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Importance of Corporate Governance in ESOP Companies

By Kenneth Serwinski

When transitioning your closely held business to new ownership with an Employee Stock Ownership Plan (ESOP), it's important to have strong corporate governance in place. It is critical to understand how this transition affects ownership and operations in different ways. The transition of an ESOP is not just a matter of dollars and cents. The sustainability of the company as well as the well-being of the employees and shareholders are also important considerations.

To create a healthy ESOP it is best to critique your existing board of directors and add new leadership if necessary to the organization. However, too many business owners delay or completely forgo this vital step.

Corporate governance shouldn't just be a priority; good corporate governance should be a prerequisite.

Corporate governance typically differs if the company is a public or a closely held, private company. In a publicly held business, employees are able to own shares of stock, but they are not able to give their input to the company board on how to operate that business. Many governance decisions are made by a board and company leaders are responsible to the company's board of directors, not the company's shareholders.

In a closely held business, the governance tends to start out as a benevolent dictatorship. When closely held businesses transition to an ESOP, the ESOP becomes an owner and its interests need to be understood and represented. When one or two individuals have controlled an entire company, they may not change their management style when the company's ownership moves to the employees. They tend to dismiss the idea that the ESOP is a new owner. The one or two original owners, often the founders, sometimes believe they can still do as they please – regardless of input from others. Though ownership has changed, the original owners don't expect to operate differently. Best practices for ESOP owned companies would dictate that they operate as if they were publicly held businesses when they transition ownership in an ESOP company.

One of the things that is worthy of being de-mystified is that corporate governance is a negative, or somehow works against the wishes of the existing management team. The truth of the matter is better corporate governance often leads to a better-run company, and that's what we see time and time again in successful ESOP companies.

When advising a closely held company with an ESOP or a management or family buyout, ownership and operational issues are addressed separately. For example, from an ownership standpoint in an ESOP company, if the original owner plans to hold on to 70 percent of his/her stock and sell 30 percent to the ESOP, that owner has to realize that he/she has created a new shareholder. In the same situation, from an operational standpoint, that same owner has to plan for management succession, because that owner is now responsible to more than just himself/herself. The owner has to train company management to eventually run the business, and the employee shareholders should have their best interests represented.

However, whether viewing the transition from an ownership or operational standpoint, one factor remains the same: better corporate governance will lead to a better ownership transition plan.

When transitioning ownership to an ESOP, it is wise for the original owners to remain with the business for some time on the governing board in order to assist in the development of the company's business strategy. The company will need a strong board of directors, including outside individuals serving on that board and the ability to select the best candidates to fill those spots. The right individuals can effectively support the company's long-term planning objectives and vision.

We have a number of clients that have gone from either a small fractional ESOP, or a zero ESOP, to a larger portion of the company being employee-owned. The trustees involved have insisted on the board of directors being increased in size by adding a few outside directors. Often the current board of directors grudgingly goes along with the plan because they know it's an important part of the deal for the ESOP trustee. But almost without exception, a year or two later, their attitude changes and they wonder, "Why didn't we do this sooner?" If they bring in the right type of directors, these executives have a lot to offer. To the extent that they are appropriately schooled in their responsibilities, they counsel and challenge the management team and the former owner, which leads to a better-run business. Focus is placed on such important factors such as achieving growth targets and margin goals or optimization of the capital structure or other important issues.

Corporate governance succession planning is an issue that every closely held business needs to address sooner rather than later. Developing strong leadership in your board and management ranks can be a highly effective value driver. This strategic guidance can be key to transitioning ownership in an ESOP company and preserving corporate culture.

A complication can sometimes occur when a former business owner has trouble understanding that the rightful owners are now the ESOP trust. This moves that former owner into the position of chairperson of the company, where he/she has to serve as steward on behalf of the ESOP participants, not the steward of his/her own behalf. Sometimes that message is heard but not acted upon. But for the overwhelming majority of owners who have confronted this issue, the ESOP is better than what they might have thought. They have their exit strategy put together with all the benefits the ESOP deal can deliver and then they are freed from the total responsibility of the business. All they have to do is acknowledge the fact that they need to let go.

This situation usually requires transition time to keep the company's culture in place and to identify the appropriate candidates for various positions, who will then also need time to adjust to their new job duties. Yet an ESOP is infinitely easier on those involved than if the company was sold in its entirety and a whole new ownership team was put in place.

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