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ESOP PROTECTION TRUST

Executive Summary

Purpose

Risk Management of Employee Stock Ownership Plans (ESOPs)

Background

ESOPs are valuable retirement plans that can comprise a substantial percentage of their beneficiaries' net worth. Because these plans are primarily invested in a single stock (employer-concentrated non-liquid stock), beneficiaries can lose all or a substantial percentage of their ESOP retirement savings should the stock lose substantial value. While this is an infrequent risk, the consequences are severe when it does happen.

Solution

A diverse group of ESOPs invests cash into an ESOP Protection Trust (EPT). For example, for EPTs protecting $5 million of stock, each ESOP invests $250,000 (5% of the value of employer stock) into the EPT. For 5 years, the cash is invested in 5-year U.S. Treasury Notes. At the end of the 5-year period, the cash is paid according to the following number of ESOPs suffering large losses (defined as losing more than 50% of enterprise value):

Zero Large Losses

- Each ESOP receives its money back
- Annual Cost of 5 Years of Protection: $0 (0% per annum)

One Large Loss

- The cash is used to limit losses as much as possible (target limit of 50%)
- Each of the other ESOPs shares pro-rata in any remaining cash
- Annual Cost of 5 Years of Protection: no more than $50,000 (1% per annum) for each ESOP

Two Large Losses

- The cash is used to limit losses as much as possible (target limit of 50%)
- Each of the other ESOPs shares pro-rata in any remaining cash
- Annual Cost of 5 Years of Protection: no more than $50,000 (1% per annum) for each ESOP

Three Large Losses

- The cash is used to limit losses as much as possible (target limit of 50%)
- Each of the other ESOPs shares pro-rata in any remaining cash
- Annual Cost of 5 Years of Protection: no more than $50,000 (1% per annum) for each ESOP

Eligible Companies

- ESOP established more than 10 years ago
- Stable corporate history and enterprise value
- ASA or CFA member valuation firm

Benefits

- Protection against ESOP companies' worst case scenarios
- Substantially reduce personal and corporate liability risks associated with ESOPs
- Reinforce ESOP culture of caring for employee-owners' long-term financial security

Fees & Expenses

- A one-time placement fee of $50,000 is charged upon closing
- Annual administrative services are covered by the yield on the U.S. Treasury Notes

Responses to Potential Objections

Employees need to understand that part of being an owner involves taking risk in order to potentially realize reward, and that is what motivates entrepreneurs

We agree that some risk is a healthy part of ownership and helps create an entrepreneurial mindset. At the same time, many entrepreneurs, recognizing that a substantial percentage of their net worth depends on a single company, take steps to mitigate the risk that a catastrophic loss could decimate their net worth. Reducing this risk is not incompatible with entrepreneurship; indeed, it is essential and prudent for entrepreneurs to reduce risk and protect years of accumulated wealth, for their benefit and that of their family.

Importantly, the ESOP Protection Trust focuses on mitigating *catastrophic* risk – without requiring participants to sell any company stock. Catastrophic risk is the risk that often triggers lawsuits, DOL investigations, corporate and personal liability, unflattering media coverage, and attacks on the tax benefits encouraging ESOP formation.

Meanwhile, research shows that employee-owners are motivated to work diligently for ESOP companies because of their unique culture of caring for the employee-owner's well-being and long-term financial security. Employee-owners are *not* motivated by the fact they can lose 100% of their ESOP retirement savings – a loss which many of your employee-owners simply cannot afford.

Our stock price cannot (or will not) go down

Stock performance is unpredictable over long periods of time. As J.P. Morgan and others have concluded, the "odds are stacked against the average concentrated holder" over the long run. Since 1980, approximately 40% of Russell 3000 companies have suffered a permanent 70% decline in the value of their stock. In addition, more than 300 S&P 500 companies (some of the largest and most successful companies in the world) have been removed from the S&P 500 for reasons of business distress. We have also compiled a list of more than 300 ESOP companies that have filed for bankruptcy. These failures are often the result of forces beyond the control of Officers, Directors, and Employee-Owners.

We don't want to pay for another ESOP's losses

The mitigation of risk – which directly benefits your ESOP – is possible only through risk-pooling, the foundation of insurance and risk management. In addition, because of the mutual structure of the ESOP Protection Trust, it is possible that, with a group of strong and healthy ESOP companies, you will receive all or a substantial portion of your money back at the end of the 5-year term.

Is this just another insurance product for funding repurchase obligation?

No, this is different. The ESOP Protection Trust enables you to mitigate your ESOP's stock concentration risk while remaining fully invested in company stock. In this way, the ESOP Protection Trust is also not a diversification technique.

1% per year is expensive

It's likely that with a group of strong and healthy ESOP companies, you will receive the entire 1% per year back at the end of the 5-year term. In addition, in the field of stock concentration risk management, 1% per year is an extremely low potential cost. Many investors regularly purchase "put contracts" for downside protection, often paying anywhere from 4% to 8% (or more) of their stock's value *per year* – and there is no prospect of receiving a refund of this cost.

This has never been done before

While new to ESOPs, stock concentration risk management has been widely practiced in the field of financial planning/wealth management since at least the early 1960s (with the advent of exchange funds/swap funds). In addition, in 1958, Louis Kelso, the inventor of ESOPs, envisioned ESOP risk management in his book *Capitalist Manifesto*. He wrote, "Where a household is primarily dependent for support upon its ownership of capital, the primary risk to be guarded against is simply the business risk inherent in a competitive and technologically evolving economy. In large measure this risk can be minimized through investment diversification, but beyond this ***it should be possible to devise casualty insurance designed to protect the family income against a coincidence of business failures that would materially impair the support derived from capital holdings***" (emphasis added, Page 244).

We already offer statutory diversification to our participants

The ESOP Protection Trust protects your employee-owners, not your diversified (non-owner) employees. The purpose is to protect the retirement savings of participants who are invested in the ESOP. Even if employees can diversify, often they choose not to, especially if the stock price has been increasing for several years. In addition, the offer of statutory diversification does not help in deterring an ESOP lawsuit, which often focuses on the operation of the ESOP and whether fiduciaries acted in accordance with their fiduciary responsibilities of prudence and loyalty to participants.

We already have D&O or fiduciary insurance

The D&O or fiduciary insurance does not protect your ESOP against losses. The ESOP Protection Trust reduces the risk of catastrophic losses to your ESOP, which helps reduce the risk you will need to file a claim under your D&O or fiduciary insurance.