

**A (PROPOSED) LAW TO ENCOURAGE  
THE DEMOCRATIZATION OF  
FUTURE CAPITAL OWNERSHIP  
FOR CITIZENS OF COSTA RICA  
[DRAFT NUMBER 1 (Amended)]**

**Requested by**

**MINISTER OF PLANNING  
GOVERNMENT OF COSTA RICA**

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**FIDUCIARIA DE INVERSIONES TRANSITORIA, S.A. (FINTRA)**

**Prepared by**

**EQUITY EXPANSION INTERNATIONAL, INC.**

**July 17, 1989**

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Employee Share Ownership Plan

The enclosed "*Explanatory Guide To Draft 1*", however, is for the business-minded. It is to show how the proposed legislation can serve as a vehicle to influence changes in the business climate of Costa Rica. It addresses the problems that have been indicated to EEI by several prominent Costa Rican individuals we interviewed:

- Get out from under foreign debt.
- Move from a state dominated economy to a market economy.
- Reduce the need for future commitments of your government to solving income disparity problems through a larger welfare state.
- Reach agreement with other major groups in Costa Rica for solutions that you are attempting to institute.
- Retain traditional business patterns that work while introducing new ways to decentralize state control of the economy and bring about private control of Costa Rica's rich resources.

This document operates from these assumptions.

## **RESPONSES TO CONCERNS REGARDING DRAFT 1 OF THE PROPOSED LEGISLATION**

Some doubts have been voiced in reaction to "Draft 1" of the proposed legislation. Let us put them on the table and address them, one by one.

- **"Family businesses would not be interested in reorganizing their records and procedures to accommodate ESOPs."**

**Equity Expansion International agrees.** We do not expect the traditional family-owned business to be the first to form an ESOP. ESOPs are there for them if they choose. But ESOPs are primarily for transforming state-owned enterprises and multinationals, and for new ventures started by new entrepreneurs. **This legislation is to create a parallel system to broaden ownership opportunities of the future.**

- **"Start-up fiscal costs of implementing this plan are large, and the plan is too complex."**

To this we reply, **invest now in new institutions.** The **current** economic system is costly and complex. Its chief advantage is that it is familiar and all factions have their claims predictably, if not comfortably, staked out. Yet, the current system increases the foreign debt, reduces productivity and competitiveness of Costa Rica's enterprises, and it aggravates income disparities—inviting

social unrest or a larger welfare state. Also, the proposed changes would start very gradually within a tax framework parallel to the present system, allowing for fiscal comparisons with the present system. The aim of the proposed legislation is to create growth revenues which are not available for taxation under the present system, so the government can only gain, not lose, revenues from our proposals. And while Draft 1 seems complex to non-lawyers, as pointed out above, it will radically cut the costs and time to get ESOPs started in Costa Rica.

- **"Other groups in society will object to provisions of the legislation."**

To this we say, "While all of our proposals are based on sound principles and decent public policy, **most things are negotiable.**"

Certain aspects of the legislation are fundamental, such as (i) providing access to low-cost credit to purchase shares for workers, (ii) allowing workers to apply the full (pre-tax) stream of corporate profits they earn to repay the stock acquisition loans, (iii) not taxing workers on shares until the shares are distributed to them and converted to spendable cash, (iv) not requiring workers to reduce their savings or take-home pay to purchase shares, (v) creating tax incentives for corporations to pay out dividends to all shareholders, (vi) creating first-class shareholder rights, including voting and disclosure rights, for worker-shareholders, and (vii) establishing fair and defensible criteria for allocations of benefits.

Other aspects can be negotiated, such as proposed incentives for allowing workers the choice to invest their retirement benefits under social security in their own companies, or letting workers convert part of their compulsory savings accounts in the Workers' Bank into stock in their own companies.

- **"It's too radical."**

This legislation is anything but radical: **it recombines in new ways** philosophies that have been flourishing for 200 years. Adam Smith's free market, Karl Marx's concern for social justice, Jefferson's dream of a classless society, and Alberto Marten's philosophy of democratizing credit are all embodied in the ESOP principle. "There is nothing new under the sun."

- **"The legislation opens a Pandora's box of possibilities: the legislation should not be widely discussed and disseminated because of uncertainty of the outcome of where it will lead."**

To this we say, it is best for several diverse Costa Rican groups to take the initiative and announce the new possibilities at the same time. Why? Because **no counter-productive outcomes will result from this legislative package over the long term.** Uncertainty is not to be feared when something good is about to be distributed.

There are other good reasons why Equity Expansion International encourages FINTRA to start a dialogue with all factions of Costa Rica that would be affected by the proposed legislation. One compelling reason is that the Draft 1 provisions comprehensively balance the interests of all major social factions (business, management, labor, government) in a way that would **produce gains for all participating parties.** Stated otherwise: the legislative package has been designed meticulously for **FAIRNESS.** This will be **a great asset in arguing the provisions of this package.**

In conclusion, we recommend that Draft 1 and all subsequent drafts can begin to be the basis of a new dialogue among a broad cross-section of Costa Rican society. Then, what begins as a set of proposals from unbiased outside consultants, can, after the outsiders are challenged from a variety of positions, be reshaped into a legislative package which reflects a new synthesis that will be entirely Costa Rican in origin.

I. EXPLANATORY GUIDE TO DRAFT NUMBER 1  
COSTA RICA ESOP LAW PROJECT

[DRAFT NUMBER 1 (Amended)]

Prepared by  
EQUITY EXPANSION INTERNATIONAL, INC.

July 17, 1989

EXPLANATORY GUIDE TO DRAFT NUMBER 1 (AMENDED)  
COSTA RICA ESOP LAW PROJECT  
DEVELOPED BY EQUITY EXPANSION INTERNATIONAL

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## EXECUTIVE SUMMARY

The following are the highlights of Draft Number 1 of the (Proposed) Law Project to encourage Employee Share Ownership Plans (ESOPs) in Costa Rica:

- Grants credit and tax incentives for corporations which implement Employee Shareholders' Associations and Consumer Shareholders' Associations.
- Proposes parallel legislation which enables workers and consumers to become owners of new wealth.
- Creates new wealth for the individual worker without taking old wealth from the already wealthy.
- Enables workers to share corporate ownership, control and profits, without reducing their take-home pay or savings and without risking their other property.
- Democratizes credit as the key to encouraging participatory corporate ownership in an expanded private sector and divested public sector companies.
- Reduces interest rates without subsidies for private sector growth linked to expanded capital ownership.
- Broadens the base of taxable personal incomes from profits of the private sector.
- Creates an Asset Democratization Trust to reduce budget deficits and the foreign debt burden by negotiating ESOP debt-equity conversions.
- Restores the original rights of private property, particularly in corporate equity.
- Builds a growing political constituency who support the freely participative and open marketplace as the best way to determine what is a just price, a just wage and a just profit.

**EXPLANATORY GUIDE TO DRAFT NUMBER 1  
COSTA RICA ESOP LAW PROJECT  
DEVELOPED BY EQUITY EXPANSION INTERNATIONAL**

July 17, 1989

**Purpose.**

The Costa Rican ESOP Law Project was initiated to recommend reforms to encourage the adoption of Employee Share Ownership Plans (ESOPs) and other economic democratization techniques for the benefit of Costa Rican workers and citizens generally.

Operationally, this project has been organized to produce a strategy aimed at building a broad-based and diverse bipartisan coalition in support of ESOP legislation. The legislation would be designed so that it could be quickly implemented, with little or no bureaucratic red tape or delays, on at least a demonstration basis within the next year. The process of building this coalition is at least as important as the form and substance of the specific ESOP law being prepared for consideration and debate. Inclusion, openness and participation are the three most important keys to acceptance of innovation. Exclusion will breed resistance to change.

The purpose of this guide is enable the reader to understand how the EEI consultant team has approached the complex task of developing specific ESOP reforms suitable to the culture and legal system of Costa Rica. The objective of these reforms are to enable workers, consumers and citizens generally to participate on a direct and personal basis as shareholders of private sector corporations located in Costa Rica.

While the ESOP technology has been developed in the United States, it would be a serious error for Costa Rica to import the complicated and highly confusing ESOP provisions under U.S. tax laws. Most American lawyers will readily admit that the U.S. tax system lacks coherence, is full of internal contradictions, and is very expensive and burdensome to administer.

No nation has yet adopted a coherent and comprehensive law specifically devoted to ESOPs, or to creating a favorable legal environment which would guide the economy toward the goal of economic democratization. Costa Rica has a unique opportunity with this project to begin to fill that vacuum, consistent with concepts of economic justice and democracy underlying the ESOP technology and based on principles derived from the experiences of thousands of companies which have implemented ESOPs from the first one in 1956. Costa Rica, by enacting this law, would pave the way for other nations, including the United States, to follow.

**What is an ESOP?**

The Employee Share Ownership Plan (ESOP) is an effective technique of economic democratization first developed in the United States in 1956. Encouraged by 19 U.S. laws, mainly tax incentives added on to more prominent features of the U.S. private retirement system, the ESOP has enabled 10 million workers to acquire equity shares in the 10,000 U.S. companies for which they work. The ESOP technology has now spread to the United Kingdom without enabling legislation. And through ministerial initiatives and USAID assistance, Egypt has recently approved the first large-scale ESOP in a developing country.

What makes the ESOP different from and significantly more effective than other methods of economic democratization is that it is **a tool of credit democratization**. The ESOP provides workers as a group with access to productive credit **to purchase** significant blocks of stock in their company (up to 100%), and for individual employees **to earn** those shares as the credit is repaid with future corporate profits, dividends or employer contributions. Individually, the workers are not at personal risk if the credit cannot be repaid. The risk of non-payment is initially on the lender and therefore generally must be guaranteed by the general credit and future profitability of the enterprise. The degree of risk to the lender is reflected in the interest rate charged for the stock acquisition loan. The risk is also protected by the credit worthiness of the enterprise itself and generally must be collateralized by corporate assets and the pledge of the shares being acquired by the workers. And the workers are provided an immediate incentive in the form of a significant proprietary stake in future profits, which they can help maximize, further reducing the lenders' risks. (See the Appendix to this Explanatory Guide for more detailed explanation and charts.)

### **Why is Credit Repayable With Corporate Profits Essential to the Effectiveness of the ESOP?**

Other methods for encouraging workers to buy shares are less effective, because they ignore the reality that workers at the bottom of the income ladder cannot afford to reduce their living conditions to buy shares out of their savings or takehome pay. With few exceptions, mainly the more highly-paid workers participate in traditional employee stock purchase schemes which are tied to the worker's past or current savings.

In addition to losing the motivational value of worker ownership, traditional methods of encouraging workers to buy shares are also counter-productive for the economy as a whole. If large numbers of workers were forced to reduce their disposable incomes in order to buy shares, effective demand for goods and services produced by the private sector would correspondingly shrink. Private sector investment, however, is fueled by the effective purchasing power of workers. Thus, shares purchased in conventional ways (with past or current savings of workers) work at cross-purposes to a nation's private sector growth and investment objectives.

In contrast, most ESOPs do not reduce the spending power of a worker's family. Instead, ESOPs work on credit designed to generate productivity increases and are geared to future savings tied to productivity and profits of the enterprise, rather than the wages of individual workers. This explains why ESOPs work and why conventional employee stock purchase programs, no matter how well-intentioned, frequently fail to attract most workers.

### **What Makes Some ESOPs Work Better Than Others?**

There is strong evidence that ESOPs alone, while desirable for meeting the social goal of broadened participation in corporate ownership, may not be sufficient for raising corporate productivity and employee motivation. An ESOP, for example, will not work without effective professional management. It will not work if the controlling owner and management are hostile to participatory ownership or treat the employee-owners as second-class shareholders. And an ESOP works poorly where it is used as a weapon to destroy labor unions. Like any other tool, in the wrong hands, ESOPs can be abusive to workers.

On the other hand, several reliable studies have confirmed that companies which make **significant contributions** to their ESOPs, and combine their ESOPs with **frequent distributions of profits, participatory management** and a **strong ownership culture**, perform significantly better than their non-ESOP competitors and those with ESOPs alone.

These studies prove that tokenism and amateurish approaches to worker ownership do not work. To be effective, worker ownership involves a strong commitment on the part of management to maximize the ownership opportunities of all employees, from the bottom-up, and a willingness on the part of both labor unions and management to collaborate to make companies more competitive in the global marketplace.

### **Why Changing the Legal Framework is Essential for Introducing ESOPs to Costa Rica.**

ESOPs are products of the law. If the legal environment of a country is hostile to the ESOP, it cannot be adopted. Even if legally possible to adopt an ESOP, if policy-makers and public officials are not supportive of or even indifferent to the ESOP, it will not be effective. In most countries, it is difficult, if not impossible, to establish ESOPs because of prevailing tax law, labor law, corporate law, trust and association law, retirement law, investment and securities law, and laws affecting interest rates, credit, savings and monetary policies. Costa Rica is no exception.

Even in the United States, where the U.S. Congress has passed 19 laws since 1973 encouraging the ESOP, the policy framework supporting ESOP is still not widely understood among U.S. policy-makers and public officials or in the mass media and universities. The first ESOP was introduced into the U.S. legal system in 1956 with little or no widespread public discussion or understanding. Now with over 10 million U.S. workers benefitting from the ESOP, it is hard to dislodge.

But there is a price to be paid for the manner in which the ESOP became law in the United States. The lack of widespread public understanding of the principles and policy framework necessary to realize the fullest potential of the ESOP, have exposed the ESOP to criticisms which could have been avoided.

Because of the many multinational corporations which have recently adopted ESOPs and the strong interest of major banks and insurance companies in supplying credit to workers through ESOPs, it is unlikely that any other country will be able to introduce ESOP legislation without significant public dialogue and understanding of principles and policy framework behind the ESOP. Interest groups which do not understand the ESOP or who were left out of the dialogue will magnify the few ESOP abuse stories, ignore the large number of ESOP success stories and create fears which can delay the passage of meaningful ESOP legislation in Costa Rica. The case in favor of the ESOP is a strong one, but it needs an open forum to win.

**This project is not aimed at replacing the present economic system of Costa Rica, but rather to demonstrate a way to reform it. For this project, the present system is accepted as a given.**

## **Philosophical Framework for Attracting Broad-Based Support for Economic Democratization Program.**

Sound ideas are more than "only theory." Ideas are sound when they provide us new insights on reality and better ways to solve old problems. As such, good ideas are good both because they work and also because they help build new "social bridges" between those who were formerly on opposite sides. The framework and principles underlying the ESOP flow from a synthesis of the ideas of Adam Smith and those of Karl Marx. Thus, it cannot be labeled "capitalism" or "socialism" or "communism". If it can be called any "ism", it is "realism". Because it is on a higher and more solid road than most ideas of political economy, the ESOP can unite political opposites. That is how the ESOP has been introduced in the United States, the United Kingdom and in Egypt. And this is how it should be introduced in Costa Rica.

Fortunately, Costa Rica has its own expanded ownership philosopher in Don Alberto Marten, the founder of the Solidarity movement and a man far ahead of his time in his advocacy of the democratization of credit, which is also the essence of the ESOP technology. Most of the ideas advocated by EEI are consistent with Don Alberto's monetary theories, although there are significant differences between his and EEI's strategy and proposed means for achieving economic democracy. (EEI recommends a more direct and decentralized approach to widespread capital ownership and less interference by the State with open market forces.) Nevertheless, Don Alberto was an early supporter of the ESOP and in 1976 collaborated with one of EEI's principals to introduce the ESOP into Costa Rican law. Those 1976 initiatives of Don Alberto have undoubtedly prepared the minds of Costa Rican citizens for the fairly modest and conservative ESOP reforms being proposed for FINTRA by the EEI consultants.

There are four basic pillars supporting the ESOP approach to economic democracy. These four pillars establish the policy framework for all of EEI's proposed tax and credit reforms and are offered to assist FINTRA and Costa Rican policy-makers to understand and judge the differences between EEI's approach and those of others. They are:

**1. Restore Open Markets for Determining Just Prices, Just Wages and Just Profits.**

**Result:** Decentralizes economic choice and power to the level of each person—as a worker, an owner and a consumer.

**2. Restore Personal Rights of Property in the Means of Production.**

**Result:** Access to profits and control secures personal choice and self-determination; represents the ultimate check on centralized government power, the economic equivalent of the ballot.

**3. Limit Government Power in the Economy to Setting Goals for Private Sector Growth and Equal Ownership Opportunities.**

**Result:** Frees public sector to promote justice for all, to prevent monopolies, to protect property, to enforce contracts, to avoid inflation, to provide an asset-backed currency, and to lift barriers to equal opportunity, especially access through the banking system to low-cost productive credit.

**4. Promote Widespread Citizen Participation in Capital Ownership Through the Democratization of Credit.**

**Result:** Removes class barriers based on property. Promotes rising property incomes and full economic participation for every citizen. Diffuses future ownership opportunities while safeguarding property rights of existing owners. Builds a broader political constituency for restoring fundamental human rights of personal access to property and an open marketplace.

### **Elements of a Parallel Legal System as a Laboratory for Testing ESOP Reforms.**

We recognize that the policy framework underlying the ESOP is based on principles and economic concepts which, while seemingly rational and universal, have never yet been implemented, at least systematically, by any nation. To change the existing system before the ESOP proves itself in Costa Rica would be disruptive and unacceptable, at least under today's conditions. One possible political alternative is to introduce the ESOP legal framework into Costa Rica as a "parallel system", totally voluntary and self-financing. This would allow a fair comparison to the existing system of economic incentives and an opportunity to test such interrelated ESOP structural reforms as:

- promoting a new social contract for workers based on participatory ownership
- increasing income distribution to private sector workers derived from productivity and profits
- simplifying taxes to encourage private sector growth linked to ESOP and to eliminate budget deficits
- expanding tax revenues linked to productivity and profits
- democratizing of productive credit to stimulate non-inflationary growth in private sector jobs and investment
- democratizing of public sector enterprises
- restoring open market competition
- reducing public subsidies and public sector controls
- restoring personal rights of property, especially in corporate equity
- restructuring foreign debt through ESOP debt equity swaps
- increasing the competitiveness of Costa Rican industries in the global marketplace
- gaining special exemptions to remaining trade barriers in U.S., European and Pacific markets
- relieving mounting employer and worker costs of present retirement systems

- creating more positive roles in the private sector for democratic trade unions and solidarity associations

This project will offer only token reforms and modest incentives to test these new concepts. If the new incentives work and they pay for themselves from a standpoint of fiscal policy and sustained national growth, the Legislature can later introduce more far-reaching structural reforms to accelerate the economic democratization process. In the meantime, without forcing anyone to abandon the present system and without major costs, the nation can judge for itself how the current system compares with the parallel expanded ownership system. And if the parallel system proves to be popular, everyone will have benefitted.

### **Target Enterprises for Introducing ESOPs to Costa Rica.**

Innovation and change, no matter how good, cannot be expected to happen overnight. All cultures resist change. This project accepts the reality that some sectors of the economy will be more resistant to changes than other. In the public sector, workers and unions whose jobs are threatened by privatization can be expected to be skeptical toward ESOP reforms, at least until they can understand the big picture behind the ESOP and how they can be better off with ESOPs than without ESOPs. In the private sector, most family-owned enterprises and farms, for other reasons, will be reluctant to offer shares of stock to their employees or to open their books and become accountable for decisions affecting profits or investment policies outside of their top managers and advisors.

Taking these realities into account, this project should aim to avoid or minimize any direct threats to the forces of greatest potential opposition. Its main focus should be on educating workers, entrepreneurs and citizens generally on the principles and policies underlying this project and how, through a few, relatively minor changes in the law, the Costa Rican private sector will have the means to take new and more vigorous initiatives for economic democratization and growth.

The three most likely "target enterprises" to serve as vehicles for pioneering ESOPs in Costa Rica are:

- **State-owned enterprises** which the State has decided to divest and which can be reorganized into competitive private sector corporations without special privileges and subsidies.
- **Multinational corporations** which have already adopted ESOP for their U.S. or U.K. employees.
- **Entrepreneurs** seeking new sources of financings for their new ventures and to attract a highly committed group of managers and workers to launch operations.

Again, family-owned enterprises and farms are not prime prospects for ESOPs. The same can be said for State-owned enterprises where it is impossible to transform them into viable private sector operations without special protections and subsidies, or where public sector workers and their labor unions cannot be offered sufficient incentives to persuade them to accept the risks of becoming worker-owners in the private sector.

## **Operational Plan for Expediting Adoption of ESOPs by Target Enterprises Within Costa Rica.**

As recommended by the EEI consulting team, FINTRA should take the initiative to organize a broad-based citizens legislative advisory group. If FINTRA acts on this recommendation and the advisory committee debates and drafts its own final version of a law to encourage ESOPs, these steps by themselves will greatly expedite the implementation of ESOPs, once the proposed ESOP law project is enacted. Many professionals will become educated in the process and the ESOP technology will be refined and will take on a distinctly Costa Rican flavor.

Seminars can also be conducted by the EEI consultants for lawyers, accountants, bankers, industrial relations specialists and other professionals who will be playing leading roles in implementing the Costa Rican version of the ESOP. In that open process, new problems and new controversies may emerge, all useful to a quality end-product with its own new citizen support base.

## **Even After Passage of the ESOP Legislation, What Features Should Such a Law Contain to Ensure that ESOPs can be Implemented with Minimum Delay?**

First, the law should contain sufficient tax and credit incentives to attract the immediate attention of the three kinds of "target enterprises" mentioned above.

Second, the law should not penalize any interest group which may not desire to become involved with an ESOP.

Third, the law itself should include a prototype ESOP plan and basic legal documentation, which upon filing with the National Registry would be automatically registered as an approved ESOP legal entity, without red tape and without requiring Costa Rican lawyers and other professionals to spend two years in developing the first prototype legal instruments. (EEI's Draft 1 of the ESOP Law Project contains such prototype documents as Appendices A, B and C; it is recommended that subsequent drafts retain such documents, both for continuing education of Costa Rican professionals and legislators and for overcoming bureaucratic delays when the new law is enacted.)

Fourth, the law should create a new civil association—the Employee Shareholders' Association—to overcome the weaknesses of the legal trust used in the United States and the United Kingdom, and thus decrease the abuses and paternalistic flavor of many U.S. ESOPs. While it would be a non-profit membership association for the specific purpose of obtaining shareholder rights and benefits for its members—and then educating its members on the meaning of corporate ownership—the Association should be operationally distinct from the operating corporation in which its members would acquire shares. The Employee Shareholders' Association should also be distinct from the laws creating Solidarity Associations and cooperatives, so that international trade union opposition to Solidarity Associations will not spill over to opposition to the ESOP and otherwise jeopardize other useful Costa Rica economic development projects. On the other hand, the law should be flexible enough to allow Solidarity Associations and cooperatives to form and manage Employee Shareholders' Associations.

Fifth, FINTRA should hold out an olive branch to the democratic trade unions in this law. Presently FINTRA has no one on its board or staff openly sympathetic with the democratic trade union movement of Costa Rica. Union leaders and their political supporters in the Legislature can therefore be expected to be skeptical about the ESOP Law Project, particularly if they are not invited to review the work of FINTRA's consultants and are excluded from the deliberations, work and interactive process of the advisory committee. (Such union involvement was recommended by the consultant team in EEI's proposal as well as in its consulting contract with FINTRA. In its Draft 1 to FINTRA dated March 26, 1989, EEI specifically recommended that democratic trade unions be encouraged to support and become involved in negotiating ESOP benefits on behalf of their members.) If FINTRA takes the initiative of offering an opportunity for unions to help shape the ESOP framework from its very inception, the unions would become aware through the interactive process of the union's potential stake in collaborating with management over issues of participatory management, thus moving both sides away from the "conflict model" to the "proprietary interest" model of labor-management relations. If even one or two union leaders can be persuaded to join this project's legislative advisory committee, passage of this law project will be significantly advanced.

### **Other Suggestions for Building An Effective Coalition for ESOP Legislation.**

1. **Avoid Divisive Words.** The word "privatization" creates its own opposition because it suggests to public sector employees a non-participatory process where a few domestic and foreign owners will take over state-owned assets and their public sector job security will be sacrificed. The concept of "democratization" suggests an alternative where workers can participate in the divestiture process and share in decisions and profits if the divestiture is successful.
2. **Seek Synergistic ("Win-Win") Solutions Rather Than A "Zero Sum Game".** Generally politics involves winners and losers. Some gain at the expense of others. In contrast, synergistic economics is based on releasing hidden growth potential by increasing human and capital productivity. It allows everyone to gain if barriers can be lifted to convert wasted human talent, wasted technology and wasted resources into marketable production. Where there are no obvious losers, resistance to legislative reform is reduced.
3. **Foster An Inclusive and Participatory Process Rather Than One Which Excludes Leaders of Groups With A Vested Stake in the Legislative Goals.** Inclusion, openness and participation are crucial to effective coalition-building. This point is only repeated here for emphasis.
4. **Avoid Coercion and Create New, Wholly Voluntary Incentives for Change.** Changes within an independent parallel system's tax and credit infrastructure can guide change toward sound social goals, without directly threatening subsidies for those who wish to remain within the existing legal system.
5. **Minimize Fiscal Costs.** Within the proposed experimental parallel system, avoid redistribution, subsidies, and anything that strengthens the centralized power of the State or increases people's dependency on the State. For example, it is dangerous from a standpoint of sound fiscal policy and for the future of a democratic order to use tax credits, rather than tax deductions to enable workers to acquire shares in their companies.

Tax deductions which involve legitimate corporate business expenses or which eliminate the discriminatory double taxation on corporate profits, are in the nature of genuine tax reform. They are not real "subsidies" and can be supported wholly on the grounds of tax justice. The most stable

ESOP tax incentives in the United States for ESOPs are in the form of tax deductions. Tax credits for ESOPs were attempted but proved to be fiscally too costly, only tokenistic in their impact, and politically vulnerable in the face of rising U.S. fiscal deficits.

Tax credits make it appear that the State rather than the people produce wealth. If the State grants 10,000 Colones of tax credits to a business which gives one of its workers 10,000 Colones worth of company stock, it is no different than if the corporation paid 10,000 Colones in taxes to the government and a government agency in turn handed the worker 10,000 Colones in cash to buy stock. Tax credits are clearly tax subsidies and place the recipients in direct head-to-head competition with all other groups and needy individuals seeking government handouts.

Tax deductions keep discretion and power in private hands, while tax credits strengthen the power of the State and increases the dependency of the recipient on the State's largesse.

ESOP tax deductions, as a matter of principle, also allow for the restoration of private property in corporate equity and thus help facilitate the social objective of democratizing future corporate ownership.

6. **Seek Maximum Fiscal Dividends for ESOP Reforms.** Look for application of ESOP structural changes within existing programs which create burdensome government deficits, which concentrate (rather than decentralize) economic decision-making, which international lenders would welcome as structural reform tradeoffs for debt reductions, and which could open up a new dialogue for restructuring the economy to allow Costa Rica to grow and become more competitive in the global marketplace. Draft 1 was focused to convert these crises situations into opportunities for change.

7. **Reforms, to be Meaningful, Cannot Avoid Controversy.** While controversial, the ESOP reforms to be recommended in Draft 1 would foster a new and healthy bipartisan debate. Even if not all the recommendations would be accepted today, future leaders could go back to the original package for thoughts for future reforms.

8. **Don't Compromise on Good Reforms Before Dialogue and Negotiations Begin.** Each interest group, including those represented by FINTRA, will approach any proposed reforms from its own particular perspective. Everyone has his own view of what constitutes the common good. If, for example, FINTRA considers a particular reform as being sound social policy, right in principle and reasonable in purpose, but thinks that it may be too controversial in the minds of other groups, FINTRA should not discard the reform on grounds of political expediency. Instead, FINTRA should bring those other groups into the deliberations and try to persuade those other groups of the soundness of that policy.

## **ARTICLE-BY-ARTICLE ANALYSIS OF PROPOSED COSTA RICA ESOP LAW PROJECT (DRAFT 1)**

This analysis has been prepared to help the reader understand the document presented to FINTRA entitled, **A (PROPOSED) LAW TO ENCOURAGE THE DEMOCRATIZATION OF CAPITAL OWNERSHIP THROUGH EMPLOYEE SHAREHOLDERS' ASSOCIATIONS AND CONSUMER SHAREHOLDERS' ASSOCIATIONS FOR CITIZENS OF COSTA RICA. DRAFT NUMBER 1.** All pages referred to in this Analysis can be found in the edited version of the Draft 1 document (Part II).

### **Preamble.**

The Preamble was written to establish a conceptual framework for legislators and the public to introduce them to the ESOP and its underlying social principles. It aims to improve understanding of why this Law Project can help improve the Costa Rican economy through a unique private sector approach approach to economic democratization, making every worker a shareholder. The Preamble is a brief version of all the points made above in this Explanatory Guide.

### **CHAPTER I, ARTICLES 1-4. General.**

**General.** These general articles create Employee Shareholders' Associations and Consumer Shareholders' Associations (Articles 1 and 2) as new legal entities subject to this law and, for matters not covered by this law, the Law of Associations, Number 218 of August 8, 1939 and its amendments (Article 3.) This makes them special kinds of democratically-controlled membership associations. These associations would operate Employee Share Ownership Plans (ESOPs) and Consumer Share Ownership Plans (CSOPs) as mechanisms for acquiring shares of specific corporations to which their members are related.

**Not Businesses.** Article 4(a) makes it clear that the two shareholders' associations are not in and of themselves businesses, and they will not control businesses. They will be mere custodians of the shares acquired on behalf of their members and will provide the means, including credit, by which such shares can be acquired.

**Personal, Not Collective, Shareholder Rights.** While the associations will hold legal title to the shares until they are distributed, the associations' main purpose is to enable each of their members to acquire shares and then exercise all the personal rights of any shareholder. Dividing shares and voting rights based on shares held in the personal accounts of members (Article 4(b) and (c)) is one way of safeguarding that each worker-shareholder can protect his own proprietary stake in the company. This maintains a republican ("checks and balances") governance structure for each corporation and reduces the dangers of politics and block voting in corporate decision-making. Requiring that associations operate independently of each other (Article 4(c)) also reduces these dangers to effective corporate governance. The democratization objective of this legislation will be met through decentralizing ownership powers to each member personally through his or her shareholdings, not by collectivizing or concentrating corporate ownership.

**Voluntary Nature.** Article 4(e)(6) also highlights the voluntary nature of the ESOP laws, which include allowing workers to invest in equity shares of their own companies on a **voluntary** basis from their savings or other accounts established for their retirement. This is **to give each person the choice over matters affecting his or her material security, a right that is fundamental in a democratic society.** Participation by corporations is also voluntary. Nothing in this legislation is coercive. This is an important distinction that deserves note.

**Cash Distributions Permitted.** Reference in Article 4(a) to "share-equivalents" is to permit cash rather than stock distributions by the association. To allow the ESOP a reasonable amount of **time to educate** its members about shareholder rights and policies and to **prevent unfriendly takeovers** of Costa Rican companies, the association bylaws may restrict distribution and disposal rights in company shares. In these cases, the cash value of shares would be distributed to terminated employees as specified in the bylaws. If the members decide otherwise, the bylaws could permit the immediate or delayed distribution of shares.

**Social Justice as Basis for Charitable Donations.** Paragraph (d) allows U.S. banks holding non-performing government debt securities to donate them to workers and get a tax deduction under U.S. charitable donation laws, similar to debt-for-nature swaps. A major goal of this legislation is to create some meaningful structural reforms aimed at broadening ownership participation by low-income workers. Such reforms would qualify Costa Rica for negotiating tradeoffs under the so-called Brady Plan for foreign debt forgiveness. In turn, these pro-private sector reforms, when combined with reduced government deficits and a lower foreign debt burden, will bring in more foreign investment. And part of that foreign capital can be in the form of loans to ESOPs which would be established by this legislation.

## **CHAPTER II, ARTICLES 5-8. Monetary Incentives.**

Chapter II adds a few positive changes to the monetary system to promote demonstrations in ownership participation for workers and consumers. These incentives do not involve subsidies and therefore add no burden to the tax system.

Traditional monetary policies shackle the future to the past. The monetary policies offered in this legislation decouple the future from the past by making credit—not past savings—the key to future investment. This puts the future of Costa Rica where it belongs—in the hands of its producers, all its workers, not in the hands of outsiders.

Monetary incentives are featured prominently in this legislation because **access to credit** is the most important key in determining whether future capital ownership will be concentrated or decentralized, whether future control over the private sector will be monopolized or democratized. What makes the ESOP work over other approaches to worker ownership is that it makes low-cost, non-recourse productive credit available through traditional commercial banking channels to people who have no savings or who cannot afford to purchase shares, even out of payroll deductions. (See "What is an ESOP" and charts in the Appendix to the Explanatory Guide.) Because credit to an ESOP is self-financing and linked to future corporate profits, the Associations and their member would not be at personal risk if there are no profits and the credit cannot be repaid. At most the shares and any corporate collateral would be taken over by the lender in the event of default. On the other hand, broad-based ownership participation is good insurance that workers will work hard to generate the profits needed to repay the credit.

Even if workers have access to credit, high interest rates could make it impossible or at least make it more difficult for the credit to be repaid. Today's **high interest rates in Costa Rica work against ESOPs.**

There are two policy reasons to support **low-interest productive credit** to encourage the formation of ESOPs: first, it is a powerful way for monetary policy to bring about structural reform (low-cost productive credit promotes more rapid rates of private sector investment). Second, it directly links private sector initiatives to expanded worker participation in ownership and profit sharing (high-cost productive credit diverts to lenders money which could have been used as dividend incentives for worker-shareholders). And it is counter-inflationary: expanded productive credit which expands productivity is not inflationary. ESOP credit, therefore, **should be favored over credit which is expanded to meet government deficits or for other non-productive uses.**

Thus, to promote a counter-inflationary interest rate policy as well as worker participation and profit sharing—all of which would clearly add to Costa Rican productivity—the Central Bank of Costa Rica would be required by this legislation to use its rediscount powers to reduce interest rates for ESOPs to the lowest possible levels. The Central Bank's rediscount rate—the base for all interest rates in the economy—would take the form of a service charge of 1% or less to cover the costs to the Central Bank of monitoring loans to ESOPs. **No subsidies would be involved in reducing interest rates to ESOPs through the Central Bank's rediscount mechanism.** Commercial banks making loans to ESOPs would still earn their normal profits. But this change in Central bank policy would be the most important signal the Central Bank could send the Costa Rican people and its foreign creditors regarding its future commitment to favor private sector growth and to discourage inflationary public sector growth.

## **Article 5. State-Owned Enterprises and Foreign Debt Reduction.**

Article 5 of this legislation requires the State to supply low-interest credit to Employee Shareholders' Associations established by public-sector employees to facilitate the divestiture of potentially viable State-owned enterprises. By enabling workers to participate in ownership and profits and by supplying the means by which worker participation can be maximized (up to 100% of the equity financing in some cases), labor's traditional opposition to divestiture is expected to be radically reduced.

To gain special access to low-cost credit, the workers would have to abandon their claims to more secure public sector jobs and subsidies. In exchange for the political dividends associated with worker ownership and significant cost reductions for the government, the government would sell its assets at an appraised fair market value and receive cash proceeds out of future profits. Because of the special circumstances involved and other political advantages of a sale to workers, the government as seller would in effect "take back paper".

The Asset Democratization Trust would be the permanent entity established by this legislation to serve as the "merchant banker" for these transactions and as principal negotiator for converting these divestiture initiatives by the State into reductions of Costa Rica's foreign debt. FINTRA is performing this role today and, if it agreed, could continue to do so under this legislation.

The Central Bank would monitor the transaction and supply whatever credit is needed at a rate reflecting the real costs to the Central Bank of making and administering the loan. **This avoids the traditional dependency in privatization situations on outside foreign or**

**domestic investors and lenders, with their much higher drain on future profits as a result of traditionally high interest rates and equity demands. It also keeps control over Costa Rica's economic destiny in friendly Costa Rican hands.**

**Article 6. Private Sector Corporations and Cooperatives Reorganized as Stock Corporations.**

By its nature the ESOP deals with shares of corporations. Article 6 makes low-cost credit (at no cost to the taxpayers) available to any corporation or cooperatives which establishes an Employee or Consumer Shareholders' Associations which meets the qualification requirements of this legislation. The Central Bank would allow commercial bank lenders to expand their lending capacity by agreeing to rediscount bankers' acceptances at a specially low rediscount rate reflecting the Central Bank's administrative costs. The lenders would add their normal markup over their "cost of money" in the interest rates they charge the borrowing Shareholders' Associations. This would supply private sector workers and consumers with low-cost credit to purchase newly issued or outstanding shares in ways linked to future productivity of the affected enterprises.

This high-powered, self-financing mechanism is critical to comparing the effectiveness of the parallel economic democratization system being tested under this legislation, with the traditional public sector-biased economic system in Costa Rica today. Article 6 is deliberately targeted to stimulate private sector productivity and growth and to serve as economic counterweights to the inflationary aspects of traditional public sector growth policies.

**The monetary and credit tools which traditionally have been used exclusively for stimulating public sector growth and to fund non-competitive public sector enterprises would now, for the first time, become the principal tools for financing the future of a more competitive and more democratically owned private sector.**

**Article 7. Conditions for Eligibility for Special Access to Central Bank Discount and Rediscount Privileges.**

This Section is designed to increase the viability and attractiveness to bankers, including the Central Bank, of loans to workers and consumers.

Section 7(1) specifies the conditions to be satisfied before the Central Bank uses the new monetary powers in encouraging low-cost credit to Associations under Articles 6 and 7. Among the conditions is that the new credit be asset-backed and guaranteed by the general credit and future profits of the corporation whose shares are being acquired by the Association, and that the members of the Association be insulated from personal risk in the event the credit cannot be repaid. Such non-recourse credit for workers and consumers through their Associations puts them in the same privileged position that existing shareholders have traditionally enjoyed when a corporation borrows directly. This Section makes it permissible for the purchased shares to serve as collateral until the loan is repaid.

Section 7(2) makes access to the Central Bank's special discount and rediscount privileges available to all members of the National Banking System and the Workers' Bank. This fosters competition among lenders to Associations, yet insulates the Central Bank from having to decide

which Associations get how much credit (except where the government is selling its own assets on credit under Article 5.)

Section 7(3) introduces the concept that lenders supplying credit under this legislation must determine that (i) the credit should be used exclusively for purchasing shares, not for some other purpose, (ii) Associations receiving such credit should pay no more than "an appraised fair market value" price for acquiring shares, and (iii) the loan repayment must be in conformity with the ESOP provisions of the Association bylaws.

Section 7(4) is to make certain that credit supplied to the Association not be used for speculating in securities or commodities, for hostile takeovers of other companies, for buying or improving homes or for consumer purchases, for funding public sector projects or activities or for other non-productive purposes. This is to guard against diverting high-powered "supply-side" credit—which this legislation intends for targeting exclusively for real productivity growth—toward inflationary and speculative "demand-side" uses. Lenders presumably are in the best position to make these distinctions.

Section 7(5) is to require lenders to review appropriate feasibility studies, business plans and other documents to be reasonably assured of the ability of the business to generate sufficient cash flow to repay the credit to be extended to the workers and consumers through their Associations.

Section 7(6) provides for the collateralization of the credit with shares, corporate assets, etc. and to provide for the release of any pledged shares as the loans are repaid.

Section 7(7) creates an additional incentive to lenders, by reducing their exposure to only 20% of the face value of the loan in the event of default. Initially, on loans to Associations, only the lender is at risk. Under this Section up to 80% of the lender's risk would be covered by a Loan Default Insurance Fund, once it is established by the National Insurance Institute. The cost of such insurance would not be supported by the taxpayers but would be funded wholly through premiums paid for by the workers and consumers as part (the so-called "risk premium") of the interest charged on loans to their Associations. In this way 80% of the initial risk to the lenders can be entirely covered by debt service payments, which would come wholly out of future profits. The risks of the workers—who today own nothing and have nothing to risk—will result after the workers have produced the necessary future profits to accumulate significant equity holdings. But this eliminates the artificial "risk issue" as a conceptual barrier to expanded worker ownership.

## **Article 8. Lender Charges Above Central Bank Rediscount Rate.**

Article 8 makes it clear that lenders may set their own markup above their cost of money for loans to Associations. Competition among lenders is expected to moderate the markup to 2%, so that the final **unsubsidized interest rates to Associations resulting from this legislation will be about 3% for purchasing shares of Costa Rica's best-managed corporations.** The availability of such low-cost credit is the single most effective tool offered by this legislation for making the Costa Rican economy more competitive in world markets.

### CHAPTER III, ARTICLES 9-17. Tax Incentives.

This chapter provides the favorable tax environment for encouraging faster (non-inflationary) rates of private sector growth linked to expanded worker ownership. In a hostile tax environment ESOPs will not work.

This chapter rests on assumptions that wealth is produced by the people, not the government. Thus, a good tax system follows the production system. For the government to spend more, the people must produce more. Therefore, the parallel democratized private sector system that will develop from this legislation provides maximum incentives for the workers to become productive and want to produce more.

The tax incentives in this legislation involve structural tax reforms and carefully avoid tax subsidies, such as tax credits. Tax credits automatically make the recipients more dependent on government largesse. Tax credits create the illusion that government—not the productive and entrepreneurial worker—is the source of wealth. The ESOP approach relies on financial credit, not tax credits, to convert workers into worker-owners. **Those who advocate tax credits for worker ownership pit the workers in direct competition with the poorest and neediest citizens and all others who depend on government subsidies and programs.** Tax credits therefore are not only socially divisive, they reduce government revenues.

The tax principles behind the ESOP reforms are based on:

- (a) voluntary **deductions** from personal and corporate income taxes for payments, contributions, or dividends used to enable workers and consumers to accumulate savings in the form of corporate shares,
- (b) permitting such deductible payments, contributions and dividends to be used to repay loans or credit made available to workers and consumers to enable them to purchase corporate shares on a self-financing basis,
- (c) tax-sheltering or deferring taxes on the shares until they are converted into spendable cash and not reinvested in other securities, thus encouraging accumulations of income-producing property for workers and consumers to meet their retirement needs,
- (d) avoiding the discriminatory double tax on corporate profits by encouraging corporations to distribute their profits and shifting the tax burden to the shareholders,
- (e) taxing dividend incomes and inflation-indexed gains from the purchase and sale of corporate stock at the same rate as labor incomes,
- (f) avoiding the disincentive effect of progressive taxation through a flat rate on all new labor and property incomes generated within the parallel ESOP system created by this legislation, and
- (g) reducing tax evasion by enlisting the corporations and shareholders' associations as collectors of personal income taxes.

Another reason deductions are better tax policy than tax credits is that deductions are more voluntary in nature and leave more discretion in the hands of the private sector. The net effect of the

recommended tax policies is that the tax system becomes simpler and fairer and offers new incentives for entrepreneurial and investment opportunities. And while it avoids penalties on property, the new tax policies redistribute future wealth **opportunities** (not wealth itself)—from the bottom-up without penalizing existing wealthholders.

The principles upon which tax policy for this legislation is based, if correct, should produce more tax revenues for the public sector than are produced under the present system. Those added revenues would come from growth of private sector productivity and from the conversion of wasted human energies and other resources into new marketable goods and services. Hence, the proposed incentives take nothing away from the present system. To prove the point, these reforms can be tested alongside the present tax system to determine which system generates the greatest amount of revenue support for public sector programs.

#### **Article 9. Exemptions.**

The Associations would be free of all taxes in order to maximize the ownership accumulations and property incomes for its members. The new property incomes would be a new source of taxable incomes.

#### **Article 10. Exemption for Member's Benefits Held by Association.**

The Association provides a "tax-shelter" for workers and consumers to invest and save for meeting their needs during their retirement years. This is a major objective of the ESOP. The more that can be accumulated within the members' Association accounts, the less retired workers will be dependent on the national social security system and the less the burden they will be on younger generations. Members will, however, be taxed on their property incomes as they are distributed by the Associations.

#### **Article 11. Tax Deductible Voluntary Contributions by Members.**

While a good argument can be made that it harms private sector growth when workers reduce their spendable income to buy shares, others argue that it is good psychologically for workers to make sacrifices to become owners. Under the "leveraged purchase" (credit) approach made possible by this legislation, workers or consumers may not be required to pay for their shares out of savings or payroll deductions. Article 11, however, is offered as a compromise with those who believe in the "sacrifice" approach to worker ownership. It would permit workers to make voluntary tax-deductible contributions to purchase shares, up to a limit to avoid excessive ownership benefits flowing only to highly-paid employees.

## **Article 12. Tax Deductions for Corporations.**

Article 12 treats tax deductions for corporations as representing legitimate costs for carrying out normal and legitimate business activities and therefore deductible before determining taxable corporate income. Wages, employee benefit and retirement expenses, interest costs, and customer rebates are examples of such business expenses. Denying such deductions would result in taxing corporations unfairly on profits it may not have earned. On the other hand, allowing deductions for these costs do not convert them into government expenditures or subsidies, as would be the case for tax credits.

Article 12 provides a number of incentives in the form of tax incentives to encourage corporations to voluntarily enter the parallel expanded ownership system by meeting the eligibility criteria of Chapter V.

Article 12(1) encourages eligible corporations to reduce their taxable corporate incomes by distributing dividends to **all** their shareholders, present ones as well those participating through Associations. Dividends which are not reinvested would become a taxable property income to the shareholders at a low flat rate, say 5%. The tax would be withheld either by the corporation or its related Association, making it easier for the government to collect taxes on corporate profits.

Article 12(2) treats cash or stock contributions to a qualified Association as a deductible business expense.

Article 12(3) allows deductions for cash paid in the form of benefits to employees and customers if such cash is used to repay a share acquisition loan, rather than becoming taxable personal incomes.

Article 12(4) has the same effect as 12(3) for dividends used to repay share acquisition loans.

Article 12(5) is designed to encourage eligible corporations to adopt gain sharing or profit sharing plans because they strengthen the motivational impact of the ESOP. ESOPs alone are not enough according to reliable studies. Deductions would be allowed for cash distributed to workers from monthly, quarterly and annual profits, provided that the corporations withholds taxes at the same low flat rate as dividend distributions under Article 12(1). This reinforces the idea that labor and property incomes should be taxed at the same flat rate but in ways that encourage workers to increase productivity and profits for the good of all.

## **Article 13. Tax on Distributions to Members.**

Article 13 requires the Association to withhold a low flat rate tax on cash or shares it distributes to its members under the Association bylaws. This eliminates the tax shelter which the Association provides on the assets it holds for its members. It also converts deferred income into taxable personal income, unless such distributions are reinvested as provided for in Article 14.

**Article 14. Exemptions for Distributions Reinvested in the Association or Another Qualified Equity Entity.**

Article 14 provides a way to restore the tax shelter after a worker or consumer or their beneficiaries receive a distribution from an Association. By reinvesting the proceeds within 180 days the distributed amounts would continue to remain exempt from personal income taxes.

**Article 15. Exemption of Gains for Investors Selling Qualified Shares to Associations.**

Article 15 encourages present holders of corporate shares to sell their shares to workers and consumers by providing current owners a way to insulate the real gains from the purchase and sale of such shares from any future capital gains tax which might be imposed, provided that the seller reinvests the sales proceeds within 180 days in other forms of productive capital. The idea of inflation-indexing is to distinguish real gains from gains which result wholly from inflation. This provision thus protects property, expands ownership and creates a new source of venture capital.

**Article 16. Capital Gains Tax on Proceeds Not Reinvested.**

Article 16 provides the government a new source of revenues by adding a 5% flat rate tax under the parallel system for the real gain to the shareholder who sells his shares to a qualified Association and does **not** reinvest the proceeds as allowed under Article 15. If, after indexing the gain for inflation for the period of time the shareholder held such shares, there was no real gain between the price he paid and the price he sold the shares to the Association, the shareholder would not be required to pay any capital gains tax. Otherwise, his gain from the purchase and sale of shares would be treated as a taxable property income and taxed at the same flat rate as labor income gains to workers under the parallel system.

**Article 17. Associations Treated as Charitable Associations for Receiving Donations.**

Article 17 amplifies Article 4(d) to create a special charitable status for Associations qualified under this legislation. Because they are designed to help the poorest citizens of Costa Rica to become economically self-sufficient, productive and independent participants in the economy, the Associations are important social instruments for promoting social and economic justice, the highest order of charity. As such, donors of shares or cash to the Associations should be given the same tax treatment under Costa Rican law as donors to other recognized charities. This Article would also be important for U.S. holders of Costa Rican debt paper, who would become eligible for tax write-offs in the United States by donating their non-performing debt paper to a Costa Rican Association representing public sector employees, which in turn would be converted into corporate shares in state-owned enterprises. The net result is that the government would reduce its foreign debt liabilities, the lender would gain more in U.S. tax savings than it could if it sold the debt paper at current discounts in the world marketplace, and a state-owned enterprise

could be converted from a public sector entity into a worker-owned company in the private sector. It is like the debt-for-nature swaps, but the poor would be the beneficiaries.

#### **CHAPTER IV, ARTICLES 18-23. Other Incentives for Forming Associations.**

##### **Article 18. Special Preferences in Sale of Assets or Shares in State Owned Enterprises to Their Employees.**

Article 18 requires that first consideration be given to employees whenever the State decides to divest itself of a state owned enterprise. A successful divestiture requires that the enterprise can be profitable in the future. Future profits cannot be generated without total cooperation of employees at every level. The likelihood of future profits is maximized to the extent that workers are working for their own profits, rather than for outsiders. Thus, the greater the commitment the workers are willing to make to make the divestiture work, the larger the percentage of ownership the government can offer them through their Employee Shareholders' Association.

The preference provided in Article 18 is a practical political tradeoff the State can offer public sector employees for the sacrifices they may be required to make in the divestiture process. The workers would be expected to work together to reorganize the enterprise as a private sector enterprise capable of competing without subsidies or special protections in the global marketplace. The ESOP would make it possible to finance such a divestiture wholly on credit. Article 18 allows the State to sell to the employees under a long-term installment payment agreement at low-interest rates. These features eliminate the need to persuade outside lenders and investors to risk their money in politically risky divestiture projects. Negotiated divestitures would involve only employee representatives and the government (and possibly management contractors), all conducted under the merchant banking umbrella of FINTRA or the Asset Democratization Trust created by Chapter X.

##### **Article 19. Preferences for the Sale of Certain State Owned Assets and Shares to Employees and Consumers.**

Article 19 comes into operation only for divestitures of highly capital-intensive state-owned enterprises, where a sale exclusively to employees might result in the average employee accumulating in excess of 4 million colones worth of stock, all through credit provided by the State. To promote the goal of credit democratization in these cases, a portion of the share acquisition credit would be allocated under this provision of the law to consumers through a Consumer Shareholders' Association.

For example, a major public utility could be divested 30% to its employees and 70% to its consumers, all on credit repayable out of future utility profits. Rate making and investment decisions could be made by the utility's board of directors, who would now be democratically accountable to the only two groups with a permanent stake in the operation's success. Since government-supplied credit would be vital to such a divestiture, the workers and consumers, through their representatives on the utility's board, would be required to negotiate whatever changes are necessary to make the buyout feasible without public subsidies or regulatory oversight. FINTRA or the Asset Democratization Trust could offer technical services to help facilitate this process, perhaps aided by the present regulatory agency.

##### **Article 20. Special Preferences for State Contracts.**

Article 20 would give a special preference to corporations owned by their workers whenever the State awards contracts based on competitive bidding. This would help make it easier for companies to be transferred from the public to the private sector, at least during a reasonable transition period.

### **Article 21. Voluntary Withdrawal From Retirement Program of National Social Security Fund.**

Article 21 is **deliberately controversial** but it is wholly consistent with this Legislature's commitment to economic democratization and private sector growth. It would give the choice to each worker to voluntarily decide that **future** contributions made in his behalf under the public retirement system be invested in shares of his own company. If a worker decides to invest in his own future, a risk that every entrepreneur must make, his public sector retirement entitlements would be appropriately reduced. **This allows people to be responsible for their own well-being.**

This provision could produce a significant new source of financing the future investment needs of a revitalized Costa Rica. It promotes an entrepreneurial spirit among workers. It would also create **an asset-backed retirement system**, which would remove some of the future funding pressures on today's "pay-as-you-go" public retirement system. It will also reduce some unpredictable burdens on future generations of workers as present generations retire. If it is determined that this provision requires a constitutional amendment, then this Article should be presented in that form.

### **Article 22. Investment of Severance Pay Obligations.**

Article 22 makes it possible for severance payments to take the form of shares of company stock. This would extend the privilege to Employee Shareholders' Associations what can be done under present law through Solidarity associations. Employers would still have to guarantee shortages in meeting its severance pay obligations, but at least the money can be invested in ways that workers can maximize the yields from their severance pay assets.

### **Article 23. Voluntary Withdrawal from Mandatory Employee Savings in the Workers' Bank.**

Article 23 is also controversial but deserves exposure to serious discussion. It would allow a worker to invest his mandatory savings in his own company, the only assets of which he can affect the return. True economic democratization requires that such a choice be put in the hands of each worker. This provision is intended to fulfill one of the original purposes of the Workers' Bank—to create savings for the workers to invest in their own enterprises. If this requires a constitutional amendment, then such an amendment should be offered.

## **CHAPTER V, ARTICLES 24-27. Eligible Corporations.**

This chapter recognizes that not all corporations will want to become "eligible" for the incentives offered under this legislation. Again, the tenor of this legislation is its voluntary quality.

Eligible corporations, as determined by the National Registry, must have certain irreducible characteristics because the nature and structure of a corporation heavily influences the quality of ownership. The main thrust of this legislation is economic democratization, a central element of which is participatory ownership. If the law is hostile or indifferent to property with respect to corporate equity, participatory ownership and the ESOP will not work. This legislation therefore deliberately reinforces the traditional rights of property so that such rights will work for all shareholders.

This chapter also guards against some of the abuses found in ESOP companies, most of which come from a breakdown of the participatory rights of employee-shareholders and a lack of the kinds of information which controlling shareholders normally take for granted. To prove that productivity and participation go together, this legislation embodies principles which are followed by the most successful ESOP companies.

If the proposed modifications help "eligible" corporations to outperform their more traditionally structured competitors, the ESOP companies in Costa Rica will serve as models for others to follow.

#### **Article 24. Mandatory Conditions of Eligibility.**

Article 24(1) requires eligible corporations to state among their corporate objectives the maximizing of participatory ownership opportunities for their employees and the maximizing of dividend payouts to all their shareholders. This commitment in the charter of incorporation reinforces the proprietary culture of eligible corporations, setting them apart from more traditional corporations. Any stock corporation or marketing or producer cooperative can become eligible under this provision.

Article 24(2) requires a cooperative agreement between the corporation and its related Association, each a separate but interdependent legal entity. This Article would, among other things, allow the Association full access to the books and financial records of the corporation, particularly for conducting independent appraisals of the value of corporate shares. It is anticipated that such **access to financial records will discourage many enterprises from applying for eligibility, but without such access, abuses can hardly be avoided.**

Article 24(3), in recognition that the ESOP cannot succeed without cooperation and contributions from the employer corporation, requires that the board of directors of the corporation ratify the ESOP provisions of the Association's bylaws.

Article 24(4), also in recognition of the role of the corporation in supporting the ESOP, requires a board resolution to make an initial contribution of cash or shares to the ESOP or to serve as guarantor of a share acquisition loan to the ESOP.

Article 24(5) requires the adoption of a participatory management program. Giving workers a voice in decisions affecting their work has been proven to enhance the effectiveness of the ESOP.

Article 24(6) requires the adoption of a gain sharing or profit sharing program which directly links future increases in the take-home income of workers to increases in productivity and profits. There is strong evidence that ESOPs without gain sharing do not work as well as ESOPs that have them. A well-conceived formula for frequent distributions of profits is a key element in making a company more competitive and providing workers greater job security. Because of the importance of the sharing of profits as an alternative to traditional inflationary compensation increases, this Article requires that the formula for distributing profits be a subject of negotiations between management and democratically selected representatives of the non-management workers. While negotiations with labor representatives will be a **controversial** subject for traditionally managed companies, it is vital to the participatory culture in the most successful ESOP companies. Involvement of democratically selected representatives of non-management workers to negotiate on an equal footing with management breeds openness, trust and a mutual sharing of responsibility.

**Article 24(7) is probably the single most controversial provision in this legislation. It proposes that eligible corporations take steps to encourage their non-management workers to voluntarily form a democratic trade union.** This is the "olive branch" the private sector should be extending to the democratic trade union movement of Costa Rica, which today has largely abandoned workers in the private sector and have devoted most of their efforts to negotiating on behalf of workers in the public sector. This legislation is designed to offer private sector workers a "new and more just labor deal" than is offered in traditionally run private sector corporations. Today's unions have a vested stake in today's state-dominated economy. Just as they are opposed to privatization of state owned enterprises, for obvious reasons, unions will undoubtedly perceive a threat from the economic democratization initiatives proposed in this legislation, particularly if they play no role in designing this legislation. If unions are to be part of the dialogue, then the initial draft should offer the labor unions "a deal they cannot refuse." And Article 24(7) is that "deal." **It will help FINTRA gain political support for the ESOP legislation, both in Costa Rica and in other countries interested in Costa Rican development.**

If the democratic trade unions can become persuaded that the new parallel "participatory ownership" system will offer them a bigger and more positive role, greater gains for their members, more revenues for union activities, and greater social influence than under the traditional "wage system" economy, unions will remove their opposition or at least become neutral if not supportive of this legislation. While it is probably unrealistic to expect support from all sectors of the trade union movement, it is not impossible to gain some support if the Costa Rican private sector reaches out to welcome participation by organized labor. In the United States, unions which were originally strongly opposed to the ESOP have today become strong ESOP advocates, but only with the kinds of labor protections proposed in this legislation.

This legislation provides an opportunity for both management and labor to go beyond the conflict model of industrial relations, into the more cooperative "share the wealth" model of the future. No one gains from the shrinking pie of the conflictive "wage system" model. Everyone can gain from an expanded pie, if everyone can own a piece of the pie. Just as not all corporations will want to taste the new pie, only the most far-sighted unions will want come to the table to test the new pie of ownership sharing. Article 24(7) is to encourage unions to come to the table.

As the ultimate incentive for labor unions to come to the table, this legislation offers them a checkoff system in which membership dues can be increasingly linked to the ownership benefits that the union helps to negotiate on behalf of their members. In this way union revenues can be directly linked to expansion of a private sector version of economic democracy, which will free the Costa Rican labor movement from its present dependency on revenues from foreign sources.

## **Article 25. Priorities in Allotment of Future Participatory Ownership Opportunities.**

Article 25 gives top priority to the employees of eligible corporations (those which voluntarily come within the framework of this legislation) whenever such corporations need to finance new investments or to repurchase existing shares. After the employees, then customers, present shareholders and outside investors would share in future ownership opportunities in that order of priority. Traditional corporations reserve this priority for existing shareholders, thus creating new wealth with no new owners. This article reflects the new policy of encouraging business corporations to voluntarily begin to fulfill their highest social purpose as vehicles of economic democratization. The credit and tax incentives offered in this legislation make it possible for corporations to go beyond their traditional production and distribution functions toward a new social role of spreading property incomes more equitably throughout society. **To the extent these incentives are accepted by the private sector, the income redistribution role that the public sector has assumed in the modern welfare state can be correspondingly reduced.**

## **Article 26. Voluntary Conditions of Eligibility.**

Article 26 allows an eligible corporation to enable Consumer Shareholders' Associations and Solidarity Associations to acquire company shares for their members under certain conditions.

Article 26(1) specifies the conditions under which an eligible corporation would go beyond its employees as the preferred shareholder group to include its customers, the second preference group. **The main social policy issue is the extent to which corporate credit repayable with future profits—the key to who will share in future share acquisition opportunities and profits—should be made accessible on an unlimited basis to any individual or group.**

Article 26(1) would extend such credit to consumers to the extent that the value of the shares acquired on ESOP (corporate-guaranteed) credit by the average employee of the company will exceed a certain level of capital accumulation (which is stated in the legislation as ten times the projected labor income of the average employee over ten years.) This level of "capital self-sufficiency" for the average employee represents an equity accumulation which should generate a "second income" from dividends about equal to his annual labor income, assuming a 10% dividend rate and an elimination of the double tax on corporate profits. If a study jointly sponsored by the corporation and the Employee Shareholders' Association concludes that the share of total equity to be acquired by the employees will exceed this threshold, the corporation would be authorized to help create a Consumer Shareholders' Association under this legislation.

**Note that the concept of "capital self-sufficiency" is not a ceiling but it is a threshold level for highly capital-intensive corporations and public utilities to consider when to begin considering other groups who should become beneficiaries of capital credit—a social good—and thus entitled as owners to share in future corporate profits.**

The concept of "capital self-sufficiency" is grounded on practical politics. A "social good", such as capital credit and other incentives created under this legislation, should not be monopolized but is a social privilege which should be broadly accessible. Otherwise the main goal of this legislation—economic democratization—would be frustrated.

There is another practical reason for Article 26(1). A completely leveraged divestiture of a public sector utility can be accomplished through a joint acquisition of all of its shares by its employees and customers through the formation of an Employee Shareholders' Association and a

Consumer Shareholders' Association under this legislation. FINTRA or the Asset Democratization Trust could serve as merchant banker on the transaction.

Article 26(2) promotes the formation of Solidarity Associations, a uniquely Costa Rican form of employee beneficial association covering both management and non-management employees. They are not substitutes for labor unions since Solidarity Associations are prohibited by law from negotiating collectively with management on behalf of non-management employees over wages, fringe benefits and working conditions.

#### **Article 27. Option to Expand the Role of Solidarity Associations.**

Article 27 permits existing Solidarity Associations to assume the functions of an Employee Shareholders' Association, thus expanding the powers and programs of the Solidarity Associations into a new area—ESOP—in which they have already expressed interest.

### **CHAPTER VI, ARTICLES 28-32. Qualified Shares and Valuation.**

#### **Article 28. Qualified Shares.**

Article 28 defines "qualified shares" for purposes of this legislation essentially as common stock and preferred stock convertible into common stock.

#### **Article 29. Valuation of Qualified Shares.**

Many of the potential abuses in operating an ESOP relate directly or indirectly to the valuation of shares acquired for or distributed to employees through their ESOP. Article 29 requires that all ESOP transactions involving shares of stock of a closely-held corporation be at "fair market value" as determined by an totally independent professional appraiser. Article 29 defines the term "fair market value" and outlines the basic factors the appraiser must consider in performing the valuation report, which must be done at least annually, or sooner in the event of a major acquisition by employees of company shares.

#### **Article 30. Exception for Associations With Less Than 20 Members.**

Article 30 allows smaller Associations to eliminate the complexity and costs of a professional appraiser for determining "fair market value." A formula using book value or adjusted book value would be allowed under certain conditions.

#### **Article 31. Exception for the Acquisition of Shares or Assets Owned by the State.**

Article 31 permits an acquisition by an Association of state-owned shares or assets at below an appraised fair market value. This article contemplates possible donations to Associations by the State for political reasons or in connection with debt-equity conversions or debt reduction negotiations with foreign creditors.

**Article 32. Exception for Shares Donated to the Association by an Eligible Corporation, a Charitable Organization or Any Private Donor.**

Article 32 permits an Association to acquire shares below fair market value as charitable donations for reasons covered in the above explanation of Article 17.

**CHAPTER VII, ARTICLES 33-34. Approval of Association Charter and Bylaws.**

**Article 33. Existing Enterprises.**

Article 33 requires the National Registry to issue a charter of incorporation to an Association which relates to an already existing company, if the bylaws conform to the requirements of Chapters VIII and IX of this legislation. Also required is a concurrence by the board of directors of the corporation, a practical requirement because of the interdependency between the corporation and the Association.

**Article 34. Newly Formed Enterprise With No Existing Employees.**

Article 34 provides for the formation of Associations to supply all or part of the initial equity capital for starting up new corporations which obviously do not yet have any employees. This allows entrepreneurs with solid business plans to create new industries and create new private sector jobs in Costa Rica, utilizing the credit and tax incentives available under this legislation. The founders of the newly formed corporation would be required to appoint a broadly representative and independent steering committee to serve as a fiduciary for acquiring shares on behalf of the future employees. If done properly under its regulations and procedures, the National Registry would be empowered to issue a temporary charter to the Association. After the company becomes operational, the new employees could ratify or amend the Association charter and bylaws.

**CHAPTER VIII, ARTICLES 35-36. Powers of a Qualified Association.**

### **Article 35. General Powers.**

Article 35 lists all the normal powers the law will recognize to enable an Employee Shareholders' Association or a Consumer Shareholders' Association to carry on operations on behalf of their members.

### **Article 36. Governance of Associations.**

Article 36 imposes certain restrictions affecting governance of the Association as a special kind of civic association.

Article 36(a) gives the Association indefinite life as long as its related corporation remains in existence.

Article 36(b) allows up to one-half of the Association's board to be appointed by management if as a practical matter the corporation will not otherwise make contributions to or guarantee share acquisition credit of the Association. In all other cases, directors of the Association must be elected by its members.

Article 36(c) distinguishes the Association from cooperatives and conventional social associations in another way. Voting by members on business of the Association or on corporate matters which are subject to shareholder vote are on a **one-share, one-vote** basis, not one-person, one vote. This is to reflect the relative proprietary stakes and relative risks of potential equity losses among the members, some of whom may acquire significantly more shares than others as explained in Article 39(k). Under economic democratization, while ownership opportunities will become more equitably distributed, people will own differing amounts of shares in different companies. The point here is to **allow people to vote that which they can lose**.

Article 36(d) introduces the concept of "share-equivalents" or "quasi acciones" to describe the accounting term to be applied in determining the number of shares each member will accumulate in his Association account, for purposes of allocations, distributions and voting rights. As mentioned earlier, the legal title to the shares would remain with the Association until they are distributed. Some Associations might decide to pay cash for a member's share-equivalents upon distribution, rather than allow shares to get in the hands of people outside the company.

Article 36(e) requires that bylaws for the ESOP be clearly separate from bylaws relating to the general governance of the Association itself.

## **CHAPTER IX, ARTICLES 37-39. Governance of Share Ownership Plans.**

Chapter IX deals specifically with the rules for setting up and administering an Employee Share Ownership Plan (ESOP) and a Consumer Share Ownership Plan (CSOP). The Association is the legal entity established by this legislation for administering either an ESOP or a CSOP. The ESOP for employees (or CSOP for consumers) under this legislation would become one part of the bylaws of a qualified Association.

### **Article 37. Governance of Employee Share Ownership Plans (ESOPs).**

**Article 37 is one of the most unusual provisions in the legislation. It is designed to make it easy and inexpensive for corporations to establish an ESOP and avoid bureaucratic red tape and delays in implementing ESOPs in Costa Rica.**

Article 37 requires the National Registry to approve an ESOP if it conforms to a prototype plan contained in Law Appendices A, B and C. **The prototype plan, which is a necessarily complicated legal instrument developed by lawyers in thousands of ESOPs around the world, would be part of this legislation.** As discussed previously, without this provision and the prototype plan, several years might pass before the first ESOP is implemented in Costa Rica. By having FINTRA lawyers and other Costa Rican lawyers scrutinize and refine this prototype before it is passed into law (and perhaps develop one or two alternative prototypes to be included in the legislation), Costa Rica can move forward more quickly to implement ESOPs.

As previously mentioned, this prototype document was written by American lawyers for Costa Rica lawyers and accountants. Non-lawyers should not become frustrated by its complexity, which is a necessary and practical byproduct of years of ESOP experience. Most important, it works.

Article 37 also permits variances from the prototype if the variances conform to the minimum requirements set out in Article 39. Thus, Article 39 offers flexibility. But the price for flexibility may be several years of delay until professionals gain proficiency in the ESOP technology. Article 37 offers a way to reduce this learning curve.

### **Article 38. Governance of Consumer Share Ownership Plans (CSOPs).**

Article 38 does for CSOPs what Article 37 does for ESOPs. The National Registry is required to approve a CSOP if it conforms to the ESOP prototype plan, with some differences: first, the membership in a CSOP would be limited to consumers as defined in Article 39 (g), and, second, allocations of benefits would be based on relative patronage.

### **Article 39. Minimum Requirements for Qualification of Association's Share Ownership Plan.**

Article 39 applies only when a prototype plan will not be used, giving the Association guidelines for inventing its own plan. The National Registry must approve the Association's ESOP bylaws if the National Registry, upon review of the plan, determines that it meets the minimum requirements of Article 39.

The minimum requirements under Article 39 include such features of an ESOP as eligibility, the composition of assets of the Association, forfeitures, vesting, allocation formulae, individual allocation limits, distribution rights, dividend rights, voting rights, valuation of shares, disclosure of information, and reports to members. These are covered in the proposed law and in general conform to the more detailed (and legalistic) provisions in the prototype ESOP.

## **CHAPTER X, ARTICLE 40. Foreign Debt Reduction.**

### **Article 40. Asset Democratization Trust.**

Article 40 is to institutionalize the "merchant banking" work now being performed by FINTRA. It would create a statutory vehicle with the power to implement Costa Rica's debt reduction strategies and debt-equity swaps with its foreign creditors.

Many other countries have formed entities called "asset privatization trusts" to carry out divestitures of state-owned enterprises. Because "economic democratization" is what is missing in the private sector development strategies of those countries, the political barriers to divestiture are frequently insurmountable. This legislation fills that void by replacing the concept of "privatization" with the more politically attractive concept of "democratization", which is the fatal omission in traditional privatization attempts.

As an example of how it would operate in a debt reduction strategy, the Asset Democratization Trust would:

- (a) receive assets and shares of state-owned enterprises,
- (b) reorganize these enterprises into profitable, competitive, and professionally-managed enterprises,
- (c) negotiate for legal and policy reforms which would allow these enterprises to operate in the private sector, set their own prices and compensation agreements, gain access to foreign exchange at market rates, and otherwise operate competitively without subsidies or special trade protections,
- (d) negotiate with public sector workers and their labor unions to develop new ownership-oriented labor agreements to enable the enterprises to become competitive in world markets without subsidies and protections,
- (e) receive foreign debt obligations under a debt reduction agreement with one or more of the government's foreign creditors, or donations from non-profit organizations which have agreed to serve as intermediaries for economic democratization purposes (thus providing U.S. creditors with tax deductions under U.S. laws),
- (f) exchange foreign debt obligations with the Central Bank for an amount equal to their face value but in Colones rather than in U.S. dollars,
- (g) lend the funds acquired in (f) to Employee Shareholders' Associations (and where appropriate, Consumer Shareholders' Associations) for the acquisition of shares and assets described in (a) above,
- (h) transfer the Colones to the government as seller of assets, which in turn would be returned to the Central Bank, cancelling out any inflationary effect from (f), and
- (i) supervising the repayment of the loan to the government out of future corporate profits, which would have a deflationary effect as the funds are returned to the Central Bank.

In addition, the Asset Democratization Trust could serve as the merchant banker for direct sales of state owned enterprises to workers, where the government would agree to sell on a long-term installment payment basis at low interest rates, as provided for in Article 18.

## **CHAPTER XI, ARTICLES 41-44. Other Governmental Support for Expanded Ownership.**

Chapter XI contains several controversial reforms, all of which would promote the goal of economic democratization. None of these are absolutely essential to promote ESOPs but they are all designed to create a more favorable climate for accelerating the growth of ESOPs in Costa Rica. Each of them is a test of Costa Rica's political commitment behind the ESOP. In the final analysis, these controversial provisions are bargaining chips in the negotiations for preserving the more essential provisions of this legislation. Since they stand on sound principle, they should not be compromised at this early stage.

### **Article 41. National Insurance Institute.**

Article 41 requires the National Insurance Institute to establish within two years the two kinds of insurance programs authorized in Articles 42 and 43 of this legislation. Both programs would spread the cost of certain risks that are inherent in any private sector development strategy, thus reducing further political opposition to economic democratization. No government subsidies would be required. All funding would be on a self-financing basis, with premiums charged to the insured beneficiaries based on projected risks and projected payouts. Article 41 challenges the private sector to offer comparable insurance, at which time the National Insurance Institute could phase out its insurance programs.

### **Article 42. Loan Default Insurance.**

Article 42 authorizes a **voluntary** loan default insurance fund to pool the lenders' risk of default on share acquisition loans to borrowing Associations. The premium would be included in the interest rate charged on such loans. Some Associations might be required to pay higher premiums, if their loans are in a higher risk category. Coverage would be limited to 80% of the possible losses on each loan in order to be certain that the lender would lose assets if it was not diligent in its lending practices.

### **Article 43. Equity Accumulation Insurance Fund.**

Section 43 would offer **voluntary** portfolio insurance for members of Associations, in recognition that inevitably some companies will fail. The premium would be paid by the Association as a service to its members. The insurance would cover 80% of the original value of the shares acquired by the Association. Again, the premium for shares of high-risk companies would

be higher than for low-risk companies. Not all Associations would want this coverage. But by recognizing the risks and suggesting how the risks could be covered, the proponents of this legislation make their total package more attractive politically.

#### **Article 44. Office of Economic Democratization.**

Article 44 establishes an Office of Economic Democratization within the Ministry of the Presidency. Economic democratization of the private sector is a major challenge for an economy which for decades has been State-dominated. Shifting from public sector growth to private sector growth demands great leadership, starting right at the top. Inevitably there will be much resistance from interest groups and public sector bureaucrats who have a vested stake in the economic status quo. Hence the provision creates a new office close to the President to champion the new economic thrust, to lift barriers to progress, to educate the people, to mobilize other leaders from all sectors of society, and generally to lend the weight and prestige of the President to the goal of economic democratization. This Office could appoint a broadly representative advisory group to help develop expanded ownership goals and objectives. This Office would also serve as facilitator of expanded ownership initiatives, including major divestitures of state owned enterprises to their employees and customers. It would also be charged with reporting annually to the President and the Legislative Assembly on the progress of the nation's economic democratization efforts.

### **PROTOTYPE DOCUMENTS**

#### **DEED OF INCORPORATION.**

The Deed of Incorporation is a prototype document developed for registering the Employee Shareholders' Association with the National Registry. It outlines the broad purposes of the Association.

#### **BYLAWS OF THE EMPLOYEE SHAREHOLDERS' ASSOCIATION**

##### **Part I, Governance of the Association.**

This prototype document would be made part of the law. It contains the bylaws for governing the Association, not the administration of the ESOP. If this prototype document and the Part II prototype are accepted by an Association, it would be automatically eligible for registration by the National Registry. Weaknesses and omissions in this document can be corrected by Costa Rican professionals who will be involved in the interactive process in which this legislation is being shaped.

## **Part II, Governance of the Employee Share Ownership Plan.**

**This prototype Employee Share Ownership Plan (ESOP) is the most complicated part of this legislation, but it is also the most important for launching ESOPs in Costa Rica within months after passage.**

The prototype ESOP is a new legal technology that has been developed by many leading ESOP lawyers in the United States and now in Egypt. It reflects experiences in thousands of successful ESOPs. It has been designed to facilitate technology transfer of the ESOP to Costa Rican lawyers.

To reiterate, the prototype ESOP is included in the legislation both as an educational tool and to expedite the development of Costa Rican ESOP models with minimal cost and bureaucratic delays. If the prototype ESOP (or one or two additional prototypes approved by FINTRA's ESOP legislative advisory committee) is adopted by an Association, Article 37 of this legislation would require the National Registry to approve the Association's bylaws.

**Non-lawyers may not have the time to read this document in any detail. The EEI consultants hired by FINTRA are prepared to work closely with FINTRA lawyers on the details of the ESOP.**

**The non-lawyer is invited to re-read Article 29 of this legislation and the Explanatory Note, "What is an ESOP?", plus the Index and Section 1 ("Nature of the Plan") at the front of Part II of the Bylaws (Law Appendix C) for a quick overview of what the prototype ESOP contains.**

## **APPENDIX**

### **WHAT IS AN ESOP?**

#### **A Brief Explanation and Charts**

**A (PROPOSED) LAW TO ENCOURAGE  
THE DEMOCRATIZATION OF  
FUTURE CAPITAL OWNERSHIP  
THROUGH EMPLOYEE SHAREHOLDERS' ASSOCIATIONS  
AND CONSUMER SHAREHOLDERS' ASSOCIATIONS  
FOR CITIZENS OF COSTA RICA**

[DRAFT NUMBER 1 (AMENDED)]

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**A (PROPOSED) LAW TO ENCOURAGE  
THE DEMOCRATIZATION OF FUTURE CAPITAL OWNERSHIP  
THROUGH EMPLOYEE SHAREHOLDERS' ASSOCIATIONS  
AND CONSUMER SHAREHOLDERS' ASSOCIATIONS  
FOR CITIZENS OF COSTA RICA**

**Preamble.**

It is a universally accepted political axiom that power follows control over property. It is also true that power tends to corrupt, and absolute power leads to absolute corruption. Costa Rica has long been an example to the world that the ultimate check on the potential abuse of concentrated power, including that of the State itself, is to keep power decentralized systematically into the hands of the people.

What universal access to the ballot can and has done for building our political democracy, which is unsurpassed among the nations of the global community, universal access to productive property now has become equally important for enabling Costa Rica to build for ourselves an effective economic democracy. As such, Costa Rica can also serve as a laboratory for economic justice initiatives for the poor, the oppressed and the powerless of all nations, within our region as well as throughout the world.

Article 17 of the Universal Declaration of Human Rights proclaims that "Everyone has the right to own property, alone as well as in association with others." It is a fatal omission for the nations of our time to deny or ignore this most fundamental of human rights. Without property or the means to become an owner of modern forms of productive property, the human person in today's high technology world remains permanently dependent on those who own and control society's productive enterprises. The human dignity, social status, freedom and economic security of the non-owner is hardly a match for those who own and control their jobs and incomes. All other fundamental human rights remain vulnerable where the ownership and control of the means of production are not widely diffused throughout society.

Article 50 of our Constitution, confirming that the well-being of our people cannot be separated from justice in the distribution of productive wealth, states:

The State will obtain the greatest well-being of all the inhabitants of the country, organizing and stimulating production and **the most adequate distribution of wealth.**

No greater injustices exist than unequal opportunities to become owners of productive capital. Many conflicts in the world begin at the workplaces of the world where historically there has been a gross disparity of opportunities between those who own and those they hire.

The restoration of the human right to own and enjoy the fruits of one's property, a natural and inalienable right which preceded the development of governments, is a challenge we are prepared to undertake in Costa Rica.

New social technologies have been developed which enable workers to become owners of new wealth, without violating property rights of the already wealthy. Participatory ownership plans in other countries have turned millions of corporate workers into worker shareholders, resulting in significant gains in productivity and profits to be shared among the new as well as the original owners. This proves that efficiency and justice at the workplace go hand-in-hand. People best take care of that which they own.

Ownership of productive industrial, commercial and agricultural enterprises is largely determined by who has access to capital credit. In contrast to consumer credit, capital credit is self-liquidating. Credit to buy investment assets is expected to pay for itself out of future enterprise profits and savings. Things bought with consumer credit must be paid for externally, out of the future earnings of the purchaser.

Just as society can structure its laws and institutions to concentrate ownership, society can reform its laws and institutions to decentralize future ownership. Since credit involves social promises, it is inherently a social thing. Thus, the issue of who should have access to productive credit primarily involves political, social and moral judgements.

The key to a more just future economy is not the coerced equalization or redistribution of the economic pie. Coerced redistribution weakens creative initiatives and virtually guarantees that pies created in the future will be smaller and less appetizing.

Distributive justice is based on the principle that economic rewards should be distributed according to what each participant contributes to the economic process. Common sense dictates that justice in distribution should follow justice in participation. If nothing is produced, there is nothing to distribute.

Distributive justice therefore depends on the equalization of opportunities among all members of society to participate fully in the economic process, both as workers and as owners. And participative justice in today's high technology world requires that future access to capital credit be more equitably and democratically distributed.

In the pursuit of the social goal of widespread and democratic participation in the ownership and profits of productive enterprises, the main focus of the Legislative Assembly will be on incentives directed to stock corporations and cooperatives reorganized as stock corporations. The social objective of these incentives is to gradually transform the modern business corporation into a more just, harmonious and effective instrument of social progress, as well as a more direct link between increases in mass purchasing power and increases in corporate productivity and technological advance.

The economic objectives of these incentives are to enable corporations located in Costa Rica to access new credit sources at lower interest rates not at taxpayers' expense, radically increase their growth and investment, improve productivity and innovation, become more competitive in the emerging global marketplace, increase corporate profits, and broadly distribute future profits to their workers as a non-inflationary way to increase their incomes.

The Legislative Assembly favors a voluntary, non-coercive approach for moving toward participatory ownership within corporate enterprises. We acknowledge the reality that many enterprises will not want to take advantage of these new incentives. No rights and powers available to such enterprises under present law will be taken from them under this law.

The principal means for encouraging participatory corporate ownership will be through credit democratization vehicles which decentralize access to future productive credit among workers and consumers, as directly and personally as possible.

**THEREFORE**, in order to liberate the creative energies and entrepreneurial potential of all the people of Costa Rica; to enable all workers to become owners so that the distribution of income throughout society is more closely linked to each person's contributions to production; to build an effective economic democracy within the private sector of the economy as a foundation for political and social democracy; to encourage accelerated rates of growth and widespread abundance without inflation; to create new wealth for the poor without threatening the property rights of the already wealthy; to convert wasted resources, technology and human potential into productive activities; to enable Costa Rican enterprises to compete more effectively in the developing global marketplace; to generate new sources of investment and savings for productive growth; to reduce economic dependency on foreign capital; to broaden political support for free enterprise policies; to restore the original rights of private property, particularly in corporate equity; to broaden the base of taxable personal incomes of the private sector; to strengthen the ability of the public sector to plan and establish long-term social goals, prevent economic monopolies and abuses, lift barriers to equal opportunity and promote social and economic justice for all; and to humanize and help transform the corporate enterprises of our economy into more just and effective instruments of social progress,

**THE LEGISLATIVE ASSEMBLY HEREBY DECLARES THAT** sharing ownership and control of modern productive property is a fundamental human right, and that the democratization of private-sector capital ownership will be a basic pillar for the future of the nation's economy, starting with the enactment of the following law.

## **CHAPTER I. GENERAL**

### **ARTICLE 1. Purpose of Law.**

This law establishes two kinds of associations of a special nature, with the purpose of promoting and implementing the voluntary democratization of ownership of productive capital through the acquisition of shares of corporate enterprises in the public and private sectors on behalf of their employees and/or customers.

### **ARTICLE 2. Name.**

These associations will be called "Employee Shareholders' Associations" or "Consumer Shareholders' Associations".

### **ARTICLE 3. Applicability of Present Law.**

Employee Shareholders' Associations and Consumer Shareholders' Associations will be governed by this Law, and the Law of Associations, No. 218 of August 8, 1939, and its amendments, shall apply to all matters not specifically covered in this Law.

#### **ARTICLE 4. Nature and Purposes of Associations.**

(a) Each Employee Shareholders' Association and Consumer Shareholders' Association shall operate on a voluntary, non-profit basis. No Association may directly manage, operate or engage in any business for the profits of the Association or in any other way compete with any business enterprise in the production and marketing of goods and services. The Association shall act as a custodian and depository for the qualified shares (or share-equivalents) and other assets it acquires and holds on behalf of its members in their personal accounts in the Association.

(b) The main function of the Association is to facilitate for its members and their families personal and effective participation in shareholder rights and powers and in profit-sharing opportunities within eligible corporations operating in Costa Rica.

(c) Employee Shareholders' Associations and Consumer Shareholders' Associations shall operate independently of each other and each such Association shall enable its respective members to exercise personal proprietary rights and powers with respect to a specific eligible corporation (or its subsidiaries and affiliates) in which its members have a direct employee or a definable personal or household consumer relationship.

(d) For implementing the social and economic justice objectives of this Law, Associations qualified under this Law are hereby declared to be serving the public good, and eligible for receiving donations and other benefits under Paragraph Q of Article 8 of the Income Tax Law.

(e) Each such Association shall have the following purposes:

- (1) To perform or make available any services needed to operate either an Employee Share Ownership Plan or a Consumer Share Ownership Plan, as appropriate and specified in the bylaws of the Association;
- (2) To obtain on behalf of and provide to its members access to productive credit to acquire and accumulate qualified shares in the specific eligible corporation in which its members have an employee or consumer relationship;
- (3) To receive dividends, contributions and donations from the related eligible corporation in the form of cash or company shares, voluntary cash contributions from Association members, and donations from others, to operate the share ownership plan of the Association;
- (4) To enable its members to participate in the governance and profits of such eligible corporations based on the number of shares or share-equivalents (as defined in Article 36(d)) in each of their individual accounts in the Association;

- (5) To enable members to earn property incomes to supplement their other current incomes and to distribute benefits accumulated in each member's accounts in the Association to provide for their future economic security;
- (6) To offer its members a voluntary substitute for or supplement to traditional retirement and pension programs to provide for their economic needs after retirement; and
- (7) To exercise all of its powers for the exclusive benefit of its members.

## **CHAPTER II. MONETARY INCENTIVES FOR FORMING ASSOCIATIONS**

### **ARTICLE 5. State Owned Enterprises and Foreign Debt Reduction.**

Qualified Associations established to purchase, alone or with other investors, assets of state owned enterprises which can be operated as viable private sector stock corporations, or to acquire shares of corporate stock presently owned by the Government of Costa Rica, shall have access for the purchase of such assets or shares to direct financing from the Central Bank of Costa Rica, at a rate of interest not to exceed the amount necessary to cover the Central Bank's administrative costs. The highest priority for such financing shall be for the acquisition by qualified Associations of assets or shares transferred by the Government of Costa Rica to an Asset Democratization Trust (described in Chapter X of this Law) established by the Government to encourage debt reduction agreements with foreign public and private creditors to which the Government is presently indebted.

### **ARTICLE 6. Private Sector Corporations and Cooperatives Reorganized as Stock Corporations.**

The Central Bank of Costa Rica shall rediscount bankers' acceptances to cover credit made available to qualified Associations for acquiring qualified shares of eligible private sector corporations or eligible cooperatives organized as stock corporations, at a rediscount rate not to exceed that which is necessary to cover the Central Bank's administrative costs.

### **ARTICLE 7. Conditions for Eligibility for Special Access to Central Bank Discount and Rediscount Privileges.**

The Central Bank of Costa Rica shall discount or rediscount at the rate specified in Articles 5 and 6 loan paper presented to it directly or indirectly by a qualified Association, if the following conditions are fulfilled:

(a) Such loan paper shall:

- (1) be issued by a qualified Employee Shareholders' Association or a qualified Consumer Shareholders' Association;
- (2) be the direct debt obligation of such Association for the purpose of acquiring qualified shares for its members;
- (3) not require any personal guarantee, personal collateral (except for the qualified shares being purchased with the loan proceeds), or be treated in any other way as the personal obligation of any member of such Association; and
- (4) be guaranteed by the general credit of the eligible corporation related to such Association.

(b) Any banks or credit intermediaries which are members of the National Banking System and the Workers' Bank shall be eligible for special access to Central Bank discount and rediscount privileges provided under this Chapter II.

(c) The credit received by the Association must be (i) exclusively devoted to purchase at a price which is no greater than an appraised fair market value, qualified shares of corporations or cooperatives eligible under Article 24 of this Law and (ii) designed to be repaid in a manner consistent with the share ownership plan provisions of the Association bylaws.

(d) No guaranties or credit acquired under this Chapter II may be used directly or indirectly by the Association or an eligible corporation or cooperative for speculation in securities or commodities, for unfriendly acquisitions of publicly traded shares of other enterprises, for consumer purchases, for home purchases or improvements, for public-sector projects or activities, or for unlawful or other purposes not intended to create marketable goods or services.

(e) Before any share acquisition loan of the Association is funded under this Chapter II, it must be supported by professionally competent and documented business plans and feasibility studies (i) justifying the need for such capital credit and (ii) demonstrating how the loan will be repaid on a self-liquidating basis through projected cash flow and/or dividends of the eligible corporation or cooperative which guarantees repayment of the share acquisition loan.

(f) Guarantees of repayment of credit extended under this Chapter II must be collateralized by whatever tangible or intangible assets are to be acquired with the loan proceeds. The shares purchased by the Association on credit guaranteed by an eligible corporation may be pledged as loan collateral to the lender, provided that such shares will be released from such pledge as the loan is repaid under a release formula specified in the Association's share ownership plan.

(g) A premium to cover at least 80 percent of the risk of default on a share acquisition loan must be included in the interest rate charged to the Association, once an Loan Default Insurance Fund is established by the National Insurance Institute to determine an appropriate charge for such premium as provided for in Articles 41 and 42 of this Law.

**ARTICLE 8. Lender Charges Above Central Bank Rediscount Rate.**

Lenders may set interest rates on share acquisition loans to an Association to reflect a competitive markup over the Central Bank's discount or rediscount rate to cover the lender's operating costs and profits, plus a reasonable charge (or the premium described in Article 7(g) of this Chapter) to cover the risk of loan default. The difference between the rate charged to the Association and the normal market rate shall not be treated as imputed interest to the lender for purposes of taxation.

**CHAPTER III. TAX INCENTIVES FOR FORMING QUALIFIED ASSOCIATIONS**

**ARTICLE 9. Exemptions for Association.**

An Association organized and qualified under this Law shall be exempt from all direct or indirect taxes, including value-added, transfer, and sales taxes, on its assets, activities or earnings.

**ARTICLE 10. Exemption for Member's Benefits Held by Association.**

Members of such Associations shall not be taxed personally on any assets held on their behalf by the Association, or on any earnings on such assets, until such time that distributions are made to members or their designated beneficiaries from their personal accounts in the Association.

**ARTICLE 11. Tax Deductible Voluntary Contributions by Members.**

Voluntary contributions to such an Association by any member for the purpose of accumulating benefits in his personal account in the Association's share ownership program shall be tax-deductible from such member's taxable annual personal income, but not exceeding 25 percent of his taxable earnings from other sources or 200,000 colones, whichever is lower.

**ARTICLE 12. Tax Deductions for Corporations.**

For purposes of corporate income taxes, deductible business expenses for an eligible corporation shall include:

(a) Dividends paid to its shareholders, whether they hold their shares directly or as members of a related Association, provided that personal income taxes on such dividends are withheld by the corporation or a related qualified Association when received as consumable income, at a flat rate of 5 percent;

(b) Cash or the fair market value of qualified shares which are contributed or donated by such corporation for the direct allocation to member accounts under the share ownership plan maintained by such Association;

(c) Cash paid by the corporation in the form of employer contributions or patronage rebates to the members of such Association to meet obligations of the Association on its share acquisition loans;

(d) Dividends paid by the corporation on qualified shares acquired by such Association through a share acquisition loan to enable the Association to repay such loan;

(e) Cash distributed to employees under gain sharing or profit sharing programs adopted by the corporation, provided that personal income taxes on such payments are withheld by the corporation, at a flat rate of 5 percent.

**ARTICLE 13. Tax on Distributions to Members.**

Except as specified in Article 14 of this Law, all distributions to a member by an Association, whether in the form of cash or qualified shares of the eligible corporation, shall be subject to a personal income tax at a flat rate of 5 percent, which the Association shall withhold on his distributions before such distributions are made.

**ARTICLE 14. Exemptions for Distributions Reinvested in the Association or Another Qualified Equity Accumulation Entity.**

Distributions to a member of the Association or his designated beneficiary which are reinvested within 180 days in the member's personal account in the Association (or in another qualified equity accumulation entity which is approved under regulations issued by the Ministry of Finance) shall remain exempt from all personal income taxes indicated under Article 13 of this Law during the period of reinvestment.

**ARTICLE 15. Exemption of Gains for Investors Selling Qualified Shares to Associations.**

Individuals, corporations, financial institutions or other investors which sell qualified shares to a qualified Association will be exempt from paying any form of tax on the inflation-indexed gain

derived from such sale, provided that within 180 days the proceeds from such sale are reinvested, in accordance with regulations issued by the Ministry of Finance, in other qualified securities.

**ARTICLE 16. Capital Gains Tax on Proceeds Not Reinvested.**

The proceeds from the sale of qualified shares to a qualified Association, if not reinvested as provided for in Article 15, shall be subject to an income tax on the capital gain on such shares, after indexing such gain for inflation for the period such shares were held by the seller, at a flat rate of 5 percent, after taking into account normal exemptions provided the taxpayer under the Income Tax Law.

**ARTICLE 17. Associations Treated as Charitable Associations for Receiving Donations.**

Donations of shares or cash to a qualified Association may be deducted from the donor's taxable income and will be given the same treatment for purposes of taxation as donations to the most preferred charitable organization, provided that the donation is not allocated to the donor, immediate family members of the donor or any shareholders who hold at least 10 percent of the shares of the eligible corporation.

**CHAPTER IV. OTHER INCENTIVES FOR FORMING ASSOCIATIONS.**

**ARTICLE 18. Special Preferences in Sale of Assets or Shares of State Owned Enterprises to Their Employees.**

In selecting among prospective purchasers of assets or shares owned by the Government of Costa Rica, special preference shall be given to enabling the employees of those enterprises to acquire such shares or shares equivalent in value to such assets through an Employee Shareholders' Association, provided that prior to such acquisition by the Association the operating enterprise becomes an eligible corporation under this Law. In determining the feasibility of this preference, those responsible for disposing of such assets or shares shall consider fully the maximum use of incentives available to such an Association under this Law. Where appropriate, the Government shall approve a disposition under a long-term installment payment agreement with the Employee Shareholders' Association, at an interest rate no less favorable than that available to the Association under Chapter II, Article 5 of this Law.

**ARTICLE 19. Preference for Sale of Certain State Owned Assets and Shares to Employees and Consumers.**

Those responsible for selling or disposing of highly capital-intensive enterprises (defined as enterprises having capital assets greater than four million colones per employee) and public utilities owned by the State shall prefer a sale on credit to employees and consumers of such enterprises over any other form of disposition. Prior to such disposition a study shall be conducted similar to that described in Article 26(a) to determine how to divide acquisition preferences between employees and consumers of such enterprises. After considering the priorities specified in Articles 25(a) and 25(b), that portion of the assets or shares which will not be sold to employees through an Employee Shareholders' Association should be considered for sale to consumers through a qualified Consumer Shareholders' Association under the same credit terms and conditions that will be made available to the Employee Shareholders' Association.

#### **ARTICLE 20. Special Preferences for State Contracts.**

Eligible corporations with qualified Associations will be given a special preference whenever State contracts for goods or services are awarded, all other factors being equal.

#### **ARTICLE 21. Voluntary Withdrawal From Retirement Program of National Social Security Fund.**

A member of a qualified Association, under regulations established by the National Health and Retirement Institute ("Caja Costarricense de Seguro Social"), may direct that future employer and employee payments required under the law to be contributed to the retirement program of the National Security Fund on his behalf, be contributed instead to his account in the Association. Appropriate corresponding reductions would be made on such employee's future entitlements under the retirement program of the Social Security Fund. In the event an employer fails to make such payments into the member's account in the Association, the Ministry of Labor shall seek immediate redress from the employer at the request of such member and/or such Association.

#### **ARTICLE 22. Investment of Severance Pay Obligations.**

Members of a qualified Association, under regulations established by the Ministry of Labor, may petition an eligible corporation for which they work to contribute future severance pay obligations on their behalf for investment by their Association, which would thereupon assume responsibility for meeting such obligations to the extent of payments received. If an employee eligible for severance pay receives a distribution of severance pay benefits from his account in the Association which is less than that employee's entitlement under the severance pay laws, the employer shall pay the difference directly to the employee.

#### **ARTICLE 23. Voluntary Withdrawal from Mandatory Employee Savings in the Workers' Bank.**

Any member of a qualified Association may, under regulations established by the Workers' Bank, direct that (i) his future mandatory savings in the Workers' Bank be paid instead to his account in such Association, and/or (ii) all or a portion of his current account in the Workers' Bank be transferred to his account in such Association.

## **CHAPTER V. ELIGIBLE CORPORATIONS.**

### **ARTICLE 24. Mandatory Conditions of Eligibility.**

An enterprise whose shares may be acquired by a qualified Employee Shareholders' Association or a qualified Consumer Shareholders' Association shall be certified by the National Registry as an "Eligible Corporation" for the benefits available under this Law if:

(a) it is duly registered under Costa Rica law as a stock corporation or a producer or marketing cooperative which reorganizes as a stock corporation, and whose charter of incorporation reflects among its major corporate objectives the maximizing of participatory ownership opportunities for its employees and the maximizing of dividend payouts to all its shareholders;

(b) its board of directors approves a cooperative agreement between the corporation and its related Employee Shareholders' Association organized under this Law, which covers (i) the right of the Association and its professional advisors to enjoy full access to the books and financial records of the corporation, (ii) arrangements for acquiring necessary information for conducting independent appraisals of the value of qualified shares and for other requirements for properly administering the Employee Share Ownership Plan, and (iii) provisions for conducting a continuing participatory ownership education programs for members of the Association.

(c) its board of directors specifically ratifies the Employee Share Ownership Plan provisions contained within the bylaws of such Association;

(d) its board of directors approves a resolution to make a specific contribution of cash or qualified shares to the Association to activate such Plan for the benefit of members of the Association and/or to guarantee the repayment of credit extended to the Association for acquiring qualified shares under this Law;

(e) it adopts a management program to maximize the participation of workers at all levels in decisions affecting their work;

(f) its board of directors agrees to adopt a gain sharing or profit sharing plan or any other plan for sharing of profits from increases in productivity, which contains a formula negotiated between management and a democratically elected and legally constituted labor union or labor relations committee representing only non-management employees of the corporation, for the distribution of a specified portion of the corporation's monthly profits to all employees as substitutes for or as supplements to normal increases in fixed compensation and fringe benefits; and

(g) if its non-management employees have not formed a democratic and legally constituted labor union under the Labor Code of Costa Rica to represent them for purposes of bargaining with management over issues of wages, hours, conditions of work, fringe benefits,

grievances, participatory management, gain sharing or profit sharing, and other participatory ownership matters, the corporation must present an affirmative action plan to the Ministry of Labor to indicate steps it will undertake to encourage its non-management employees to voluntarily form such a labor union, including a statement of willingness of management to institute a checkoff system in which membership dues to operate such labor union can increasingly be linked directly to the ownership system rewards such labor union helps negotiate for their members.

## **ARTICLE 25. Priorities in Allotment of Future Participatory Ownership Opportunities.**

(a) **Employees.** An eligible corporation shall give first priority in its support of new equity issuances, the repurchase of existing shares and other participatory ownership opportunities under this Law to its full-time employees through their Employee Shareholders' Association, in order to encourage maximum harmony, efficiency and personal incentives in the productive process and to link future compensation and fringe benefit agreements increasingly toward the sharing of gains in productivity and profits.

(b) **Customers.** After planning for a reasonably satisfactory level of share accumulations for present and future members of its related Employee Shareholders' Association, the corporation, especially if it is a public utility or an extremely capital-intensive enterprise, shall give second priority in supporting future participatory ownership opportunities under this Law to its customers.

(c) **Present Shareholders.** Third priority for financing expansion or share repurchases shall be offered to present shareholders of the corporation.

(d) **Outside Investors.** Fourth priority for financing expansion or share repurchases shall be offered to the public, with preferences given to Costa Rican citizens over foreign investors.

## **ARTICLE 26. Voluntary Conditions of Eligibility.**

An eligible corporation may also cooperate in the formation of a:

(a) **Consumer Shareholders' Association.** The Consumer Share Ownership Plan bylaws of a Consumer Shareholders' Association may be ratified and supported financially by an eligible corporation only after a study jointly made by the Employee Shareholders' Association and the corporation to determine the projected value after 10 years of company share accumulations of the average employee who is a member of the Employee Shareholders' Association. Where that projected value is expected under conservative assumptions to exceed 10 times the projected total annual cash earnings (from participatory ownership benefits as well as fixed compensation) of that average employee after 10 additional years of employment with the corporation, the corporation may allot a fixed percentage of its financing support under its participatory ownership program to enable its consumers to participate as corporate shareholders through a Consumer Shareholders' Association.

(b) **Solidarity Association.** If one does not exist, an eligible corporation may help form a separate solidarity association to represent both management and non-management employees for the purpose of managing severance pay obligations of the corporation and all other functions authorized under laws governing solidarity associations.

**ARTICLE 27. Option to Expand the Role of Solidarity Associations.**

A new or existing solidarity association whose members are employed by the eligible corporation may organize itself as an Employee Shareholders' Association by conforming to the requirements of this Law.

**CHAPTER VI. QUALIFIED SHARES AND VALUATION.**

**ARTICLE 28. Qualified Shares.**

Qualified shares issued by an eligible corporation which are qualified for acquisition by an Association are:

- (a) shares of common stock issued by an eligible corporation which are readily tradable on an established securities market; or
- (b) if such shares do not exist, shares of common stock issued by an eligible corporation having a combination of voting power and dividend rights equal to, or superior to, the voting powers and dividend rights of any other class of common stock of such corporation; or
- (c) noncallable preferred stock which is convertible at any time into shares described in (a) or (b), at a conversion price which is reasonable as of the date of acquisition.

**ARTICLE 29. Valuation of Qualified Shares.**

(a) **General Rule.**

Shares traded actively on an established securities market will be valued at the closing market price on the day of the transaction.

Valuations of qualified shares which are not readily tradable on an established securities market with respect to activities carried on by the Association (including share acquisitions, sales, distributions and annual reporting to the members) shall be at fair market value, as determined as of the date of the transaction by a professional appraiser who is independent of (and has no other professional relationship with) the Association, the corporation and other parties involved in such activities.

For purposes of this Law, "fair market value" is defined as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."

In determining fair market value of qualified shares, the appraiser should consider and analyze the following factors:

- (1) The nature of the business and the history of the enterprise from its inception.
- (2) The economic outlook in general and the condition and outlook of the specific industry in particular.
- (3) The book value of the shares and the financial condition of the business.
- (4) Whether or not the company has goodwill or other intangible value.
- (5) Currently appraised value of tangible and intangible assets owned by the business.
- (6) The earnings capacity of the company.
- (7) The dividend-paying capacity of the company.
- (8) Other sales of the shares and the size of the block to be valued.
- (9) The market price of shares of other corporations engaged in the same or similar lines of business having their shares actively traded in a free and open market, either on an exchange or over the counter.

**ARTICLE 30. Exception for Associations With Less Than 20 Members.**

Associations with 19 members or less may adopt a valuation formula for all activities of the Association based on book value, or book value adjusted by present market value of all corporate assets, provided that such formula is consistently applied and the Association bylaws permit any member to hire his own professional consultant to review the facts upon which such a valuation is based.

**ARTICLE 31. Exception for the Acquisition of Shares or Assets Owned by the State.**

A qualified Association may acquire qualified shares owned by the State or shares reflecting State-owned assets acquired by a related eligible corporation, as a donation or based on a valuation which is less than fair market value or book value.

**ARTICLE 32. Exception for Shares Donated to the Association by the Eligible Corporation, a Charitable Organization or Any Private Donor.**

The Association may acquire qualified shares as a donation or based on a valuation which is less than fair market value or book value.

**CHAPTER VII. APPROVAL OF ASSOCIATION CHARTER AND BYLAWS**

**ARTICLE 33. Existing Enterprises.**

The National Registry shall issue a charter of incorporation to any Association of an existing eligible corporation, after determining that such charter and bylaws of the Association meet the requirements of Chapters VIII and IX of this Law, including appropriate approvals of such charter and bylaws by the members of the Association with concurrences by the board of directors of the corporation.

**ARTICLE 34. Newly Formed Enterprise With No Existing Employees.**

The National Registry may issue a temporary charter to an Association representing future employees and/or consumers of a newly formed enterprise which has organized as an eligible corporation for the purpose of qualifying for the benefits available under this Law, provided that (i) the charter and bylaws are in compliance with Chapters VIII and IX of this Law and (ii) the founders of such corporation appoint a broadly representative and independent steering committee to serve in a fiduciary capacity for the formation of an Association on behalf of and subject to future ratification by the future employees and/or consumers, under regulations and procedures adopted by the National Registry.

**CHAPTER VIII. POWERS OF A QUALIFIED ASSOCIATION**

**ARTICLE 35. General Powers.**

An Employee Shareholders' Association and a Consumer Shareholders' Association shall have the power to:

(a) **Employee (or Consumer) Share Ownership Plan.** Adopt and administer an Employee (or Consumer) Share Ownership Plan which qualifies under Articles 36 and 37 (for employees) or Article 38 (for consumers) of this Law.

(b) **Shares of Company Stock.** Acquire, on credit or otherwise, hold legal title to, pledge, enable members to receive distributions of and enjoy voting privileges with respect to, repurchase and transfer qualified shares in an eligible corporation according to a plan adopted by the Association, and distribute cash dividends to members according to their company shares accounts in the Association.

(c) **Dividends.** Receive and distribute dividends and other income on assets of the Association to supplement members' incomes from other sources, to establish a fund to serve as a market to repurchase equity interests of its members, or to repay loans used to purchase shares on behalf of its members.

(d) **Borrow Money.** Borrow money and give a lien or pledge on any of its property as security for any borrowing.

(e) **Advances.** Make cash advances to members exclusively within the limitations specified in the Association's bylaws and consistent with the purposes of this Law.

(f) **Act as Agent.** Act as an agent or representative of anyone participating in the Association's activities.

(g) **On Cash and Other Liquid Assets.** Hold cash and cash equivalents and invest in marketable securities other than those of the eligible corporation.

(h) **On Real and Personal Property.** Buy or lease any real or personal property that is needed or useful in the operation of the Association.

(i) **Instruments and Obligations.** Draw, make, accept, guarantee, and issue promissory notes, bills of exchange, drafts, warrants, certificates, and all other kinds of obligations, including negotiable or transferable instruments, for any purpose for which the Association was created, and give a lien on any of its property as security for such obligations.

(j) **Other Powers.** Exercise all other powers, privileges, and rights granted to ordinary corporations and employee beneficial associations by the laws of Costa Rica and all other powers and rights that are needed to carry out the purposes for which this Association was formed, unless those powers and rights are inconsistent with Article 4 of this Law and other laws and regulations under which the Association is incorporated.

(k) **No Restriction on Powers.** The enumeration of powers in this Section is not a limit or restriction on any general powers given to the Association by law.

## **ARTICLE 36. Governance of Associations.**

(a) **Duration.** The Association may exist for an indefinite duration, as long as its related eligible corporation remains in existence, and, upon the termination of such corporation (and its successor corporations), for the time it takes such Association to wind up its affairs.

(b) **Directors.** Up to one-half of the directors of the Association may be appointed by management of the eligible corporation where (i) the repayment of share acquisition credit extended to the Association is guaranteed by the eligible corporation or (ii) the eligible corporation enters into a binding agreement with the Association to make specific mandatory contributions to the

Association other than those required by law. In all other cases, directors of the Association shall be elected by its members.

(c) **Voting.** At any meeting of the members of the Association, or on any matters of the eligible corporation which are subject to vote of its shareholders, each member shall be entitled to vote on a one-share, one-vote basis, reflecting the relative proprietary stakes and relative risks of potential equity losses among the members.

(d) **Share-Equivalents ("Quasi acciones").** Share-equivalents is the accounting term applied to qualified shares held by an Association, for purposes of determining allocation, distribution and voting rights of its members.

(e) **Bylaws.** Qualifications for membership in the Association and other matters related to the governance of the Association shall be specified in the bylaws of the Association, which shall be divided into two parts: (i) bylaws pertaining to the governance of the Association itself and (ii) bylaws pertaining to the governance of the Employee or Consumer Share Ownership Plan of the Association (see Articles 37 and 38 herein.)

## **CHAPTER IX. GOVERNANCE OF SHARE OWNERSHIP PLANS**

### **ARTICLE 37. Governance of Employee Share Ownership Plans.**

The bylaws of an Employee Shareholders' Association pertaining to governance of its Employee Share Ownership Plan shall be approved by the National Registry if they conform to the prototype plan contained in Appendix C of this Law. Any variances from the prototype plan may be submitted for approval by the National Registry and shall be approved if they are consistent with the objectives of this Law and meet the minimum requirements specified in Article 39 of this Law.

### **ARTICLE 38. Governance of Consumer Share Ownership Plans.**

The bylaws of a Consumer Shareholders' Association pertaining to governance of its Consumer Shareholders' Association shall be approved by the National Registry if they conform generally to the prototype plan for an Employee Shareholders' Association contained in Appendix C of this Law, with the following exceptions:

(a) The allocation formula for dividing contributions, donations and forfeitures each year among the members shall be based on relative patronage, as specified in Article 39(k)(2).

(b) Eligibility of members shall be limited to consumers described in Article 39(g).

### **ARTICLE 39. Minimum Requirements for Qualification of Association's Share Ownership Plan.**

In cases where the bylaws of an Association do not conform to the prototype bylaws for an Employee Share Ownership Plan (Appendix C), the National Registry shall be guided by the following minimum requirements in approving an Association's bylaws dealing with the governance of the Association's Share Ownership Plan:

- (a) **Written Instrument.** The Share Ownership Plan must be in writing.
- (b) **Approval by Qualified Association and Concurrence by Related Eligible Corporation.** The Share Ownership Plan must be approved by the board of directors of an Association which has been formed to qualify under Articles 33 and 34 of this Law and must be ratified or concurred with by an eligible corporation to which the members of the Association relate to as employees or consumers.
- (c) **Maximum Feasible Benefits to Members and Their Beneficiaries.** The Plan shall be established, administered and maintained for the maximum feasible benefit of members of an Association chartered by the Ministry of Justice under this Law, or their beneficiaries.
- (d) **Nondiscrimination.** The Plan shall not be designed or operated to discriminate in favor of officers of the related eligible corporation, highly compensated employees, shareholders holding at least 10 percent of the outstanding shares of such corporation, or members of their immediate families, on matters affecting eligibility, allocation of benefits, forfeitures, rights of participation, investments or distributions of benefits.
- (e) **Fiduciary Responsibilities in Administering Plan Assets.** Officers, employees and agents of the Association must operate the Plan, negotiate loans, and make investment decisions on behalf of the members as fiduciaries acting in a prudent manner and for the exclusive benefit the members, in order to further the Plan's purpose of maximizing the proprietary rights, powers and benefits of the members as shareholders of the eligible corporation.
- (f) **Eligibility for Membership in Employee Shareholders' Association.** All full-time employees of an eligible corporation shall normally be eligible to become members of a qualified Employee Shareholders' Association and participate in its Employee Share Ownership Plan, except that an Association may exclude full-time employees with less than one full year of service or who work for less than 1,000 hours in a year. An Association may broaden the coverage of its membership to cover part-time employees, seasonal employees, persons working on commission, professional advisors, consultants and suppliers.
- (g) **Eligibility for Membership in Consumer Shareholders' Association.** All regular customers or subscribers of an eligible corporation who have a definable personal or household consumer relationship in the form of separate billing accounts with such corporation, shall be eligible to become members of a qualified Consumer Shareholders' Association approved by such corporation. A consumer which is a corporation or another enterprise may qualify if the benefits which might be allocated to such enterprise as a member of the Consumer Shareholders' Association are in turn distributed among the employees of such consumer enterprise, provided that such enterprise adopts a qualified Employee Shareholders' Association which conforms to the requirements of this Law.
- (h) **Designed to Invest Primarily in Qualified Shares.** The assets of the Plan must be invested at least 50 percent in qualified shares of an eligible corporation.
- (i) **Designed to Receive Loans or Credit to Acquire Qualified Shares.** The Plan must be eligible to receive credit or loans on behalf of its employees and/or consumers and to repay such credit or loans out of future corporate revenues.

(j) **Forfeitures and Vesting.** A Plan may be designed to cause a forfeiture of all or a portion of a member's accounts in the Plan if his property interest in Plan assets have not become fully (100 percent) vested because of an early termination of such member's relationship with the eligible corporation. Plans which have forfeiture provisions must contain a specific vesting schedule in which (i) 100% vesting will automatically occur upon a member's death, permanent disability, age of retirement, or 10 years of full-time employment or 10 years of a defined customer relationship with the eligible corporation, and (ii) a minimum vesting of 30 percent will occur upon 3 years of a member's employee or customer relationship. Forfeited accounts will be reallocated among other members' accounts according to the Plan's allocation formula.

(k) **Allocation of Benefits.** A Plan must have defined formulae for allocating among its members each year's corporate contributions, donations, forfeitures and net earnings (or losses) of the Plan. The allocation formula is designed to reflect the value of each person's participation in the eligible corporation for that year in the following manner:

- (1) **Employee Share Ownership Plans.** Annual allocations of corporate contributions, donations and forfeitures among employees who are members of an Employee Shareholders' Association are normally based upon their relative total compensation within the eligible company for that year.
- (2) **Consumer Share Ownership Plans.** The allocation formula for dividing annual contributions, donations and forfeitures among customers who are members of a Consumer Shareholders' Association shall be based on the relative patronage in the eligible corporation of each of the participating members for such year.

(l) **Individual Allocation Limits.** The maximum amount which may be allocated to the personal Plan account of any member during any year from corporate contributions, donations and forfeitures may not exceed five times the average amount allocated to all participating members of such Plan for that year.

(m) **Distribution of Vested Benefits.** Vested benefits under the Plan must be distributed in a nondiscriminatory manner among members and their beneficiaries. In a manner specified in the Plan, such distributions may be in the form of qualified shares or in cash reflecting the vested capital accumulations in such member's accounts.

(n) **Marketability of Qualified Shares.** The Plan must provide for its members a market for qualified shares distributed under the Plan, if such shares are not actively traded in a public stock market. Where the Plan will repurchase such shares or share-equivalents in member accounts, the Plan must regularly analyze its future repurchase liabilities and establish a special liquidity reserve fund to meet projected long-term repurchase requirements.

(o) **Cash Dividends.** Cash dividends received on qualified shares (or share-equivalents representing qualified shares) held by the Association and allocated to personal accounts of the members under the Plan, shall be first applied for repaying any loan under which such shares were acquired, and any balance shall be immediately distributed to members or reinvested in their Plan accounts, as specified in the Plan.

(p) **Voting Rights.** All voting rights on qualified shares held an Association, whether such shares are allocated or unallocated to member accounts, shall be voted on a one-share, one-vote basis, to reflect the relative proprietary risks among members.

(q) **Valuation of Shares.** Qualified shares whose fair market value cannot be determined in an active public stock market, must be appraised at least annually by an independent professional appraiser as a means for properly making share acquisitions and sales, contributions, donations, allocations, distributions and annual reporting to members.

(r) **Limited Liability of Association and Members.** A loan made to the Association for acquiring qualified shares must be without recourse against the Association or the members, except to the extent of the shares acquired with loan proceeds, contributions made to meet the Association's obligations under the loan, earnings attributable to such shares and contributions, and any assets pledged as collateral by the corporation to guarantee repayment of such loan.

(s) **Annual Statements and Reports to Members.** The Plan must provide annual statements to the members on the status of their individual accounts and the value of their shares or share-equivalents, as well as an annual report of the activities and the financial status of the Association.

## **CHAPTER X. FOREIGN DEBT REDUCTION**

### **ARTICLE 40. Asset Democratization Trust.**

To encourage voluntary debt reductions by foreign public and private creditors presently holding debt obligations issued or guaranteed by the Government of Costa Rica, an Asset Democratization Trust shall be established under the supervision of the Central Bank. Such Trust shall be organized:

(a) to receive assets or shares in State-owned enterprises (including financial institutions) which operate profitably or which offer reasonable prospects for being reorganized into profitable, competitive and professionally managed enterprises if (i) such enterprises were owned and controlled by their employees and/or consumers through qualified Associations, (ii) the tax, monetary and other incentives offered under this Law continued to be available to such enterprises, and (iii) other reforms were instituted to allow such enterprises to set their own prices and compensation agreements and otherwise operate competitively without any subsidies or special trade protections;

(b) to exchange (i) foreign debt obligations of the Government which have been received by the Trust under a debt reduction agreement with one or more of its creditors (or a comparable arrangement with a non-profit foundation which has agreed to serve as an intermediary for this purpose) for (ii) an amount equal to the face value of such foreign debt obligations, in Costa Rican currency or in a special depository account payable in Costa Rican currency; and

(c) to lend funds received under (b) of this Article to Associations organized under this Law for the acquisition of assets or shares acquired under (a) of this Article or to finance other share acquisitions of such Associations, at rates specified in Article 5.

## **CHAPTER XI. OTHER GOVERNMENTAL SUPPORT FOR**

## EXPANDED OWNERSHIP

### **ARTICLE 41. National Insurance Institute.**

The National Insurance Institute, within two years after this Law is enacted, shall establish two self-supporting insurance or re-insurance programs to support the democratization of capital ownership, which will remain in existence until the private sector offers comparable insurance.

### **ARTICLE 42. Loan Default Insurance.**

A loan default insurance fund will be established to pool the lenders' risk of default on share acquisition loans of qualified Associations, to be supported entirely by premiums to be charged borrowing Associations by lenders and included within the interest rates charged on such loans. Such premiums may vary based on differentials in risk categories of the various eligible corporations which guarantee repayment of such loans and should be designed to cover not more than 80 percent of projected losses to lenders on such loans.

### **ARTICLE 43. Equity Accumulation Insurance Fund.**

An equity accumulation insurance fund will be established to insure the accounts of members of qualified Associations against the risk of failure of eligible companies whose shares are acquired by such Associations. A premium will be charged each Association that desires such insurance, which would be designed to guarantee that at least 80 percent of the original value of qualified shares acquired by the Association will be available for distribution to members as provided for under the Association's share ownership plan.

### **ARTICLE 44. Office of Economic Democratization.**

The Ministry of the Presidency shall establish an Office of Economic Democratization, with a broadly representative citizen advisory group, to develop national expanded ownership goals and objectives, to serve as facilitator for the implementation of the nation's expanded ownership initiatives and to report annually to the President and the Legislative Assembly on the progress of such expanded ownership initiatives.