ESOPs and Benefit Corporations

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What We'll Cover

- What are certified B Corps and Benefit Corporations?
- Benefits of combining BC and ESOPs
- Challenges of combining BC and ESOPs
- Case Study
- Lessons: best practices
- Q&A

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Key Concept

Certified B Corp

-versus-

Benefit Corporation

Certified B Corp

- Certified by B Lab, a non-profit
- Generally adopted by board of directors
- Requires bylaw changes

Certified B Corp

- Over 1,000 organizations – businesses, non-profits, others
- International
- Requires bylaw changes

Certified B Corp

- Step 1: Assessment
- Step 2: Legal changes
- Step 3: Sign B Corp declaration

- www.bcorporation.net

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Definition of Benefit Corporation

A "company that turns a profit while benefiting its workers, its community and the Earth, sometimes at the expense of its owners."

– B Lab

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Benefit Corporation

- Legal status in law of 34 states
- Adopted by shareholders
- Extends fiduciary duty of boards beyond shareholder value

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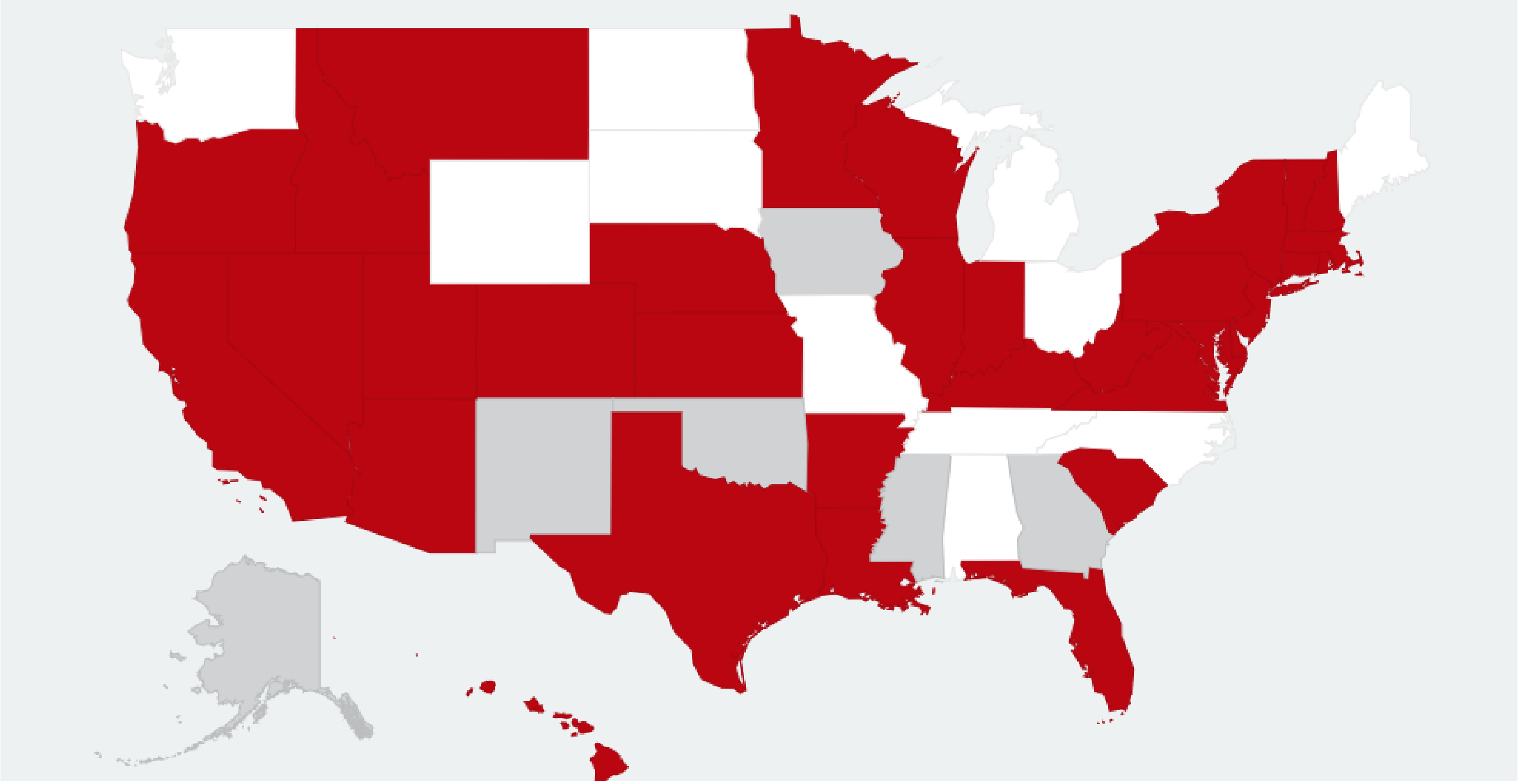
Benefit Corporation



benefitcorp.net

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Benefit Corporations in Virginia

- Authorized by Va. Code Ann. §§ 13.1-782 to -791
- A benefit corporation must be formed in accordance with Va. Code Ann. §§ 13.1-618 to -625, and its articles of incorporation must state that it is a benefit corporation
- One of the corporation's purposes must be "creating a general public benefit"
    - "General public benefit" defined as "a material positive impact on society and the environment taken as a whole, as measured by a third-party standard, from the business and operations of a benefit corporation"
    - Examples of specific public benefits include "[p]reserving or improving the environment" and "[i]mproving human health"

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Outline

- Different strengths / logic for pursuing each strategy
- Different limitations of each strategy
- How the 2 approaches can mutually reinforce one another
- Quick examples (before detailed case)

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Unique Strengths: ESOP

- ESOP is a buyer of shares
  - From a seller who wants to sell and has certain priorities
  - To a buyer that is an ERISA (federal law) qualified retirement plan
  - For the benefit of participants in the retirement plan = eligible employees
  - Requirement for ESOP Trustee (shareholder) to demonstrate decision-making in the exclusive best interests of plan participants
  - Tax benefits to company, participants, and (sometimes) selling shareholder
- ESOPs outperform other firms
  - *If* employee-owners are engaged appropriately in decision-making
  - The opposite is true: micromanagement negates the ESOP performance advantage
  - Not mandated by ERISA, but observed consistently in research data over extended period
  - Bottom line: shared ownership creates performance opportunity…but not guarantee

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Limitation of B Corp vs. ESOP

- B Corp does not provide a buyer for stock
  - Eventually, someone else will own your company…who?
  - If your startup intends to go public or sell to investors, how will you structurally protect your mission?
- B Corp does not (yet) have objectively demonstrated financial performance advantage
  - No tax benefit – other than very small local issues
  - The potential is obvious; the data are less mature, much shorter history
- No (required) mechanism for employees to participate in equity growth of the company

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Unique Strengths: B Corp

- Certification and/or state-level corporate registration
- Requirement to serve multiple stakeholders, not *only* focus on shareholder financial interests
- More wiggle room for Board & leadership to make decisions that balance the interests of various parties
  - Shareholders
  - Employees
  - Customers
  - Vendors
  - Local community: income & wealth sharing – employment, charity, etc.
  - Global community: environment
  - Often described as “triple-bottom line: people, planet, profit,” from Ben & Jerry’s
- May limit sale of the firm to mission-aligned buyer…but doesn’t provide the buyer
- Many of these concerns are *permitted* but *not required* under various state corporate laws
- Requirement to audit / document business practices in line with stated mission claims

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Limitation of ESOP vs. B Corp

- Does not require balancing interests of multiple stakeholders
- May require prioritizing participants’ financial retirement interests at the expense of other corporate priorities
- No mechanism to audit / document business practices that may be attractive to certain consumers and/or investors

ESOPs & B Corps Together

- Best of both worlds…if both worlds matter to you
  - Accountability to mission, community, stakeholders beyond only shareholders (B Corp)
  - Sustainable control of the firm / mission beyond current generation of owners / investors (ESOP)
- "Who wins in court": not extensively litigated
- You're never locked in: shareholders or company can change the decision
  - Terminate ESOP or sell ESOP company
  - Change state-level incorporation to eliminate B Corp designation (but this will require shareholder (ESOP) approval)

Combining ESOP and B Corp

- Examples: all became B Corps *after* being ESOPs
  - Dansko (PA)
  - EA Engineering, Science, and Technology (MD)
  - Eileen Fisher (NY)
  - Gardeners Supply (VT)
  - King Arthur Flour (VT)
  - New Belgium Brewing (CO)
- Characteristics
  - Most are consumer-facing brands whose customers are passionate about mission issues
  - Many self-identified “socially responsible” ESOPs have not (yet) found B Corp to be compelling
  - Your mileage may vary!
- Test the waters: take the B Corp Impact Assessment, and see if it feels like a fit
  - http://bimpactassessment.net/

Duties of ERISA Fiduciary

- Build pecuniary value for shareholders, solely as shareholders
- Cannot consider preservation of jobs, even for shareholders
- Cannot consider social, environmental and other non-pecuniary benefits to the company, its customers or society
- Can consider or evaluate those items as they are factors in building long-term pecuniary value of the company
- Fiduciary needs more than vague assurances regarding long-term value

Duties of a Benefit Corporation/Director

- Creating general public benefit—i.e., material positive impact on society and the environment taken as a whole
- Typical specific public benefits:
  - To design products that create minimal environmental and social harm
  - To create an inclusive workplace that respects and honors differences in gender, age, race, ethnicity, religion, sexual orientation and political views
  - To conduct business in ways that empower the un-empowered, support the fair treatment of all people and preserve the environment
  - To work collaboratively and transparently with other companies in the fashion industry to advance ethical business practices
- Public benefit considerations shall be in addition to or predominate over the other purposes of the Corporation and shall be considered as one factor to be weighed for or against any inconsistent purpose

Reconciling B Corporation and Pecuniary Considerations

- Can an ESOP Trustee justify purchase of B Corporation shares or conversion to B Corporation status? (Hint: conversion to B status may be more difficult than purchase of B Corp)
- Legitimate case for long-term value
- Value demonstrated by past and current performance
- Value adjustment already baked into price
- Process for determining return on investment

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Existing vs. Conversion to B Corporation

- With purchase of an existing B Corporation, there is a better argument that value adjustment is already “baked in” and simply affects value
- With a conversion to B Corporation (where Trustee holds decisive vote) status of an existing ESOP company, Trustee should be satisfied that conversion will not materially change corporate behavior
- Trustee can insist on limits on level of consideration given to B Corporation values—i.e., that they be considered as a factor but predominate over other factors
- Trustee can insist that company evaluate return on investment for major initiatives

Return on Investment Process

- Trustee may require Company to conduct a return on investment analysis for major initiatives
- Trustee should NOT be involved in the review of individual initiatives
- Trustee may want to require that the company adopt a written process for such evaluations and review the written process

Third-Party Offers to Purchase

- Company officers may have a duty to decline a sale if jobs and corporate culture are in jeopardy
- ESOP Trustee may have a duty to sell if price is high enough
- If ESOP owns 100% of company, Trustee may have duty to sell over the objections of company management
- If ESOP owns less than 100%, other shareholders may not want to sell and it is not typical for the ESOP to hold drag along rights

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ESOPs + B Corps

butler/till

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EILEEN FISHER

GARDENER'S SUPPLY COMPANY

KING ARTHUR FLOUR

MAZZETTI

MissionBell reclaimed

NEW BELGIUM BREWING

Recent B Corp Activity

- Danone NA (owns Stonyfield Yogurt)
- Athleta (sub of Gap)
- Innocent Drinks (owned by Coca-Cola)
- Participant Media
- Megafood
- Luke’s Lobster
- Wanderlust
- Just Water

“We’re at an Inflection Point.”
– Bart Houlahan, B-Lab Co-Founder

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Case Study:
EA Engineering, Science, and Technology, Inc., PBC

- Delaware Public Benefit Corporation
- $140M Revenue
- 100% ESOP-owned
- ~530 multi-discipline staff
- 100% environmental focus with full service capabilities:
    - Habitat Restoration
    - Environmental Compliance
    - Natural/Cultural Resources
    - Remediation, Hazardous Waste, and UXO

EA – A Brief History

A consultancy specializing in environmental services for government and industry

2014 100% ESOP, PBC
Institutional Investor and Management bought out

2005 Partial ESOP
Founder sells to ESOP and Management

2001 Private
Went private

1986 NASDAQ
Publically traded, acquired to diversify

1973 Founded
Founded as Ecological Analysts

EA's Core Purpose:

IMPROVING THE QUALITY OF THE ENVIRONMENT IN WHICH WE LIVE, ONE PROJECT AT A TIME®

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EA’s Conversion to PBC Status

EA’s status as a PBC:

- Reinforces our commitment to EA’s environmental mission
- Requires EA’s Board of Directors to:
  - Balance the interests of <u>stock</u>holders and other <u>stake</u>holders with the promotion of our specific public benefits as stated in our Charter
  - Plan, measure, and report EA’s progress in delivering our specific public benefits, resulting in a report to stockholders at least biennially
    - ✓ We opted for an annual report to the public, available on our Web site

From EA’s New Company Charter

“…the specific public benefits to be promoted by the Corporation are to (i) reduce human and ecological risks associated with environmental degradation and natural resources impairment, and (ii) improve air, water, soil, and sediment quality. The Corporation will achieve these specific public benefits by focusing exclusively on the delivery of professional environmental services; and by encouraging its employees to support the communities in which we live and the clients that we serve in an environmentally responsible manner.”

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Process to Establish

- Decide on legal status adoption vs. B-Corp certification, or both (we chose legal adoption)
- Assess legal feasibility within ESOP framework
- Evaluate pros and cons of adoption
    - Governance implications
    - Client perceptions
    - Employee perceptions
    - Potential initiatives to implement and cost
    - Transaction costs
- Work through Board and Trustee deliberations
    - Fiduciary decision was easier because of positive participant impact of going 100% ESOP at the same time

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ESOPs and Benefit Corps (EA's View)

- ESOPs
  - Long-term investment view – the ultimate "patient capital"
  - For-profit, but also building employee engagement and ownership culture
  - Typically interested in community involvement and support

- Benefit Corps
  - For-profit companies
  - Broader view of stakeholder benefits
  - Outgrowth of Corporate Social Responsibility Movement – Environmental, Community, and Employee issues

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Benefit Corporations and Engagement

- Research has shown that ESOPs tend to struggle with Employee Engagement just like all other companies (and possibly more)
- So, how to get employees engaged?
    - ESOP awareness: love your retirement benefits!
    - Ownership culture: work together to improve productivity
    - Corporate Social Responsibility (CSR): work together to make the world a better place
- For professional service firms like EA, CSR seems to resonate most with our work force

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What About Fiduciary Concerns?

- Just like CSR programs in large public companies, the impact of benefit corporation status on profits is negligible (if implemented prudently)
  - Benefit corporations are still for-profit companies
  - Especially easy to justify where CSR activities align with the mission of the firm
  - In the long run, any cost will be offset by productivity gains, employee attraction and retention, and customer perceptions
  - Long-term investment horizon
- CSR costs and benefits are difficult to measure
- As with all things, extremes are a bad idea, e.g., “Let’s give away 50% of profits to charity forever!”

Don’t Forget!

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Questions?

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- Christopher, a member at Kaufman & Canoles, P.C. and a Director of ESOP Strategies, LLC, has an extensive background in corporate law including M&A transactions and Benefit Corporations to complement his broad ESOP background. Christopher has worked with numerous corporations in a wide range of corporate ownership succession transactions, including leveraged buyouts, corporate stock repurchases, and corporate reorganizations in addition to Benefit Corporation elections. His ESOP practice focuses primarily on the design, implementation, maintenance, and compliance of ESOPs, while representing ESOP sponsors or trustees.
- Christopher's employee benefits practice focuses on the design, implementation, maintenance and compliance of employee stock ownership plans. Christopher works with both ESOP Sponsors and ESOP Trustees in initial stock purchase transactions, second stage transactions and sale transactions of successful ESOP companies. Christopher also advises ESOP Sponsors in the management of mature ESOPs including evaluating repurchase obligation options, resolving administrative issues, counseling on acquisitions and secondary purchase transactions, and coordinating and designing executive compensation plans complimentary to ESOPs.
- Christopher's executive compensation practice involves a variety of nonqualified executive compensation plans. Christopher works with corporations in the design, adoption, implementation and compliance of nonqualified plans which have involved phantom stock, stock appreciation rights and other synthetic equity, stock options, restricted stock, deferred compensation and other executive compensation arrangements. Christopher also represents executives in the negotiation of executive compensation arrangements and employment agreements, taking an inclusive approach so to ensure the compensation structure is a part of the executive's broader trust and estate planning.

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Questions?

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- Since joining EA in October 2001, Peter has played a key role in the Company's transition to a privately-held company, its turnaround in financial performance, and its evolution into a 100% ESOP-owned Public Benefit Corporation.
- His responsibilities include ESOP planning and administration, corporate governance, mergers and acquisitions, strategic planning, and ongoing analyses of EA's financial performance.
- Peter received a BA in Economics (with honors) from Oberlin College, and an MBA from the Smith School of Business at the University of Maryland.

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- Lance is a professional fiduciary with over 16 years of ESOP trustee experience.
- Lance's clients have ranged from very small ESOPs to high profile ESOPs and fiduciary engagements including for CITI, Wal-Mart and Ford Motor Company.
- Lance received his J.D. degree from The University of Alabama School of Law and is a member of The ESOP Association and the National Center for Employee Ownership and frequently speaks on ERISA and ESOP fiduciary issues.

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