The Employee as Stockholder

An Employee With Ownership Can Be a Valuable Asset—If You Choose Carefully

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Each year, wall and ceiling contractors—as owner-managers of closely held corporations—sometimes consider extending ownership to their employees.

Motivated for a number of reasons, the wall and ceiling contractor may move quickly to bring one or more key people into the stockholder circle.

Success or failure depends on several critical issues. Basically, a “good deal” for both the corporation and the employee rests with these issues:

Attitude. What is the owner’s attitude toward making stockholders out of his employees? Does he want them to become participants in decision-making? Does he want them to take on the point of view of an owner? Or does he want them to remain uninvolved in important issues of the company?

What is the employee’s attitude? Is he looking for a piece of the action? Security? Status? Does he want to be offered the chance to make a life-time career in the company? Does he want to become an executive? Or is he looking for a reward for past service and a return on his investment, paid out at his retirement?

Information. Will the prospective stockholder receive factual information about the financial condition and potential of the corporation? Information about the stock purchase process, its responsibilities, mechanics, and rewards? This knowledge must be conveyed to the purchaser clearly and concisely, so that he can make a decision based on facts.

Market. This is the critical question which the stock purchase agreement must answer. “Is there a market for the stock should the stockholder wish to sell?” When no buy-sell agreement is included in the document, then the buyer and the seller have a bad deal—neither the stockholder nor the corporation can be assured of a market for the repurchase of the stock.

Plan. Without planning for the expansion of ownership in a reasonable and sound fashion, the contractor might choose to extend ownership for all the wrong reasons and the employee might choose to buy or not buy for the wrong reasons. The contractor must plan carefully for redistribution so that it benefits the corporation and the employee. Anything less is a lose-lose proposition.

When the contractor considers sale of stock to employees, the first question that he must answer is, “Why?” What goals does he want to accomplish?

Typically, the contractor offers stock ownership to employees in order to ensure continuity of the corporation. No other reason is as basic as this one, for without highly competent, experienced, and vitally interested managers, no corporation can continue indefinitely. No amount of assets or earnings can make the machine run. People are the key.

But there are other reasons for offering stock purchase: When there are key people in the firm who have made or are expected to make significant contributions to its success; when certain employees have devoted a great portion of their lives to the company; when the corporation needs to raise capital; when the company wants to retain specialized employees; and when the owner-manager wants to motivate or change the attitude of his employees.

What does the contractor really want from his stockholder/employee? He wants the prospective shareholder to become a concerned, forward-thinking owner. He wants him to consider his actions’ effect on earnings in one, three, and five years. Further, he wants him to be more knowledgeable about the condition and the potential of the corporation. Finally, he expects him to be a source of constructive comment to the corporation, offering suggestions from an owner’s point of view.

What he doesn’t want is the minority shareholder telling him what to do. Often, a new stock-
holder, no matter how little representation his stockholdings provide, thinks that he should have a majority voice in the decisions. The contractor needs to make clear the limitations of minority stockholdings, as well as his expectations.

In order for the employee to meet the contractor’s expectations, they must be spelled out. But this is rarely done. The owner-manager thinks that it is sufficient to extend the invitation to buy, and assumes the employee will accept and will know what is expected of him. This assumption is unfortunate. In few cases does an employee understand what it means to be a shareholder. He may never have invested in stocks in his life. He may distrust any investment except government bonds and real estate. He should not be expected to know his rights, responsibilities, and limitations as a minority shareholder. In short, the contractor must go out of his way to make sure that the prospect understands the basic questions of stock ownership. Finally, if the owner-manager wants his key employees to become shareholders, he needs to make sure that they want to become owners.

**The Stock Purchase Package**

Once the owner has screened his key employees, the stock offer can be made. The invitation should be extended both verbally and in writing so that all information is available in one place. The stock purchase package is a selling tool, designed to prove that stock ownership is a good deal. It is an opportunity for the employee to buy at today’s value and benefit from its growth.

The first piece of information in the package tells the prospect how many shares of stock are being offered, the selling price per share, the percent of outstanding stock that the shares represent, and the distribution of shares outstanding.

The distribution of outstanding shares is an important point for the prospect to consider. If virtually all of the stock is held by the owner and there is no plan to redistribute his holdings further, the prospect risks a bad deal. Should the owner die, what chances exist for the corporation to survive? What confidence would buyers of the company’s services have in the corporation without its prime owner? What confidence would creditors have in the firm, especially if the owner has personally indemnified some debt and if bonding has been made based on the owner’s character?

The purchase agreement also describes whether the stock is common or preferred, voting or non-voting. The method of valuing the stock is described, and the accompanying audited financial statements for the most recent period reinforce the credibility of the value.

Book value is generally accepted as a reliable value for stock purchase, but other methods may be more appropriate. The prospect should review the financial statements for treatment of these items:

No allowance should be made for **good will** because it is an intangible asset. All **fixed assets** should be valued at their depreciated value with the method of depreciation indicated. **Accounts receivable** should be valued on a sliding scale such that new receivables are valued at 100 percent and old receivables (more than 180 days) are valued at zero.

**Inventories** should be valued at cost or market value, whichever is lower. Only the cash value of **insurance** should be treated as an asset, not the proceeds. Neither the cash value nor the proceeds of deferred compensation insurance policies should be listed as assets because these belong to the individual, not the corporation.

**Securities** should be valued at

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their closing prices as of the last trading date prior to the closing date of the statement.

Real estate should be valued at its current market value prior to the closing date of the statement. These practices ensure that the value of all assets is not inflated, producing an inflated net worth value.

Liabilities, too, should be scrutinized to see that all short- and long-term debts are subtracted from assets to produce a true net worth value.

The Purchase Agreement
The stock purchase package should include a copy of the purchase agreement. In its simplest form, the agreement provides for the stock transaction and acts as the legal instrument to execute the sale of stock. But often it is much more than that. It usually outlines the corporation’s goals for continuity and describes its shareholders as actively engaged in the corporation’s management and policy decisions. This is a critical point for the new stockholder since majority stockholders whose daily lives are not caught up in the business may be less concerned with keeping it alive and growing, two factors which are very important to the prospective stockholder. The agreement provides for a trustee; delineates stock purchase insurance policies to ensure that at a key stockholder’s death, the corporation has sufficient capital via the proceeds to repurchase much of the deceased shareholder’s stock; and allows the trustee to hold the certificates that will be reimbursed by the insurance proceeds. This stock repurchase insurance, whose premiums are payable by the corporation, is important for the prospective stockholder to note, for it ensures the major stockholders and their estates that there will be a market for their stock.

The stock agreement may also describe deferred compensation insurance or key man life insurance, which insures the lives of the majority stockholders and which protects the corporation from a sudden and damaging loss of a significant member of the company. Were it not for the insurance proceeds, the loss might ruin the health of the corporation. Again, the prospective shareholder should understand that these policies protect his investment by providing capital in proceeds that substitutes for the capital services of the deceased major stockholder.

Perhaps the most important provisions that the stock purchase agreement contains are its repurchase or buy-sell agreement clauses. These assure the major and minor stockholders a market for their shares should they die, retire, become disabled, or wish to sell their stock for other reasons.

The buy-sell agreement identifies and restricts the buyers or repurchasers of the stock. Typically, the corporation and the remaining stockholders are the only markets for sale or repurchase. Terms usually provide for closing within 30 days and payments not to exceed five years from the date of the sale. However, the five-year payout period is seldom used. The corporation and/or the stockholders usually prefer to pay for the stock all at once rather than be indebted to the former stockholder or his estate. In a provision for installment repurchase, the agreement should stipulate the interest rate to be charged, either a fixed amount or at some point premium above the prime rate of a specified bank.

These restrictions assure that the stock does not fall into the wrong hands; that is, anyone who is not actively involved in the corporation. Thus, no surviving spouse, no child, no man in the street can inherit or purchase the stock. A good buy-sell agreement prohibits it, at the same
time that it provides a market for the stock.

This policy will make sure that long-term interest in the company, most likely to be manifested by those who work in it, overrides short-term decisions about operations and continuity.

The right to sell the stock, as provided for in a good buy-sell agreement, can be exercised at any time, although usually it is not in the shareholder’s best interests to do so. It is required, however, at retirement. (The retirement age should be identified in the agreement.) Sale must also take place at termination for disability, which must be established by certification by two physicians, by a federal agency pursuant to the Social Security Acts, or by the insurance company pursuant to payment of a disability income policy. When an employee quits the company, he must sell his stock and must notify the company 30 days prior to his termination. Should the employee be terminated for cause, the stock sale must also take place within 30 days. In this case, the corporation may exercise its right to pay for the stock over a long period of time for its protection.

To Buy Or Not To Buy

When the prospective shareholder has reviewed his invitation, the valuation of the stock, the corporation’s financial statements, and the stock purchase agreement, he is ready to make his decision. If the stockholders have exhibited a positive attitude toward him as a potential team member, if he has been informed of his rights and responsibilities, if the company’s financial information has been made available to him, if he has studied the stock purchase agreement, then he will be an informed decision maker and will choose to become a stockholder with full knowledge of his opportunity.

The corporation makes a commitment to an employee when it offers stock ownership. The employee should make an informed commitment in return. Nothing less is beneficial to either party.