
Low-income women[3]	$21,000	$17,000	*24%*	$8,820	$7,600	*16%*
Single women of color	$28,000	$24,000	*17%*	$7,000	$5,000	*40%*
Single women	$31,000	$25,000	*24%*	$9,089	$6,000	*51%*
Single parents	$33,000	$23,000	*43%*	$10,000	$7,500	*33%*

Employee Ownership and Economic Well-Being, 2017. See OwnershipEconomy.org

[2] Household wealth is respondent's asset holdings (real estate, businesses, vehicles, etc.) and amount of debt owed to create a net worth amount. This amount does not include any assets in a retirement plan.

[3] For this table, "low income" means less than $30,000 in annual income from wages.

Conflicting Standards

Currently, many business preference programs treat an ESOP trust as a disqualified owner. As a result, if an ESOP trust owns more than 49% of a company's stock, the company often can not meet the ownership standards and fails to qualify for the preferences.

This is true regardless of the composition of the employees benefitting from the trust. A company where 65% of the employees are women, for example, including the non-ESOP owners, may not satisfy the ownership criteria of a woman-owned business. In addition, the certification standards often define control to ensure that eligible individuals who are owners are also decision-makers. This standard of control is difficult to adapt to a company in which ownership is shared by a broad base of employees.

Certification standards effectively require that companies wishing to retain their preferred status must limit ownership by an ESOP to 49% or less (leaving majority control in the hands of the preferred-status shareholder). Rather than manage within this limitation, many owners choose not to set up ESOPs at all. This may limit employee ownership in companies in which assets in the ESOP would be allocated to qualifying individuals, resulting in a lost opportunity to spread ownership to more of the population the preference program hopes to benefit.

A related problem is that even certifying agencies willing to consider an ESOP-owned company are rarely willing to approve the structure before the transition to employee ownership takes place. Companies that are considering employee ownership would have to risk losing a substantial portion of their revenue immediately after becoming employee owned if the certification is ultimately denied. This risk, even if low, is understandably enough to discourage many companies from considering employee ownership. The following two case studies illustrate this dilemma from the perspective of two business leaders.

CASE 1

One business, which chooses to remain anonymous because its situation has not been resolved, is owned primarily by a woman and is certified as woman-owned by its state certification agency. The certification is a substantial business advantage—the state has set a target of doing approximately one-third of its business with companies that are certified as women- or minority-owned.

The primary owner has sold a minority stake in the business to an ESOP, and the employees are her preferred buyer for the remainder of the shares. She does not want to liquidate the business, and she worries that if she finds an outside buyer, the jobs and character of the business she built may be lost.

She hesitates to sell more shares to the ESOP because of uncertainty about the company's ability to retain its woman-owned status. She is also concerned about the burden in time and money of attempting to maintain the certification with the ESOP in place. If the ESOP owned more than 50% of the stock, the certification process would require, for example, documentation of the individual personal net worth of female ESOP participants. In addition to requiring intrusive and time-consuming work for the company, there is no ability to predict how the agency will review and assess the documentation will be received by the agency. Transferring more than half of the stock to the ESOP would threaten the company's certification status and its continued viability.

Despite the appeal of transferring the ownership of the company to its employees, the owner is doubtful that it is worth the risk, meaning that dozens of women (as well as male) employees will likely forgo a retirement asset in the form of company stock. Moreover, these employees will face uncertainty about the plans and philosophy of whoever ends up owning the business after the founder leaves. When an ESOP is not available for ownership transition, the alternative transactions could create instability and loss of wages and benefits for the employees.

CASE 2

A twenty-year-old science firm employs more than 50 people, over half of whom are women. The company was founded by a man and a woman, with the woman having been and continuing to be the majority shareholder. As the company grew, more owners were added, and over time 15% of the company has been sold to employees through direct ownership of shares, but the female founder continues to retain her controlling majority stake. The governance of the company is similarly firmly in the hands of women—the CEO, CFO, and controller are all women.

The current ownership and governance structure allow the business to receive contracting preference certification through two separate state agencies. To obtain these certifications, the firm provides multiple years of financial data, board meeting notes, specific details on leadership roles and responsibilities of the executive team, tax returns, and copies of office leases. One of the agencies, in addition to setting ownership and governance requirements, also stipulates that the majority owner not have personal net worth in excess of a set amount, in order to qualify as economically disadvantaged. The firm consults with clients from the public, private, and non-profit sectors and, as a result, its certifications are integral to its business. One of the certifications alone accounts for up to 25% of the company's revenues.

The firm's board of directors has spent months investigating ESOPs and has determined that purchase by the ESOP of 100% of the company's shares is in the best interests of the current owners, the emerging leadership team, and the work force as a whole. The board believes that employee ownership will enhance employee retention and strengthen the company's culture and its benefits package. The company has been informed that it is likely to continue to meet the qualifications for one of the certifications, but possibly not the other. The leadership team believes that the risk of losing recertification is small, but is also concerned that missing even one year of certification could cause financial loss that would be extraordinarily difficult to recoup. Such a financial loss would likely lead to layoffs. As a result, the company is hesitant to choose the succession plan that otherwise best suits its needs.



Preferred-Status Certification: The Basics

WHO DETERMINES CERTIFICATION?

The landscape of preferred-status certification is large and complex, involving various entities, inconsistent standards, and lack of clarity. Certification applies to contracts with various federal agencies, including the Department of Defense and the Small Business Administration. Many states and municipalities have legislation defining their preference programs, such as the New York State law on "Participation By Minority Group Members and Women with Respect to State Contracts"[4] or Chicago's Minority Business Certification Program,[5] which itself includes five separate certification types. Some state agencies or quasi-government agencies have their own certification programs, such as the California Public Utilities Commission. State and federal requirements may interact. For example, the California United Certification Program[6] provides "one-stop shopping" certification services to small, minority and women businesses seeking to participate in the United States Department of Transportation (USDOT) Disadvantaged Business Enterprise (DBE) Program."

In addition, non-profit and for-profit entities of sufficient size may have their own purchasing preferences. Some general contractors working with state governments, for example, may be required to hire a certain number of subcontractors with preferred status certification. Others, such as Kaiser Permanente, have preferences for their own strategy or mission-related reasons.

Finally, a number of third-party certifications have been developed. Certification by one of these organizations may be accepted by many other organizations, making them often the most important actors in making changes in preferred status certification. The most prominent of the third party certifications are:

- Women's Business Enterprise National Council
- The National Minority Supplier Development Council
- The National Women Business Owners' Corporation
- The U.S. Department of Veterans Affairs

NONPROFIT CASE STUDY: KAISER PERMANENTE

Kaiser Permanente, a regional healthcare and health insurance provider, has a "supplier diversity" program. The program has several requirements, one of which is that suppliers be "51% owned, managed and controlled by a U.S. citizen with affiliation in one of the following segments: ethnic minority, woman, or veteran." Rather than certify suppliers itself, Kaiser asks that they be certified by a third party certification agency from their approved list, which includes National Minority Supplier Development Council (NMSDC), Women's Business Enterprise National Council (WBENC), U.S. Small Business Administration (SBA), Association for Service Disabled Veterans (ASDV), and other city, state, federal and municipal agencies.[7]

WHAT TYPES OF CERTIFICATIONS EXIST?

Although there are several variations with different titles and different definitions, the main categories of certification are:

- Minority-owned business: a sample definition of "minority," provided by the National Minority Supplier Development Council, is a U.S. citizen with at least one-quarter heritage in one of the following ethnicities: Asian-Indian, Asian-Pacific, Black, Hispanic, or Native American;

[4] http://public.leginfo.state.ny.us/lawssrch.cgi?NVLWO: No direct links to individual sections of this law exist. After clicking on this link, go to "Laws" in the menu bar, then "Laws of New York." In the following list, click on "EXC" (for "Executive") then on Article 15-A.

[5] https://www.cityofchicago.org/city/en/depts/dps/provdrs/cert.html

[6] http://californiaucp.org/

[7] https://kaiserpermanente.aecglobal.com/Supplier/Supplier_Registration_Checklist.aspx

- Women-owned business;
- Small disadvantaged business / disadvantaged business enterprise: defined by federal law and administered by the U.S. Department of Transportation;
- 8(a) designation: run by the Small Business Administration, the 8(a) designation is broad and includes minorities as defined above and others who can demonstrate that they are disadvantaged because of "race, ethnicity, gender, physical handicap or residence in an environment isolated from the mainstream of American society";
- A HUBZone business enterprise must be located in a "historically underutilized business zone" and 35% of its employees must reside in that zone; and
- A Disabled Veteran Business.

WHAT ARE THE REQUIREMENTS?

Various organizations use different terms to refer to those meeting qualifications. In this paper, the term "eligible individual" is used as a general term. For most certifications, eligible individuals must be U.S. citizens or resident aliens and must be members of the certification's intended group. For many certifiers, individuals must demonstrate that their personal net worth falls below a specified threshold.

Once eligibility has been established, the following are typical requirements for certification.

1. Ownership by Eligible Individuals

Most certifications specify that at least 51% of the company's stock must be owned by eligible individuals, and certifications generally have careful standards for defining ownership to ensure that their ownership is not superficial. The New York State statute, for example, specifies that the ownership must be "real, substantial and continuing," and sets tests to ensure that is the case. The ownership standards for many certifications overlap, but they are not identical, and examples of tests include:

- The owners must provide documentation of acquiring ownership, such as canceled checks and signed purchase agreements.
- Companies must represent that there are no side agreements, buy-sell agreements, or outstanding claims on shares (such as stock options or warrants) that would dilute the ownership of the eligible individuals.
- The owners must demonstrate that they made substantial contributions in time and/or money to earn their ownership stake.

Some certifications offer examples of evidence that ownership is not genuine, such as the purchase of shares using funds loaned by a non-eligible individual (especially non-recourse loans), stock certificates not in the possession of the nominal owner, minimal cash outlay for the stock purchase, or ownership of shares is by a trust.

2. Control by Eligible Individuals

In addition to ownership, eligible individuals must also have control of the certified company. For example, the National Minority Supplier Development Council defines control as meaning that "the management and daily operations are controlled by the minority group members."[8]

Demonstrating control can also require a variety of forms of evidence, such as:

- Company bylaws, articles of incorporation or other documents that define the roles of company leaders;
- Minutes of board meetings that demonstrate the nominal decision-makers are actually leading the company;
- A review of resumes to ensure that the nominal leaders have sufficient expertise to effectively manage the company; and
- Evidence that no shareholder agreement, covenants, or restrictions remove effective control from the nominal company leaders.

[8] http://www.nmsdc.org/mbes/mbe-certification/

3. The Business Must Be a Small Business

The SBA's definition of small business is often used, and it states that a small business is one that:

- "Is organized for profit;
- "Has a place of business in the U.S.;
- "Operates primarily within the U.S. or makes a significant contribution to the U.S. economy through payment of taxes or use of American products, materials or labor;
- "Is independently owned and operated;
- "Is not dominant in its field on a national basis";[9] and
- In addition, the business must not exceed the SBA's size standards, which are updated periodically and vary by industry[10]

4. Time in Business

Some certifications require that companies have been actively engaged in business for a minimum period before becoming certified.

5. Fees

Some certifications require payment of a fee, although some government certifications are free.

6. Recertification

All certifications require that the company continue to document its compliance with the standards. Most of the third-party certifiers require annual recertification, although some governmental certifications last for three to five years. All certifications require the company to notify the certifier in the event of a change of control or ownership.

WHAT ARE THE BENEFITS?

The most common reason that businesses seek certification is that they want access to contracts that are set aside for qualifying businesses. Governmental agencies may require a portion of the contracts be through these set-aside contracts, and those requirements may extend to subcontractors. Other entities, from corporations to nonprofits, may have their own preferred contracts.

In addition, some preferred-status certifications may bring other benefits, such as loan preferences or other support. Certification may be a marketing advantage.

[9] https://www.sba.gov/contracting/getting-started-contractor/qualifying-small-business

[10] https://www.sba.gov/contracting/getting-started-contractor/make-sure-you-meet-sba-size-standards

ESOPs: The Basics

Congress created the legal framework to encourage ESOPs in 1974 because its members believed that ESOPs could achieve a number of policy objectives.

Legislators expected that ESOPs would create a broader distribution of wealth, especially for workers who otherwise would have only limited financial assets. Congress also expected ESOPs to improve company performance and to provide a way for owners of closely held companies to preserve their business legacy rather than closing or selling to an outside buyer.

Congress's expectations have largely been borne out. The number of companies with ESOPs has grown to almost 7,000. Although ESOPs fulfill many purposes simultaneously, understanding how they work depends on keeping their two distinct functions in mind.

FUNCTION 1. ESOPS ARE EMPLOYEE BENEFIT PLANS

ESOPs are company-sponsored employee retirement plans governed by the 1974 Employee Retirement Income Security Act (ERISA), the same law that governs 401(k) plans. Many ESOP features are intended to ensure that they are managed properly and fairly for all participants. By law, ESOPs must be broadly inclusive and allocate benefits to employees on a more level basis than typical 401(k) plans or equity compensation plans. Companies with ESOPs tend to have additional retirement plans, usually 401(k) plans, and on average they make larger contributions to employee accounts than non-ESOP companies do.

FUNCTION 2. ESOPS ARE A WAY TO TRANSFER OWNERSHIP

When the current owner of a private company cannot or chooses not to maintain ownership, the company will need to find a new owner or cease operations. The owner may sell to a family member, the management team, or an outside buyer, but some choose to transfer ownership to employees via an ESOP. The advantages of an ESOP for these owners include significant federal and, usually, state tax incentives, as well as a flexible structure that allows owners to exit the business on a schedule of their choosing. Unlike many other prospective buyers of privately-held companies, ESOPs neither require nor prefer a controlling ownership stake. Sellers to an ESOP receive fair market value for their shares, as determined by an independent appraiser who advises the trustee of the ESOP. In some cases, the tax incentives available in ESOP transactions mean that the former owners end up with greater after-tax proceeds. When owners can earn more by selling to an outside third party, that transaction may be more advantageous.

For most sellers, legacy is at least as important as maximizing the financial value of the sale. They may prefer selling to the ESOP because they worry that outside buyers will have different goals for the company. Those buyers may not be willing to ensure the continued employment of the existing workforce, or they may change the location, the values, or the character of the business.

Although ESOPs can be complicated, the core principles are straightforward. They permit continued private ownership of companies, often with substantial tax advantages both to the seller and to the company, with the economic benefits of ownership flowing to the people who work at the company every day and contribute to its value.

The ESOP Trust and Regulatory Oversight

The first step in setting up an ESOP is for the company to establish an ESOP trust and appoint a trustee. The trust then acquires company shares on behalf of employees. Extensive federal legal requirements and a high standard of fiduciary duty for ESOP trustees are designed to ensure that ESOPs are fair to the employees who participate. Federal law requires, for example, that the ESOP trustee at a private company must hire an independent firm to appraise the value of the company stock. That appraisal must consider warrants, options, buy-sell agreements, and any other shareholder agreement or company document that would affect the rights or value of the shares purchased by the ESOP. The plan is not permitted to pay more than fair market value for shares, and both the IRS and the Department of Labor provide oversight.

Federal law also requires that ESOP trusts be managed solely in the interest of the employees in whose benefit the trust owns shares. ESOP trustees are held to the so-called "prudent expert" standard for fiduciaries, which is the highest fiduciary standard in federal law. ESOPs may not be designed to primarily benefit highly compensated employees, and complex anti-abuse rules ensure that creative ownership structures cannot subvert this intent.

Setting up an ESOP

Unlike other forms of employee ownership, ESOPs are almost always adopted by companies that have existed for years and have established an effective business model. Unlike an outside buyer, who will generally insist on an immediate 100% sale, an ESOP may acquire a minority interest, or it may become the sole owner, and it may acquire the shares immediately or over a period of years.

A company may contribute new shares to the ESOP, or it may contribute or lend cash to the ESOP to permit the ESOP to buy shares from existing owners. An ESOP is the only qualified retirement plan that is permitted to borrow money and it is common for the ESOP trust to borrow money (usually from the company) to buy shares. Employees, with very few exceptions, do not pay directly or give anything up to acquire shares.

Operating an ESOP

Once the ESOP has been set up, the company will generally make contributions each year to the ESOP. If the ESOP was established with a loan, the company must make sufficient cash contributions to the ESOP trust to enable it to make the required loan payments. The ESOP is a company-funded benefit plan, so all contributions to an ESOP are tax-deductible expenses for the company.

Although there are some exceptions, generally all full-time employees over age 21 participate in the plan. Shares in the trust are allocated to individual employee accounts. When a loan is used to purchase stock, the shares are allocated over time as the loan is paid off. Otherwise, the allocation happens immediately after the



contribution. Allocations are made either on the basis of relative pay or some more level formula. As employees remain actively employed at the firm, they acquire an increasing right to the shares in their account, a process known as vesting. Federal law requires that employees become 100% vested in no more than three years for a cliff vesting schedule, and in no more than six years for step, or gradual, vesting schedule.

When employees leave the company, they generally receive distributions of their ESOP account balances starting not later than six years after they leave, unless they retire, die, or become disabled. In those cases, payment generally starts after one year. The company must buy back shares in a participant's ESOP account at their fair market value (unless there is a public market for the shares), although companies can spread this repayment over time.

ESOPs and Employee Voice

Although many people equate worker ownership with worker control, federal law takes a different approach. Because the core law governing ESOPs covers retirement plans, the legal requirements and regulatory oversight focus on protecting the financial value of participant assets, rather than on providing employees a voice in company decision making. ESOPs guarantee that participants have a limited set of governance rights, and those rights concern decisions that affect the value of participant accounts (such as the liquidation of the business) rather than the ongoing direction of the company (such as electing the board of directors). By contrast, worker cooperatives are by definition governed democratically.

Although ESOP companies are not legally required to provide greater room for employee input into decision making, many of them choose to do so. ESOP companies often invest in business literacy training, open-book management, and structured ways to ensure that employees' voices are part of the company's decision-making process.

ESOPs and Taxes

Congress established a number of tax incentives to encourage business owners to establish ESOPs. Many of them apply differently to C corporations and S corporations.[11]

Deductibility of ESOP Contributions: Employer contributions to ESOPs generally are tax-deductible up to a limit of 25% of covered payroll (this limit also includes employer contributions to other defined contribution plans), and possibly more.

Deferral of Seller's Capital Gains Taxation: The Internal Revenue Code allows the owner or owners of a closely held C corporation (but not an S corporation) to defer capital gains taxation on stock sold to an ESOP if the transaction meets certain conditions.[12]

S Corporation Benefits: In an S corporation with an ESOP, the percentage of profits attributable to the ESOP's ownership is not subject to federal, and usually state, income tax. So in an S corporation 30% owned by an ESOP, no federal income tax is due on 30% of its profits; in a 100% ESOP, no federal income tax is due.

Deductibility of Dividends: Companies that sponsor ESOPs can, in some circumstances, deduct dividends paid on ESOP-held stock.

Tax Treatment of ESOP Benefits: Employees pay no tax on stock allocated to their ESOP accounts until they receive distributions. At that point, they are taxed on the distributions, unless they roll the money over into a traditional IRA or a successor plan.

[11] C corporations are the original form of corporate ownership and allow more flexibility of ownership structure, such as multiple classes of stock. Both corporate income and dividends are taxed. S corporations are simpler. They allow only one class of stock, and corporate income is taxable only once. That tax is paid by the corporation's owners rather than the corporation itself.

[12] The main conditions that the transaction must meet in order for the seller to qualify for the deferral of capital gains tax are that the ESOP owns 30% or more of outstanding stock following the transaction, and that the seller reinvests the sale proceeds into stocks and bonds of U.S. operating companies during a 15-month period. None of the shares sold to the ESOP in such a transaction may be allocated to ESOP accounts of the seller, certain relatives of the seller, non-selling shareholders holding more than 25% of company stock, or family members of the more-than-25% shareholders if they own stock by attribution (e.g., spouses).

ESOPs and Preferred-Status Certification

The two main barriers to better coordinating preferred-status certification and ESOPs are standards of ownership and standards of control.

The first challenge is ownership. Most certifications require that an eligible individual or individuals own shares, while in an ESOP company, some or all of the shares are owned by the ESOP trust on behalf of employees. The trust is a legal entity, not a person, and therefore is not itself an eligible individual.

The second challenge is control. The tests for control of the company used by most certifiers apply to the nominal owners of the companies to determine if they are, in fact, the company's decision makers. The tests determine, in essence, whether the owners are the executives and have power in the board of directors. An ESOP fits poorly in the tests for control designed for non-ESOP companies for three reasons. First, the trustee of the ESOP is charged not with managing the company but with protecting the asset value for plan participants. Second, the employees who are beneficial owners via the trust include by design the majority of the workforce. Employee-owners are largely rank-and-file workers, not the senior managers or directors for whom these tests were designed. Even if the eligible individuals who are decision-makers participate in the ESOP (which is not always allowed), those individuals will be unlikely to own collectively 51%of the stock. Third, a primary goal of the ESOP is to allow the owner—in this case an eligible individual—to exit the business and retire.

Imagine a hypothetical 100% ESOP-owned business in which the majority of employees are women, the majority of shares are held (inside the ESOP) by women, the CEO is a woman, and the board is majority women. Such an enterprise may still fail to be certified as a women-owned business because the trust, as the sole owner, has no gender or personhood.

Not all ESOP companies have demographics or leadership structures like this hypothetical company, of course, and most ESOP companies would not pass any reasonable test for preferred-status certification. Even if they do have the ability to pass a look-through test initially, it may be force difficult hiring or promotional decisions to maintain certification. Certification can also be jeopardized by a few women/minority employees leaving and altering the census. Without changes to certification standards for both ownership and control, the existence of an ESOP owning more than 49% of a company's shares causes a near-automatic loss of the preferred status.

The two challenges facing companies involved in both preferred-status certification and ESOPs are, first, the possibility that the two are incompatible, and second the uncertainty about what the certifier will decide until after the company has made its decision about the sale to an ESOP.

The following case study of the Illinois certification standard raises many of the issues about the importance of the specific wording of the certification standards and the impact of uncertainty.

STATE CASE STUDY: ILLINOIS

The Illinois Business Enterprise for Minorities, Females, and Persons with Disabilities Act[13] "establishes a goal that at least 20% of contracts awarded by State agencies subject to the Act be awarded to businesses owned and controlled by minorities, females, or persons with disabilities" (section 10.05). The statute both creates its own process

[13] Title 44: Government Contracts, Grantmaking, Procurement and Property Management; Subtitle A: Procurement and Contract Provisions; Chapter V: Department of Central Management Services; Part 10 Business Enterprise Program: Contracting with Businesses Owned and Controlled By Minorities, Females and Persons With Disabilities, (ftp://www.ilga.gov/JCAR/AdminCode/044/04400010sections.html).

to certify businesses and allows the acceptance of certification from other Illinois governments and third-party certifiers, subject to those entities meeting specified conditions (section 10.63). The law specifies that the owners must be U.S. citizens or resident aliens, that the business may have annual gross sales of less than $75 million, and that the business must be at least 51% owned and controlled by persons who are minorities. Ownership and control are both relevant to understanding the relation between ESOPs and this certification.

The definition of ownership (section 10.67) specifies that it must be “real, substantial and continuing and not simply a matter of form,” and provides some indicators of ownership that may meet this requirement. For example, the purported owners must demonstrate the means by which they became owners and document that they made a substantial contribution, such as money or expertise, in exchange for that ownership. Especially relevant for ESOP ownership, the law lists several factors that “may indicate ownership is not as stated,” one of which is “stock held in trust.”

The law specifically notes that control is a separate issue: “Ownership by eligible group members does not equate to control” (section 10.68). The definition of control is that the eligible individuals must have “direct control of the day to day operations, and must have, and exercise, the power to make major decisions on management, policy, fiscal and operational matters.” The indicators that a company meets this definition of control are broad, and include:

- The duties of directors;
- The rights of shareholders, including language that may limit the effect of their voting power;
- Demonstration that the eligible individuals have “sufficient background, including education and training,” to exercise effective control over the business;
- The existence of any stock options or other shareholder agreements that could later dilute the control of the eligible individuals; and
- Determining who in the firm “negotiates contracts and loans [and] prepares estimates.”

ESOP participants as individuals would be unlikely to meet these tests. ESOP companies are more likely to engage in participative management, but the majority of ESOP participants would not have the background or be involved in day-to-day control of the business, including contracts and estimates. In addition, although some ESOP companies choose to have ESOP participants direct the vote on all shareholder issues, federal law requires only that ESOP participants be able to direct the way the ESOP trustee votes on a subset of shareholder issues.[14]

Despite the above discussion, correspondence between a representative of the Illinois Business Enterprise Program (BEP), which manages this certification, and an ESOP company that prefers to remain anonymous because of its ongoing discussions, indicates that BEP permits ESOP firms to “look through” the ESOP to the ESOP participants in order to determine whether a company meets the ownership test. The representative affirmed that the ESOP participants must also meet the control requirements, though he did not indicate whether or how those requirements would be interpreted in the context of an ESOP.

The implications of the current Illinois law are that ESOP companies may be able to qualify, depending on the demographics of their work forces, but that they face considerable uncertainty about whether they would qualify, and that uncertainty would not be resolved until after the transfer of ownership to the ESOP.

[14] Those issues include liquidation, sale of a majority of the company’s assets, merger, reclassification, dissolution, and other “fate of the company” issues. ESOP participants do not need to be given a vote on the sale of stock, meaning that the company could be sold without approval by employees.

CASE: BUTLER/TILL

There are examples of majority ESOPs that have retained or acquired certifications notwithstanding their ESOP structure. Butler/Till, an integrated media and communications firm founded by Sue Butler and Tracy Till in 1998, is one such company. Headquartered in Rochester, New York, Butler/Till employs more than 100 people and has more than $160 million in billings from clients across the public, private, and non-profit sectors. Among its numerous accolades, Butler/Till has been ranked as one of the 5,000 fastest-growing companies in *Inc.* magazine, and one of the best places to work in advertising and media, according to *Advertising Age.* It is also a 100% ESOP-owned company.

Butler/Till was first recognized as a Women-owned Business Enterprise (WBE) in 2001 and continued to be so until Sue Butler and Tracy Till sold 51% of the company to the ESOP in 2011. The company lost WBE status the following year and did not appeal the decision, nor did it try to renew in the following years. The company and its owners completed a second transaction in 2014 to become a 100% ESOP. The company did not try to change its status until the following year, when it purchased WBE certified company Brand Cool.

Brand Cool is a marketing consultancy also located in Rochester, New York, that is both a certified B Corp and a New York State Benefit Corporation. It is primarily focused on the Energy Sector at both the state and federal level and, in conjunction with being an approved contractor for the US General Services Administration (GSA), maintained a client portfolio and business development pipeline that included several government contracts that required WBE status. When Butler/Till purchased Brand Cool, the resulting change in control at Brand Cool required that Brand Cool apply for WBE recertification, and rather than seek to recertify the subsidiary, Butler/Till decided to seek to regain its own WBE certification.

The combined company has leadership teams that are majority women, including a female president, and 71% of ESOP participants are women, and 71% of ESOP shares as well are held in accounts of women. The combined business met the size requirements for a WBE. Butler/Till submitted an extensive application packet, which included documentation of the purchase of Brand Cool, evidence of the gender and U.S. citizenship for ESOP participants representing at least 51% of company stock, documentation that the controlling managers were women and U.S. citizens, and a copy of its ESOP documentation. Following a site visit, WBENC granted recertification.

Butler/Till then sought to restore its certification with New York State. After a four-month process, which involved providing additional documentation, such as proof of gender and affidavits of personal net worth for a majority of female ESOP participants, the company was recertified by the state.

Catalog: Certifiers and ESOPs

The NCEO has created a database that catalogs the basic requirements for preferred-status certifications throughout the nation, with a specific focus on minority-owned, women-owned, veteran-owned, and disadvantaged business enterprises. The database will likely always be a work in progress, and was created by drawing on personal conversations, input from experienced advisors, and a wide variety of sources from throughout the internet.

The database is in the form of an online spreadsheet at www.nceo.org/r/preferreddatabase

FIELDS

The descriptions, requirements, ESOP-specific rules, populations, contact information, and other information for each certification are summarized to the greatest extent possible in the following fields.

State: Where the agency is located

Agency: The name of the certifying agency

Jurisdiction: The geographic and, when applicable, industry to which the certification applies

Certification: The name of the certification awarded

Agency Type: Government agency or independent certifier

Population Considered: Women, minorities (definition of minorities), disabled veteran etc.

% Ownership Requirement: Percentage of company shares that must be owned by eligible individuals

Control Requirement: Does the certification require demonstration of control by eligible individuals? When available, a summary of requirements are included.

ESOP Specific Rules: When rules include provisions specific to ESOPs, the database summarizes those rules. When we have verified that the certification has not made any ESOP specific rules, that is indicated.

Fee: The dollar amount, if any, required along with the application.

Site Visit: Whether a site visit to the applicant company is required.

Telephone Interview: Whether a telephone interview with the applicant company is required.

Documentation Requirement: When available, the database indicates some of the documents that must accompany applications.

Fast Track Option: Whether the agencies offers expedited processing of membership applications or renewals.

Timeline for Decision: If known, how long companies wait between submitting an application and receiving a decision.

Certification Duration: How long the certification remains in effect before renewal is required.

Website of Certifying Body: if available.

Contact Name, Contact Number, Contact Email, Secondary contact: If available.

Other Common Certifications: offered by the same agency, if available.

TABS

The database is organized into various tabs for different types of certifications.

Tab 1: Disadvantaged Business Enterprises (DBEs)

DBEs have nearly uniform requirements and expectations from state to state as the regulations are set by the US Department of Transportation.

Tab 2: Minority-Business Enterprises (MBE)

A wide variety of certifications provide MBE certification. Many government entities at the state and local level have their own MBE programs that carry with them specific government procurement benefits. There are also widely used third-party certifications, provided primarily by the National Minority Supplier Development Council. Some government agencies offer reciprocity with third-party certification.

Tab 3: Veteran Business Enterprises

These certifications are handled and regulated by the Department of Veterans' Affairs and can often be somewhat more arcane.

Tab 4: Women-Business Enterprises (WBEs)

A wide variety of certifications provide WBE certification. Many government entities at the state and local level have their own WBE programs that carry with them specific government procurement benefits. There are also widely used third-party certifications, provided primarily by the Women's Business Enterprise National Council for WBEs, as well as their regional affiliates. Some government agencies offer reciprocity with third-party certification.

Tab 5: Other

The Small Business Administration's (SBA) 8(a) and Historically Underutilized Business programs are found in this category. Other less orthodox or harder to qualify certifications will be listed here as they come up.

Tab 6: Glossary

The glossary contains the alphabetical list of some of the more common terms and acronyms, with definitions established by government agencies.

The database is available at www.nceo.org/r/preferreddatabase

Recommendations for Companies

The most common scenario, and the one for which this recommendation is intended, is a company that currently holds a preferred status and that is considering establishing an ESOP that would own more than 49% of shares.

1. RESEARCH YOUR CERTIFICATION AGENCY'S POLICY ON ESOPS.

Each agency has different requirements, and some have experience with ESOPs. Advance research may help you make the most effective case to your certifying agency. Companies also need to pay attention to the details of the certifiers policy. One anonymous company designed a transaction so that an eligible individual would continue to own a majority of shares, but instead of 51%, he retained 50.5%. That did not meet the certifiers requirements, so he had to attempt to repurchase 0.5% of the shares.

2. REQUEST ADVANCE ASSURANCE OF CERTIFICATION.

Write a formal letter to the certifying agency explaining the outlines of the transaction you expect to take and offering to provide specific documentation, such as minutes from board meetings, representations and warranties that the seller will make in connection with the ESOP transaction, a description of the fiduciary standards that apply to the ESOP trustee, and a description of the number of eligible individuals among the work force, including projections about the portion of ESOP stock that would be allocated over time to their accounts. Your letter should request from the certifying agency instructions that your company must follow to be assured in advance that it will continue to be certified following the ESOP transaction.

3. PROVIDE EXAMPLES FROM OTHER CERTIFYING AGENCIES.

The case study of Butler/Till (page 14) may be useful.

4. CONSIDER DESIGNING YOUR ESOP TO MAXIMIZE THE CHANCES OF MEETING CONTROL REQUIREMENTS.

Since most certifications require not just ownership but control by eligible individuals, you may choose to set up your ESOP to specify that all shareholder votes will be passed through to participants. The law governing ESOPs allows but does not require this "voting pass-through," but it does allow it. You may also want to ensure that the ESOP trustee or a majority of a trustee committee are qualifying individuals. More broadly, you may want to be conscious about defining a group of eligible individuals with sufficient skills and documented responsibility who can fill control requirements by serving in key executive roles, such as CEO, CFO, COO, and ESOP trustee.

5. CONSIDER A PHASED TRANSITION / PARTIAL SALES.

Since in most cases the conflict between ESOP ownership and a preference status arises only after the ESOP owns more than 49% of shares, consider a phased transition. The ESOP can buy any portion of the shares, and many companies find that a two-stage transaction works best for them. For example, the ESOP may purchase 40% of shares and when the loan for that transaction has been repaid, the ESOP may then purchase the remaining shares. This two-step process allows you to make a stronger case to the certifying agency, because the transaction is smaller and you will already have accumulated some data, such as the census of ESOP participants and the amount of company stock in each eligible individual's account.

Recommendations for Certifying Agencies

Facilitating the adoption of ESOPs by certified companies could provide stability to certifying agencies by encouraging the long-term viability of the independent companies they certify. We provide suggestions to make it easy.

BENEFITS OF ESOPS FOR CERTIFYING ORGANIZATIONS

The first potential benefit is that ESOPs are designed to provide an ownership transition, so they can help avoid the gradual attrition of certified companies as the current owners of those companies approach retirement age. Businesses everywhere, including those that hold preferred-status certification, are frequently owned by baby boomers. As that cohort approaches retirement, their companies must find new owners. Although it is possible that the company will find another eligible individual or individuals to become owners, it is also possible that they will sell to another company or to a non-qualifying individual. The inevitable loss of these currently certified businesses is a threat to the viability of the certification agencies. Effectively denying the possibility of certification to all ESOP-owned companies reduces the size of the pool of businesses that would otherwise pursue certification.

Second, one of the most challenging tasks certification agencies face is finding an efficient and credible way to gauge whether ownership and control are genuine. The tests certifying agencies must use to make that determination is costly in time for the candidate companies and for the agencies themselves. ESOPs have a well defined process for ensuring that ownership is genuine, and although that process cannot replace the current due diligence performed by certifiers, it may serve as an alternative or supplemental verification of the authenticity of ownership.

Certifying agencies should consider four recommended approaches to resolving the tension between their certification requirements and ESOPs. Recommendation 1 simply provides clarity. It would require minimal change and would reduce the uncertainty facing certified companies as they consider adopting an ESOP, but it would not resolve the fundamental tension between certification and ESOPs. Recommendations 2, 3, and 4 can be done together or separately. All three suggest amendments to current definitions that would provide clear requirements for companies that are currently certified to retain that certification after becoming majority owned by an ESOP. Recommendation 2 concerns eligible individuals, recommendation 3 concerns ownership, and recommendation 4 concerns control.

The recommendations that follow do not seek to make employee ownership itself a reason for companies to receive preferred status, a topic this paper does not address. Rather, the recommendations seek to remove barriers that currently prevent companies that would otherwise qualify for preferred status from adopting ESOPs.

RECOMMENDATION 1: Provide advance assurance of future compliance

Certifying agencies must review completed applications, so they cannot promise certification in advance. Without amending their policies, however, they can take steps to give current owners greater assurance that creating an ESOP will not result in the loss of certification. Agencies should provide clear, public, written guidance to companies that explain and give examples of the interaction between certification and ESOPs. Such guidance could include sample language to include in the ESOP document. Guidance in writing is important, because companies are unlikely to rely on oral assurances when their viability is dependent on continued certification.

RECOMMENDATION 2: Allow "safe harbor" definitions for eligible individuals in ESOP companies

Certifiers take the reasonable step of requiring individual owners to document that they are eligible individuals, often by requiring them to document that they are members of a specific group and that their personal net worth does not exceed a threshold. This requirement is extremely time-consuming when applied to all eligible individuals who participate in an ESOP, many of whom are working Americans and do not approach any such wealth threshold. A simpler way to approach the personal net worth requirement may be to allow companies to use payroll data and to set a threshold for annual compensation below which employees would be presumed to be below the personal net wealth requirement.

RECOMMENDATION 3: Amend the standards of ownership to incorporate ESOP-specific language

Instead of viewing the trust as a legal entity and disqualifying an ESOP-owned company, certifying agencies could instead "look through" the trust to consider the identities of the ESOP participants in whose interest the trust owns those shares. A company would provide data on the total allocated shares and shares expected to be allocated in the accounts of qualifying individuals in the ESOP. If that, in combination with shares held by such individuals outside the plan were greater than 50%, the company would meet the ownership requirements. If the current policy notes that trust-based ownership (as in the Illinois statute) is a sign that a company may fail the ownership test, then stating explicitly that an ESOP trust is not such a sign.

RECOMMENDATION 4: Amend the standards of control to incorporate ESOP-specific language

As currently written, ESOP ownership does not provide individuals a level of control that would satisfy the requirements of most certifiers, and since the ownership in an ESOP company is broad based and extends far beyond the ranks of executives, the current standards of control are not good fits for ESOPs. The ESOP trust itself, however, must have "control in fact" if it has paid for it, so ESOP companies have documented control already as part of their communication to the firm that appraises the value of their shares.

Given the way ESOPs work, the standards of control could be written so that the ESOP itself must have control, rather than the participants. This distinction would allow certifiers to create some definitions of control that are specific to the structure created by an ESOP. For example, they could require that the trustee of the ESOP be an eligible individual or that the majority of a trustee committee be eligible individuals.

Some other definitions of control that would apply to both ESOP and non-ESOP companies may also be useful, such as

- The chief executive officer of the company (or president if there is no CEO) is an eligible individual;
- Other executives, especially the CFO and COO, are eligible individuals;
- The board of directors has a majority of eligible individuals.

CONCLUSION

Both preferred-status certifications and ESOPs aim to achieve social and economic benefits for people who would otherwise have less access to economic prosperity.

Recent research shows that employee ownership through ESOPs could strengthen and deepen the impact of preferred-status certifications. In addition, ESOPs could also extend the benefits of certification to more people and provide preferred-status companies a new tool to survive the retirement of their current owners.

Despite this potential synergy, specific parts of both programs' design features clash with each other. Although the definitions and designs that both have developed over the years are thoughtful and serve their missions, they have the unintended consequence of frequently making the two programs incompatible.

As the experience of a handful of companies shows, however, the combination of these two programs can be achieved, and the simple steps described in this paper will allow more preferred-status companies to adopt ESOPs.

[15] Public companies have ESOPs, usually as a component of their 401(k) plans, but with the lone exception of United Airlines in the late 1990s, public company ESOPs own less than 50% of company shares.

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