ESOPs for

EMPLOYEE OWNERS

NCEO NATIONAL CENTER FOR EMPLOYEE OWNERSHIP

ESOPs for Employee-Owners

If you're like most people, until you joined this company, you had never heard the term "ESOP" before. And now that you're part of one, it might seem like a confusing concept. **"ESOP" stands for employee stock ownership plan.** An ESOP is both a business ownership structure and a qualified retirement plan that enables the employees of the company to own stock through a trust. You might think that being an owner means you have to buy stock, but not in an ESOP. It's a benefit provided for employees working here. This booklet is meant to help you understand what an ESOP is and how it can work for you.

The idea behind an ESOP is simple. It's a plan designed to hold stock the company acquires for the plan in the name of all the employees who meet the basic rules for eligibility. Each eligible employee has an account with some company stock and sometimes other investments. The stock stays in the plan and, hopefully, grows in value. After you leave the company, you get what is in your account.

Let's take the rules one step at a time. **Remember:** this booklet is for educational purposes only—the official documents you've received from your company are what determine the actual rules of the plan.

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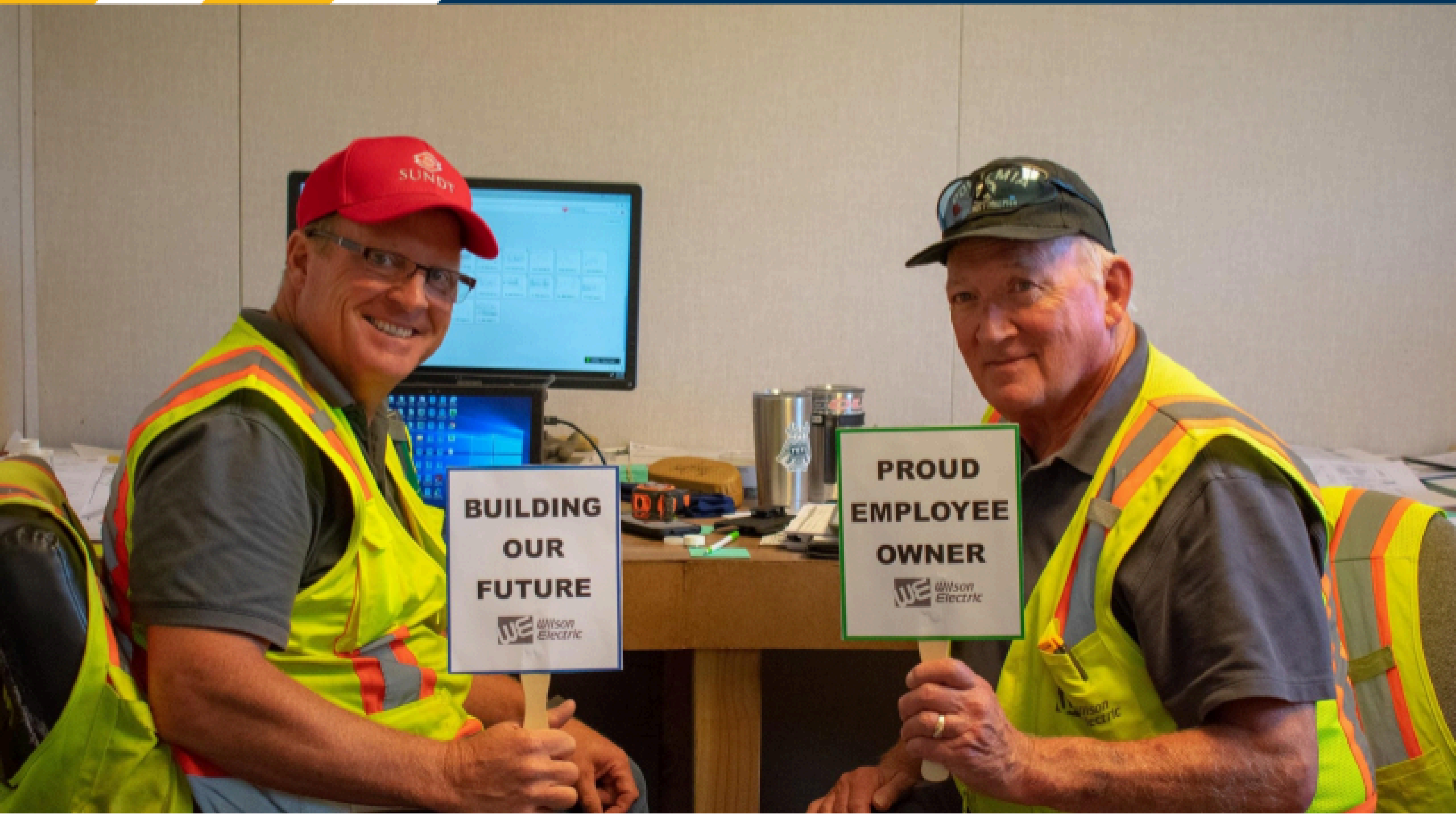


Becoming ESOP Eligible

Imagine you have some money you want to save. You go to a bank, set up an account, and deposit the money. Maybe you invest it in something like a Roth IRA or a similar retirement plan. Or maybe you are saving in a 401(k) account that your employer set up.

You can think of an ESOP like setting up a 401(k) account, except that:

- You don't put your own money in.
- The company actually contributes to your ESOP account by buying company shares in your name. Sometimes, it may contribute cash too.
- Similar to paid time off or other benefits, companies typically default to waiting a while to make sure an employee is working out before providing this benefit, so there is a waiting period before your account is set up.
- The company generally adds more to your account each year.
- The value will go up or down depending on how the company's stock does. There may be some other investments, too.
- As you work for the company, you get an increasing right to what is in your account (a process called "vesting").
- Some time after you leave, you get what is in the account.

Let's start with eligibilty.

Getting Into the Plan

Your first goal is to get in the plan, also called becoming a plan participant. To reach that, you need to [COMPANY PUTS IN LIST OF REQUIREMENTS].

Every year on [COMPANY FILLS IN DATE OR DATES], everyone who has worked the required number of hours is now in the ESOP. We call that the “entry date.” To be in the plan, you need to have worked at
least [XXX HOURS] in the last plan year (a plan year is the annual start and end date for the plan).

Receiving Contributions to the Plan

The next goal is to receive a contribution from the company. Every year, the company will make a contribution to everyone in the plan. [COMPANY CAN PICK WHICH OF THE FOLLOWING APPLIES]

- We contribute some cash out of the profits you help us earn to buy stock from [AN OWNER; OWNERS; THE COMPANY; OTHER EMPLOYEES].
- We borrow money and reloan it to the ESOP to buy stock from [AN OWNER; OWNERS; THE COMPANY; OTHER EMPLOYEES]. Don’t worry—you don’t have to pay it back! Instead, we make a contribution to the plan to make the loan payments each year. As we do that, more shares get put into your account (we’ll explain this in more detail below).
- We put cash into the plan, in addition to buying shares. That goes into investments that earn money over time.

How Much Will I Get Each Year?

At this point, you and your fellow plan participants will start getting a share of company contributions to the ESOP. Each year, you receive a portion of this contribution allocated to the account in your name. We call this an allocation.

In a typical retirement plan, how much you get from the company depends on how much you put into the plan yourself. But an ESOP is a better deal. You do not have to make any contribution to the ESOP to get a share of what the company puts in.

Instead, each year, you get a share of what we put into the ESOP that is based on your share of the total payroll (IF THIS IS NOT YOUR FORMULA, EXPLAIN IT HERE).

Imagine that Riley makes $30,000 this year. The total payroll of people in the ESOP is $3 million.

$30,000 of

$3 million is 1%, so Riley gets 1% of whatever we put into the plan that year. Rachel makes $40,000, so she gets 1.33% of what we put in. If we put in $200,000 that year, Riley gets $2,000 (1% of $200,000 is $2,000) and Rachel gets $2,667 (1.33% of $200,000). [CHANGE EXAMPLE TO FIT YOUR SITUATION]

IF YOU HAVE A LOAN, YOU MAY WANT TO ADD THE FOLLOWING OR THE ALTERNATIVE SIMPLER LANGUAGE AT THE END:

In our case, the ESOP borrowed money to buy shares. So, on the first day, we bought [X SHARES AT $Y PER SHARE]. You don't pay back this loan. The company does. Because of the loan, how much goes into your account is a two-step process.

In step one, each year, we make a contribution to the plan to make the annual loan payment. That contribution releases shares into your account. So, instead of getting a percentage of the dollar amount contributed that year, you get a percentage of the value of the shares paid for that year. The share value can go up or down (ours has usually gone up), so the amount that gets added to your account depends on two things: how many shares get paid for that year and what they are worth that year.

A simple example can help explain this. Say you and nine friends buy a house for $250,000. To make things more like our ESOP, assume you borrow all the money and pay it back over 10 years (of course, with a house, you'd have to make a down payment, and the loan would be longer). You rent the house out to help pay off the loan. You pay off 10% of the loan each year. Because you each have different responsibilities for keeping up the house, how much each of you gets depends on what you do. Let's say that Riley gets 5% of the house, while Rachel gets 10%.

When you first buy the house, the house value equals the debt, so you don't have any built-up equity yet. However, imagine that in the first year, you pay off 10% of the loan, and the house is now worth $275,000. So, 10% of the house is now allocated to the ten of you ($27,500). Riley gets 5% of that ($1,375), and Rachel gets 10% ($2,750).

Each subsequent year, the house value will change, and so will how much is paid for. The table below shows what would happen over 10 years, using a set of numbers that is similar to what happens to the values of companies historically.

These numbers are just for illustration. Compared to what we hope you will get in the ESOP, they are also very conservative. We expect to do a lot better.

Year	Value of House	% of Loan Repaid	Amount of Equity Value for the Whole House	How Much Riley Owns with 5% of the Equity	How Much Rachel Owns with 10% of the Equity
2016	$275,000	10%	$27,500	$1,375	$2,750
2017	$260,000	20%	$52,000	$2,600	$5,200
2018	$320,00	30%	$96,000	$4,800	$9,600
2019	$300,00	40%	$120,000	$6,000	$12,000
2020	$370,000	50%	$185,000	$9,250	$18,500
2021	$420,000	60%	$252,000	$12,600	$25,200
2022	$390,000	70%	$273,000	$13,650	$27,300
2023	$450,000	80%	$360,000	$18,000	$36,000
2024	$490,000	90%	$441,000	$22,050	$44,100
2025	$540,000	100%	$540,000	$27,000	$54,000

Earning a Right to What's in Your Account

That last section was a bit of a slog. It's worth thinking it through again, because the most important thing for you in the ESOP, of course, is how much you get.

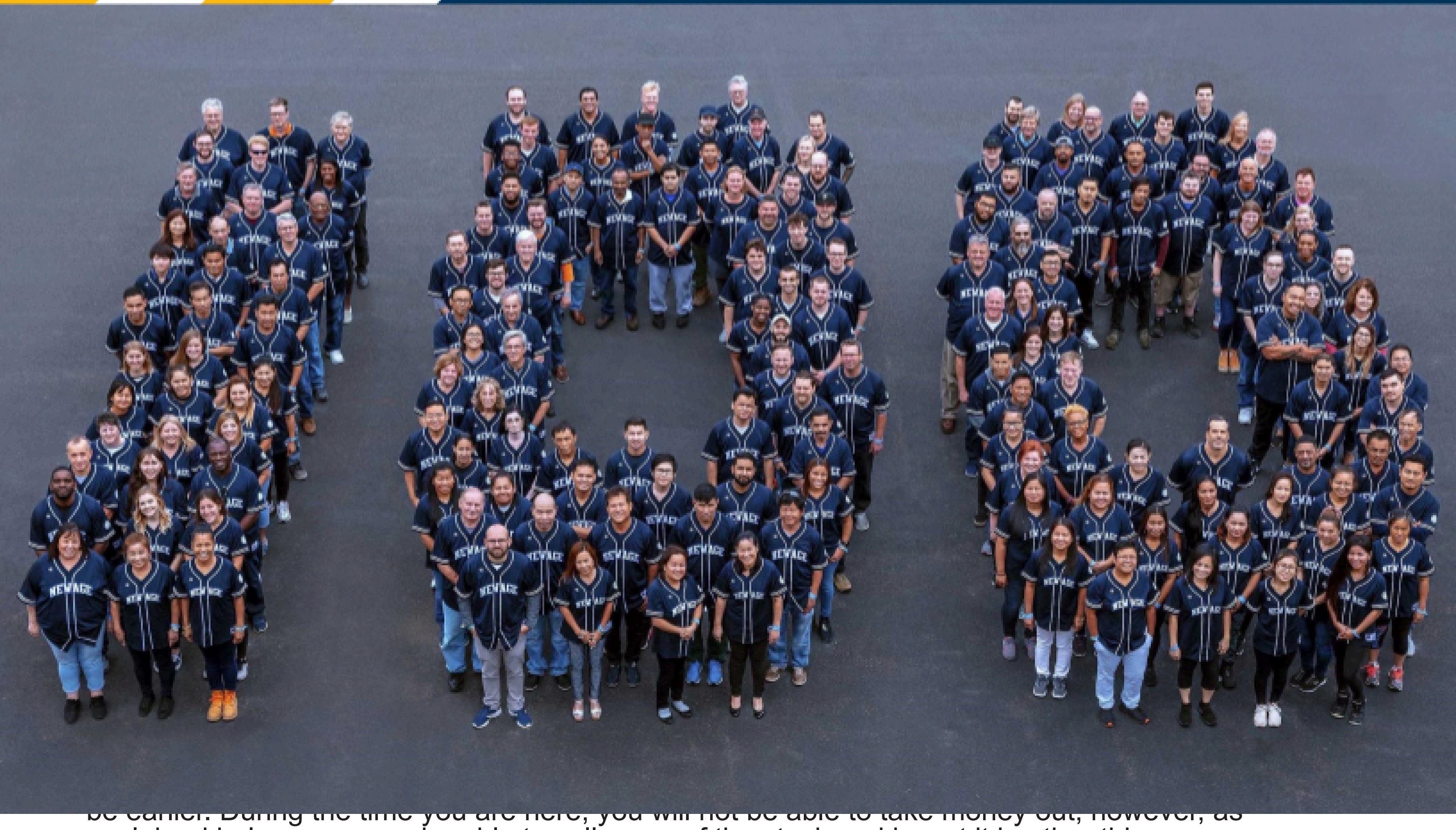
But there are still more steps before the payoff. Because we want the ESOP to most benefit those employees who stick around, what goes into your account is earned over time, a process known as "vesting." The term actually comes from centuries ago—to "vest" someone was to clothe with a garment. Over time, another use—to "clothe" someone with a right to something—made its way into law.

In almost all retirement plans, employees get an increasing right to what is allocated to their account as they vest. By law, this process can take no more than six years. Here is how our vesting schedule works:

After:	You Are:
One Year of Service	0% Vested
Two Years of Service	20% Vested
Three Years of Service	40% Vested
Four Years of Service	60% Vested
Five Years of Service	80% Vested
Six Years of Service	100% Vested

So, if you have worked for three years and have $8,000 in your account, you would be 40% vested in that, meaning you have a right to $3,200 of it (.4 x $8,000 = $3,200). Whatever is vested cannot be taken away. In other words, even if you do not make it to 100%, we'll still give you credit for how far you got.

What happens to what is in your account if you leave before becoming 100% vested? In that case, you get whatever percentage you have earned ($3,200 in the example above). The rest of your account balance ($4,800) gets redistributed into the accounts of everyone else. These redistributed shares are called forfeitures. So, if you stick around, you get more. This means that how much you end up with is not just what we put in, but what you get from other people who do not stay.



be earlier. During the time you are here, you will not be able to take money out; however, as explained below, you may be able to sell some of the stock and invest it in other things.

Most of us would like to get paid the day we leave. But if the company had to pay everyone off right away, it could cause some problems.

There are a couple of reasons federal law is set up so that companies do not pay right away.

We Don’t Want to Encourage People to Leave Just to Get Their Money

If the ESOP works well, account values can be very large—tens of hundreds of thousands of dollars. Some people might be tempted to leave just to get that money. However, we hope that people leave more for different reasons—retirement, a great offer somewhere, health issues, or other compelling reasons.

We Need to Manage Our Cash Carefully

When an ESOP works well, it builds up a very large repurchase obligation. The law sensibly requires us to buy back your shares at the value they have when you get paid out. That can be a big cash obligation for the company, which makes this a liability. By building in a reasonable delay after people leave, it is easier for us to be sure we have the cash both to buy back the shares and run the business profitably.

COMPANY NEEDS TO PUT IN THE RULES HERE; LANGUAGE BELOW IS AN EXAMPLE OF COMMON RULES ONLY

When you get paid out will depend on why you leave. Here are the possibilities:

You leave before retirement, death, or disability

You will start getting paid out **five years** after the end of the plan year after you leave—the plan year is the yearly start and finish date for plan accounting; in our plan, it is XXX. For example, if you left in April 2022 and our plan year ended on October 31, 2022, you would start getting paid out on October 31, 2027. You will get paid in five equal installments.

You leave because of retirement, death, or disability

You will start getting paid out **one year** after the end of the plan year after you leave (the plan year is the yearly start and finish date for plan accounting; in our plan, it is XXX). You will get paid in five equal installments.

There are some exceptions to these rules, most notably for very small accounts (under $5,000), but they require more detail than this basic explanation can provide. If they do apply to you, you will be informed at an appropriate time.

What Happens to My Account After I Leave But Before I Get Paid?

COMPANIES HAVE DIFFERENT RULES ON THIS, SO THESE ARE JUST TWO EXAMPLES; PICK THE RIGHT ONE OR AMEND

Option 1

After you leave, you still have stock in the company in your account. It will still go up and down in value, so how much you get will depend on how we do.

Option 2

When you leave, we cash in your shares and reinvest the money in safe investments. Whatever those are worth when you get paid out is what it will be worth.

So Just What Do I Get When I Leave?

COMPANY DESCRIBES HOW THEY PAY OUT EMPLOYEES; CHOOSE FROM BELOW AND EDIT

ACCORDINGLY STOCK ONLY DISTRIBUTION OPTION; INSTALLMENTS

When you get a distribution, you will get shares of our stock, plus any cash that has been contributed to the account. You then have 60 days to sell them back to us or, if you prefer, you can wait a year and sell them during the next 60-day period. You will get X% of your shares each year for Y years.

CASH OPTION; NO INSTALLMENT

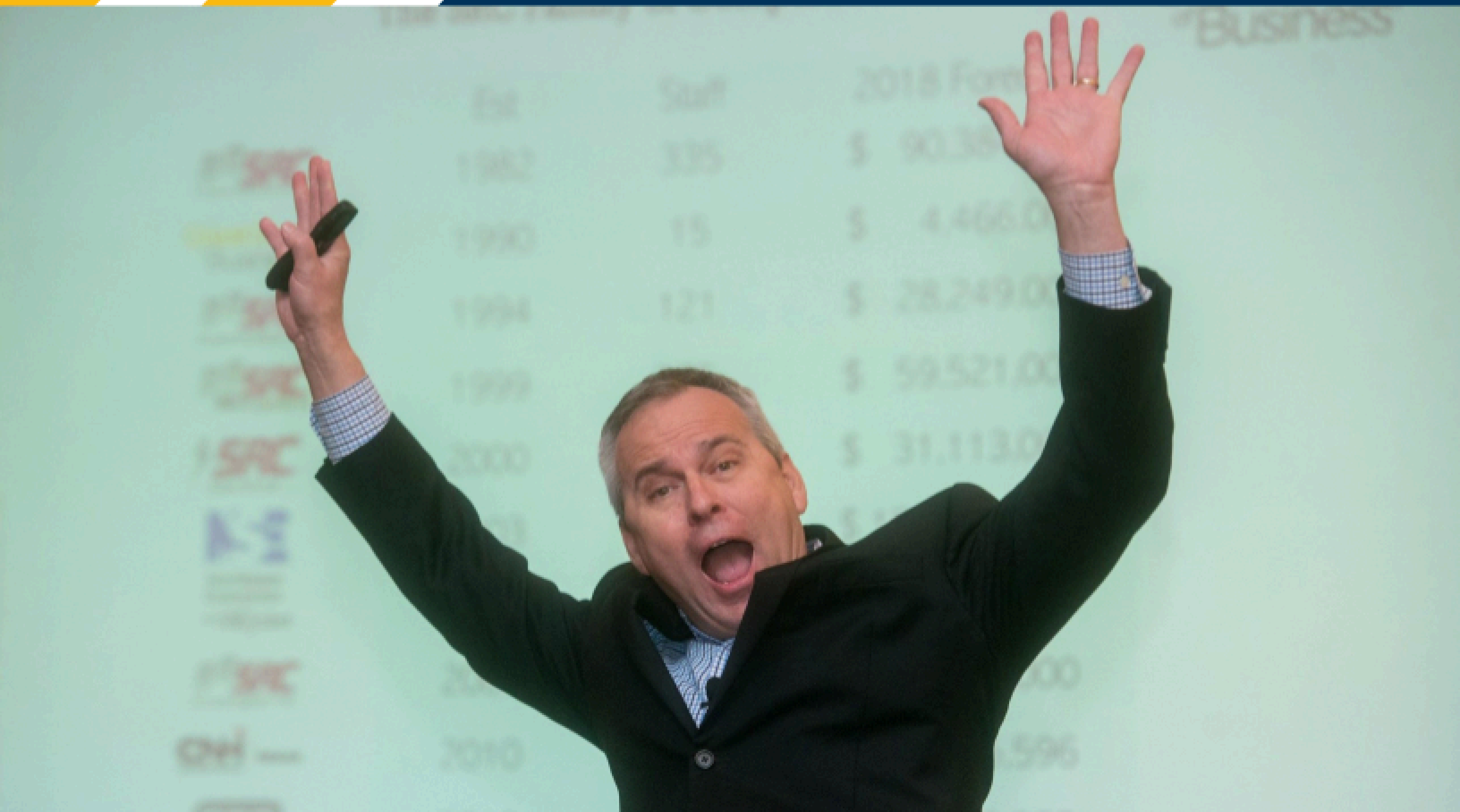
Just before you get your distribution, we will buy the shares in the ESOP and replace them with their value in cash. That amount will then be distributed to you.

STOCK DISTRIBUTION PAID IN INSTALLMENTS

When you get a distribution, you will get the shares in your plan, plus any cash that has been contributed to the account. You then have 60 days to sell them back to us or, if you prefer, you can wait a year and sell them during the next 60-day period. Once you do sell the shares, we will pay you out in equal installments over five years, with interest.

STOCK DISTRIBUTION; PAY IN CASH UP FRONT

When you get a distribution, you will get all the shares in your plan, plus any cash that has been contributed to the account. You then have 60 days to sell them back to us or, if you prefer, you can wait a year and sell them during the next 60-day period.



the markets. It changes constantly as people buy and sell shares. If there is more demand for shares, the price goes up.

Our company is not traded on the stock market. We don’t allow just anyone to buy our shares. So, how is stock value determined?

The law requires that the price be determined by an independent, outside expert called an appraiser.

Each year, they have to adhere to very strict standards to determine what our business is worth. The basic question they are considering is how much a reasonable person would be willing to pay to buy our company.

If you had a lot of money and wanted to buy our company, you’d ask yourself how much of an annual return you would want to justify the risk. If you buy a mutual fund, the risk is low, so you might be happy with an 8% return. Mutual funds have lots of companies, and that makes them safer, because some can fail, but the success of others will make up for it. However, buying just one company is riskier, so you’ll want a bigger return.

If you were buying Company A, for example, you'd want to think about a number of things:

- Risks (such as emerging competition)
- What else could I invest in, and what rate of return would I get?
- How risky is Company A relative to other investments?
- What is the rate of return a buyer wants from owning Company A given these risks and alternative investments?
- What are the general economic conditions?
- How easy is it to get my money out? The harder it is, the less I want to pay.
- Will I have full control of decisions about Company A?

Some investments are worth more because they are easier to cash in, allowing buyers to use the money for other investment opportunities that come up. Higher interest rates mean lower stock values, other things being equal. A shaky economy drives down all stock values because people don't want to invest. The more risk we perceive with Company A, the bigger the return we will want.

If we want a big annual return, we won't want to pay a lot for Company A because it will take too long for Company A to make the money back. However, if we think Company A is really a good bet (that it is likely to make even more money in the future, and that other investments are not so appealing at the moment), we will pay more.

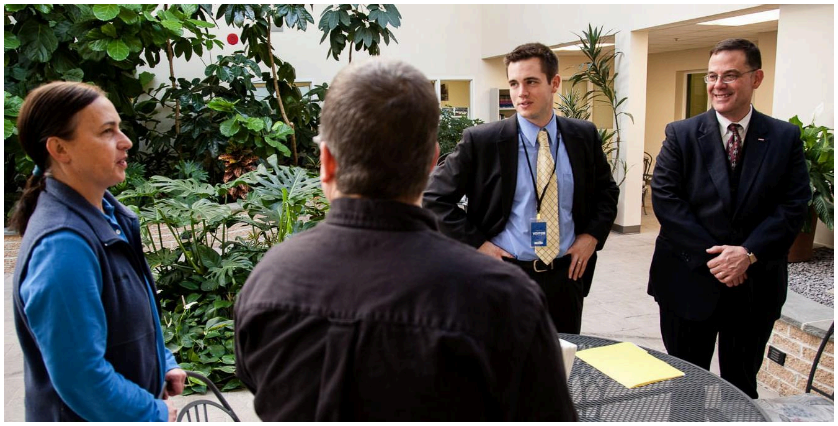
Private companies are valued much like Company A. Appraisers look at all these factors, then take the company's expected future earnings and determine what an investor would pay. It is often, but not always, between three and seven times one year's earnings. That means every extra dollar in profit a company makes gets most employee owners three to seven times that difference added to the value of the company. So if a company has a multiple of four times earnings, every dollar in profit it makes increase stock value by $4.
When an employee shares profits, he or she gets a fraction of each added profit dollar; when an employee is an owner, he or she gets a multiple.

Can I Take Money Out Early?

Once you reach age 55 and have at least 10 years of participation in the ESOP, you can diversify up to 25% of the stock in the plan. What that means is that if you choose to do so, we will buy your shares at their current fair value and you can then reinvest the money in COMPANY FILLS IN WHETHER IT IS ESOP, 401(k) PLAN OR BOTH OR IT IS PAID OUT in other investments. If you have not had 10 years in the plan when you reach age 55, you can start diversifying as soon as you do.

If you choose not to diversify, you can change your mind in any of the next five years. After five years, you can then diversify up to 50% of the stock in your account.

We do not allow employees to take the money out early, however, nor do we allow employees to borrow against the account. Taking money out early or borrowing could have adverse financial consequences for you and, if lots of people did it, could cause a big cash drain for the company.



What Will My Taxes Be?

The ESOP is taxed like other retirement plans. That's good news for you.

There is no tax due when the contributions are made to the plan. If you take your distribution and roll it into an individual retirement account (IRA), you don't pay any taxes on it until you take the money out after retirement.

If you get your distribution in shares, you can also choose to pay tax on all or some of it right away. The part that is a result of the growth in share price can be taxed as a capital gain, which means a lower tax rate for many people. The part that is based on what we contributed is taxed as ordinary income at whatever your usual tax rate is.

If you take money out when you are less than 59.5 years old and do not roll it into an IRA, you will have to pay a 10% penalty tax on whatever portion of the distribution is taxed as ordinary income.

Can I Vote My Shares?

When ESOP laws were written, many business owners worried that if employees could vote their shares, they might make unwise choices. So, some legislators argued, if the law required voting rights, owners would be more reluctant to set them up.

Congress decided, therefore, not to require voting rights [IF YOU DO THIS, EXPLAIN IT]. Instead, the stock is voted by a trustee for almost all issues, such as who is on the board. There are a few issues, however, that you can vote on, such as liquidating the business or selling substantially all of its assets.

Who Runs the ESOP and the Company?

The company is governed by a board of directors. [YOU MAY WANT TO WRITE A BIT ABOUT THAT HERE]. The board hires and manages/oversees the president/CEO of the company and provides overall guidance on broad corporate issues. On a daily basis, the management of the company remains in charge.

The ESOP is governed by a trustee appointed by the board. The trustee [EXPLAIN WHO IT IS] has to follow a very specific, strict set of federal rules enforced by the Department of Labor. These rules require the trustee to run the plan to maximize the long-term value of plan assets. This includes making sure the valuation is done properly and all the rules for the ESOP are followed.

Can the Company Be Sold?

We are not for sale, but it is possible that one day, someone will want to buy us and offer such a good price that it makes sense to say yes. If the company is sold, everyone becomes 100% vested and gets paid out for the (now much higher) value of the shares. The law provides a very strict set of guidelines about how offers must be considered to protect the interest of people in the plan.

How Will I Know What's in My Account?

You will get an annual statement telling you what is in your account.

How Do ESOPs Stack Up, Generally?

Every ESOP is different. How well we do will depend, in large part, on how often employees contribute ideas for how we can do better.

In the meantime, we can look at some key numbers about how ESOPs do overall.

- *ESOP companies grow faster:* The typical ESOP company adds about 2.5% more new jobs per year than it would have if it did not have an ESOP.
- *ESOP companies lay off far fewer people:* National survey data over the last decade show that people in ESOPs are about a third as likely to be laid off as people not in ESOPs.
- *ESOP participants have fatter retirement accounts:* It is a startling fact that only about half of all full-time adult workers participate in any kind of company retirement plan. And, for many of those people, most of what is in their plan comes from them, not the company. However, employees in an ESOP get their contributions from the company and generally end up with at least twice as much in their retirement accounts as employees not in an ESOP.

What If I Have Other Questions?

It is important if you do not understand something about the ESOP, you ask for help. You can contact {FILL IN}.

You can also visit the website of the nonprofit organization, The National Center for Employee Ownership, to find articles about how ESOPs work, including “The Rights of ESOP Participants.”

How You Can Help

Being an ESOP company should make us different. As owners, we all have an interest in making the company more successful. In part, that comes from making the extra effort owners make to save money, treat customers and colleagues well, and work hard.

Yet, the real difference does not come from working harder—it comes from employees contributing ideas about how their work, their team’s work, and the company’s work can be done better. Great ESOP
companies process hundreds of these ideas annually. As owners, you deserve that voice, and managers want to hear it. So, get engaged—it’s your company!

QUESTIONS about

YOUR ESOP?

Reach out to membership@nceo.org today.

NCEO NATIONAL CENTER FOR EMPLOYEE OWNERSHIP