From Our Committees and Sections

Maximizing Stakeholder Value in Business Transitions

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By Sean-Tamba Matthew

Finding Sustainability through Considering Stakeholders

In 1970, American economist Milton Friedman authored an essay entitled "A Friedman Doctrine — The Social Responsibility of Business Is to Increase Its Profits" in the *New York Times Magazine* as a rejoinder to corporate executives promoting the idea that businesses needed to be "socially responsible." Many executives stated that their business decisions should not only concern the profitability of the enterprises that they operated but should consider and address issues of "providing employment, eliminating discrimination, [and] avoiding pollution." Friedman responded that businesspersons who promoted such ideas were "unwitting puppets of the intellectual forces that have been undermining the basis of a free society" and that directing a business's efforts to solve social problems inevitably leads to an inefficiently and ineffectively operated enterprise. From Friedman's perspective, a business's sole responsibility is to "use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception fraud."

Just over 50 years later, Friedman's position is facing its most significant challenge to date. The actions of the Business Roundtable, an organization for U.S.-based businesses that publishes a guide entitled Principles of Corporate Governance, most exemplify the shift away from shareholder primacy and profit maximization. In the versions of the guide published after 1997 through 2018, the Business Roundtable took a Friedman-based approach that stated the corporation's purpose was to "exist principally to serve [its] shareholders." However, in 2019, the Business Roundtable's Statement on the Purpose of a Corporation shifted away from its shareholder primacy orientation for a corporation to an approach that considered the effects of a corporation's action's on all "stakeholders." The 2019 statement provided that "[w]hile each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders… Each of our stakeholders is essential." Furthermore, the statement provided that companies must be committed to delivering value to customers, investing in employees, dealing fairly and ethically with their suppliers, supporting the communities in which they operate and generating long-term value for shareholders.

The Business Roundtable's pivot to a "stakeholder capitalism" approach to corporate governance was in response to a groundswell of calls on the left and right of the American political spectrum and changes in the law and practice made in reaction to the Great Recession of 2008, the increase in the disparity between wage growth and stock gains in recent years and the growing concern regarding environmental sustainability issues. The push toward a "stakeholder capitalism" orientation for corporate governance was also driven by the success of large corporations such as Walmart, Unilever and Whole Foods Markets in making investments in environmentally sustainable initiatives that have yielded positive economic returns in the long run.

While the Business Roundtable's participating corporations have the capacity to take on "stakeholder capitalism" efforts — most are large corporations — it may be unclear to most closely-held business owners how or why they would want to take stakeholder considerations into account. Investments in green technology and sustainable sourcing are time-consuming efforts that many small businesses cannot effect while operating their businesses effectively. Additionally, increased compensation for employees may lead to conflicts between shareholders running the business and passive shareholders who have certain expectations regarding dividends/distributions.

Nevertheless, a "stakeholder capitalism" approach can have the double bottom line effects of providing economic value to closely-held business owners while ensuring opportunity and benefit for stakeholders in one critical aspect: business transitions. With nearly $10 trillion in business value transitioning during the next decade and only 20-30% of businesses that go on the market selling, transitioning a closely-held business to new owners while providing liquidity to selling shareholders can be an uncertain process that often ends with value left on the table or with businesses being shuddered after an owner retires. Such results can be disastrous for a business's employees and the communities in which the companies operate.

Fortunately, two mechanisms in the law allow business owners to get liquidity from their businesses while providing a chance for their employee stakeholders to build wealth — establishing an employee stock ownership plan (ESOP) or converting to a worker cooperative. Both options offer the transfer of ownership or the benefit of ownership to a company's employees while using tax-advantaged dollars.

Employee Stock Ownership Plans (ESOPs)

Established under federal law in 1974, an ESOP is a tax-qualified retirement plan that invests primarily in the employer's stock. Through an ESOP, business owners gain liquidity from their companies by selling their ownership interests to the ESOP. Typically, such a transaction is funded with debt financing obtained by the company and secured primarily by the business's assets and equity value.

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An ESOP eliminates the need to undergo a full sale process to sell a business, which typically takes more than a year and will not always result in a viable offer. Additionally, a business owner who sells to an ESOP can be eligible for federal capital gains tax deferral for ESOP sale proceeds reinvested in certain securities of U.S. operating companies. And those owners who want some liquidity while maintaining control of their businesses are eligible for capital gains tax deferral as long as they sell at least 30% of the company. Furthermore, suppose a business is a 100% ESOP-owned S-Corporation. In that case, it does not have to pay federal or, in many cases, state income taxes, allowing it to use the additional free cash flow to pay down transaction debt, make acquisitions or enhance the benefits received by the company's employees.

For workers, ESOP participation can be a life-changing tool for developing wealth and employment stability. This experience is affirmed by a robust

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PBA Presents County Bar Recognition Awards to 20 Bar Associations

The PBA presented County Bar Recognition Awards virtually to 20 local bar associations during the 55th Annual Seminar of the Conference of County Bar Leaders on Feb. 25.

The awards, which are non-competitive in nature, annually recognize bar associations throughout Pennsylvania for projects that improve the legal profession, justice system and community.

"We are so proud of the innovative projects and programs that members of each local bar association initiate to better serve its community," said PBA President David E. Schwager. "We are even more proud to recognize these good works each year and applaud the efforts of the many volunteers that contributed to their success."

The following county bar associations received awards for notable projects and programs:

- Allegheny County Bar Association: Police Use of Force and Court Rules for Bail, Probation and Incarceration Committee
- Beaver County Bar Association: CYS Christmas Gift Drive, Donations to Local Food Pantries and Young Lawyers Charity Golf Outing
- Berks County Bar Association: COVID-19 Legal Response Program and Perk Up the Vote
- Bucks County Bar Association: Keystone Attorneys Pro Bono Recognition Program, Child Advocacy Initiative and COVID-19 Updates and Resource Newsletter
- Chester County Bar Association: Chester County Evictions Court Prevention Program
- Cumberland County Bar Association: Adulting?!? for High School Seniors and YLD Adopt-A-Family
- Dauphin County Bar Association: Virtual Pro Bono Clinics, River-Front Chats and Eviction Mediation Program
- Delaware County Bar Association: COVID-19 Emergency Committee and Community Outreach Committee Virtual Events
- Erie County Bar Association: Diversity and Inclusion Division and Register to Vote Initiative
- Franklin County Bar Association: Young Lawyers Division Food Drive
- Lackawanna Bar Association: Bylaws and Long Distance CLE Provider
- Lancaster Bar Association: Classroom Heroes Program
- Lycoming Law Association: Angel Tree Holiday Toy Drive, Lycoming Law Association Foundation Grants and Lycoming County Historical Society Gift
- Monroe County Bar Association: Community Thank-You Project and Food Pantry Donations
- Montgomery Bar Association: Delaware Valley Legal Expo 2020 — Live+Virtual, Diversity: Countering Divisiveness & Injustice with Empathy and Respect and Responding to the Needs of Members Amid a Global Pandemic
- Northampton County Bar Association: Mission: Hand Sanitizer in a Pandemic and Online CLE Program
- Philadelphia Bar Association: Judiciary Coronavirus Response and PPP Loans for Nonprofit Partners
- Schuylkill County Bar Association: "Food" Drive, Gifts for Our Kids and Service Organization Project
- Westmoreland Bar Association: New Headquarter Building Project
- Wilkes-Barre Law and Library Association: Antisemitism, America & the Law Live Webinars, MLK Day Celebration and Commemoration of the 100th Anniversary of Women's Right to Vote
- York County Bar Association: Impact Grants, Legal Aid and Scholarships, Making a Difference ... Boosting Soles and Souls! and YCBA and YCBF Presidents Establish Joint Diversity, Equity and Inclusion Task Force

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body of academic literature, which has demonstrated that ESOP participants have two and half times more in retirement account balances than non-ESOP employees, and Black ESOP participants surveyed had three times the median household wealth of African Americans nationwide. Additionally, employees at ESOP companies were four times less likely to be laid off during the Great Recession, and ESOP companies are 25% more likely to stay in business. ESOP-owned companies also see improved returns on assets and increased sales.

Worker Cooperatives

Like ESOPs, worker cooperatives are tax-advantaged business entities that allow business owners to transition ownership to employees and avoid a full sale process. A worker cooperative is a business organization created under state law in which the employees are members of the business and elect the company's board of directors on a one-person, one-vote basis — disregarding relative ownership percentages. A worker cooperative's net earnings are allocated to members based on their patronage — their work for the company (which can be based on W-2 earnings, hours worked and seniority). Under Subchapter T of the Internal Revenue Code, there is no double taxation of the net earnings paid out to worker cooperative members. In addition to operating on a tax-advantaged basis, business owners who sell at least 50% of their company to a worker cooperative are eligible for capital gains tax deferral.

Evaluations of worker cooperatives, like the research on ESOPs, have shown that the worker cooperative structure positively impacts employees and their companies. Worker cooperatives have driven increases in employee wages and have, in turn, reduced pay inequality. Additionally, studies of worker cooperatives have demonstrated that they are more productive than conventional business firms.

Conclusion

As shareholders and executives of closely-held businesses wrestle with the uncertainty and necessity of transitioning companies owned and operated by baby boomers, taking into account stakeholder considerations and models may provide a win-win solution. Companies that have at least 20 employees and earnings of around $1 million can be viable ESOP candidates, while smaller companies can successfully operate as worker cooperatives. Given that these employee ownership models cover the full spectrum of viable closely-held businesses, trusted advisors should have their clients evaluate whether an employee ownership model would fit with the company's and the shareholders' long-term goals. By utilizing an ESOP or a worker cooperative, closely-held companies and shareholders can control their transitions and ensure liquidity while establishing a legacy by providing the opportunity for their employees to own a stake in the company's future.

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