

ESOPs:

After boom days of the 1980s, popular pension plan levels off

While many companies still swear by them, the complexity of government rules turns off many others now considering ESOPs in the 1990s.

By JACK SCISM
Staff Writer

Remember ESOPs, the pension plans that corporate America embraced with such ardor in the 1980s?

ESOPs — acronym for employee stock option plans — are still around but the affection for them has waned decidedly in the 1990s. After a sevenfold increase in the 1980s, the number of companies with ESOPs is the same today as it was in 1990.

And yet, with a few exceptions, companies that started ESOPs in the '70s and '80s are still as enthusiastic about them as ever. And this seems to be so in both the executive office and on the assembly line.

"It has been outstanding," Pete Cross, Cross Sales & Engineering Co. president, says of an ESOP started by his father 16 years ago.

The ESOP, he said, has created a "sense or culture of ownership, and that is motivating."

An ESOP is a tax-qualified, defined-contribution, employee-benefit plan that invests primarily in the stock of the sponsoring company on behalf of the

employees, who become shareholders of the firm.

When a company starts an ESOP, it creates a trust to which it makes contributions annually from its profits. These contributions then are used to buy stock from the company in the name of the employees.

At the 20-employee Greensboro office of the Virginia-based Anderson and Associates civil engineering firm, business relations manager Tina Vaughn says the company has extremely low turnover rate and attributes it to the feeling of ownership generated by the company's ESOP.

"It's the next best thing to working for yourself," she said.

Despite such rave reviews, interest in ESOPs nationwide has definitely cooled in the 1990s.

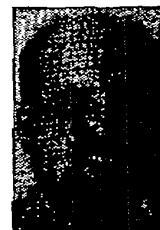
After rapid growth in the 1980s, the number of companies with ESOPs has leveled off this decade.

According to ESOP Association in Washington, the number of ESOPs in the country grew from 1,500 in 1981 to 10,000 in 1990.

But five years into the 1990s, that figure has not gone up at all. The association estimates the number of ESOP companies still stands at 10,000.

ESOPs first gained popularity because they offered significant tax advantages for participating companies.

WHAT THEY'RE SAYING



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Keith Price,
Anderson and Associates

Everyone understands we're all on this team together and if one person succeeds, we all succeed.

Tina Vaughn,
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For instance, the employer can treat as an expense all payments made into the plan and dividends paid on the ESOP controlled stock.

From its beginning, an ESOP has been an excellent device for owners of small and medium size, closely held companies to dispose of their stock and save taxes. Owners incur no taxable gains on a sale of stock to an ESOP if the ESOP owns at least 30 percent of the company immediately after the sale.

Meanwhile, for bigger, publicly held companies, ESOPs often were used to avoid unfriendly takeovers. Cone Mills in Greensboro, for instance, created an ESOP in 1984 to buy up its stock and go private, thereby turning back a bid by a New York investment company to take it over.

In more recent years, struggling airlines such as United and Northwest have used ESOPs to convert to worker ownership and stay afloat in an extremely cost-sensitive industry. United, for instance, gave its employees 55 percent ownership and the employees in return gave up 23 percent of their compensation.

Finally, as the comments of Cross and Vaughn indicate, ESOPs are a proven method of increasing productivity by giving employees a stake in the ownership.

Anderson and Associates vice president Keith B. Price Jr. notes, "When people have the feeling of ownership, you see them cutting off lights when they leave, saving paper clips, and things like that. When everybody does that, it is a win-win situation."

So why has the growth of ESOPs tapered off so dramatically in recent years.

Dennis Stearns of Stearns Financial Services, a Greensboro investment management and business consultant firm, thinks it has to do with the complexity of government rules.

Stearns has helped start about eight ESOPs in the past 16 years but now, when he talks to company owners about them, he finds they are turned off after he explains the federal rules that govern their operation.

"There's been a general backlash against their complexity because of all the government regulations," he said.

Another factor, Stearns said, is

the elimination of tax advantages banks once enjoyed on loans for leveraged ESOPs.

Part of the interest from such loans used to be exempt from taxes but no longer is.

ESOPs also now must compete with other, less complex pension plans.

Cone Mills, for instance, quit making contributions to its ESOP in 1993 because "we found this was not an efficient way to fund our pension plan," said Jim Buckner, vice president of industrial and public relations at the Greensboro denim manufacturing giant.

Cone now has a 401(k) plan for its hourly employees.

Two other major Greensboro textile manufacturers — Burlington Industries and Guilford Mills — continue to have and fund ESOPs.

ESOPs can be expensive to set up and this can be a deterrent for small companies.

Nations Business magazine estimates the legal, accounting, actuarial and appraisal fees for a small- or medium-sized firm can total about \$30,000 while annual expenses to maintain the plans run \$10,000 to \$15,000.

While an ESOP can be an excellent way for the owner of a private company to minimize taxes in disposing of his or her interest in the company, another section of the federal tax code is attractive to small, closely held companies for its tax advantages. This is designation as an S Corporation. An ESOP corporation cannot become an S corporation.

Small companies often opt for the S corporation designation since this allows them to pass income directly through to shareholders without paying tax on the income. This avoids the double taxation problem of bigger companies, which pay tax on their income before dividend distribution and whose shareholders then must pay tax on their dividend income.

Still, for an owner of a small company anticipating retirement, an ESOP provides both tax advantages for the owner and incentives for the employees.

Cross at Cross Sales & Engineering said that's what happened when his father, William (Bill) Cross Jr. started an ESOP in 1979.

"We were closely held and he used the tax advantages of an ESOP in effect sell the company," he said.

Today, 45 percent of the company is owned by employees.

Experts warn that only companies with good growth and profit

prospects should start an ESOP. If a company is stagnating or declining, an ESOP will not reward employees for loyal service and could leave them resentful, they explain.

Cross emphatically agrees.

He noted that the 260-employee Cross Sales & Engineering — an industrial distribution firm that sells motion and control products in nine states in the Southeast — has been a high growth and profitable company throughout the years.

"An ESOP is no good unless you have those elements of growth and profit," he said.

Cross also cautions that ESOPs do create a long-term issue. As employees retire, die or quit, their holdings in the ESOP must be redeemed and cash is needed for this.

"Companies with 401(k) plans can make a contribution and then forget it. They have no downstream obligation," he said. "A company with an ESOP makes a contribution but has an obligation to buy the stock back eventually, so it must remain interested."

Buying back this stock can become expensive, he said.

To start an ESOP, a company creates a trust to which it makes annual contributions. These contributions are allocated to individual employee accounts within the trust. Allocations may be made based on a number of different formulas, including compensation and length of service.

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.

An ESOP is intended to cover all employees, and it requires that the owner disclose certain financial information about the company, its performance and its key executives' salaries. Thus, a company's management must be committed to this type of openness, says Nations Business magazine.

Still, it reported, advocates of employee ownership argue that the benefits outweigh the disadvantages.

Vaughn at Anderson and Associates, where the ESOP owns 38 percent of the company, says there's no doubt in her mind about this.

"The benefits include higher employee morale and greater productivity," she said. "Everybody understands we're all on this team together, and if one person succeeds, we all succeed. And from top to bottom, everybody knows if we're not successful, we all lose."