Achieving ESOP Sustainability

Managing Your ESOP Repurchase Obligation

Minimize Surprises!

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Successful management of the ESOP repurchase obligation is one of the most important aspects of achieving ESOP sustainability.

As ESOP plans "mature" and participants retire or separate from the company for other reasons, some companies have been surprised, even shocked, by costly ESOP repurchase obligations that require the company to come up with large amounts of cash in a year or less, regardless of the company's current profitability or other financial commitments. To achieve sustainability of their ESOP, companies must minimize those surprises.

Typically, the provisions of the ESOP plan are the source of the shocks, and the surprise factor can be greatly reduced by revising the plan to allow for more gradual payouts of ESOP accounts. More gradual payouts help to avoid staggering cash demands on otherwise healthy companies, unplanned sales of ESOP companies that terminate employee ownership of the company, and even bankruptcies.

Every ESOP company has a legal obligation to pay every ESOP participant an ESOP benefit as prescribed in the company's ESOP Plan Document. That payment is optional for the ESOP trust, but it is mandatory for the ESOP company.

The ESOP repurchase obligation is related to many different aspects of the company and its ESOP Plan, and it can be a struggle to manage it together with everything else involved in managing a company successfully. Much of the stress arises from the surprise factor. Structuring ESOP Plan provisions, policies and procedures to minimize the surprise factor in repurchase obligations and to maximize its predictability increases the odds of keeping the company healthy and allowing everyone to sleep soundly at night.

Here are some scenarios of potential trouble caused by repurchase obligations: The ESOP Plan might include a provision that whenever someone terminates employment with the company for any reason, (s)he will receive the ESOP benefit distribution in a lump sum as soon as administratively feasible. The provision reflects the philosophy that "our company wants to be an employee-owned company and not a company owned by ex-employees." At first glance, this seems perfectly reasonable. But this approach maximizes the surprise factor – 100% of the repurchase obligation is a surprise.

What if the stock value spikes after a good year and then a bad year follows? Employees have the incentive to leave and collect the ESOP benefit at the high stock price, possibly causing a cash crisis for the company.

Owners of young ESOPs that have an immediate lump sum payment policy may conclude that paying off departing employees with a lump sum is not an issue at their company because of the small size of ESOP balances. That may be true at first, but ESOP balances have a way of growing over time, and there may be a huge problem when the ESOP is 8-15 years old.

It's almost impossible to guarantee that there will be sufficient cash on hand at all times or sufficient borrowing capacity to fund unpredictable repurchase obligations. The likely outcome: bankruptcy for the company at some unknown date.

How do you minimize the surprise factor in ESOP repurchase obligation? By making the obligation more predictable through the structure of your ESOP Plan.

There are three aspects of repurchase obligation to deal with in minimizing surprises: (1) the nature of an employee's termination; (2) when ESOP benefit distributions begin; and (3) the form of the ESOP benefit distribution. What ESOP plan design will minimize repurchase obligation surprises?

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Nature of Employee's Termination

Employees can terminate employment in one of four ways: death, disability, retirement, or other termination (quit, fired, laid off) prior to retirement. Death and disability can't be predicted for specific individuals, but they can be actuarially projected for larger populations. For most ESOP companies of 50-250 employees, they can be regarded as unpredictable surprises. Retirement age is specified by the company in the ESOP plan, with a government-prescribed maximum of 65. A company can select any ESOP retirement age less than 65, but it can minimize the surprise factor from early retirements by setting a higher age for retirement. Other termination prior to retirement can be projected based on a company's turnover history for various categories of employees.

Commencement of ESOP Benefit Distributions

Government rules establish the dates for commencement of ESOP benefit distributions for death, disability and retirement. The first payment must be made prior to the end of the plan year after the plan year when the event—death, disability or retirement—occurred. Typically, the first payment occurs within a year of the event. There is little the company can do in structuring its ESOP Plan to minimize the surprise factor of the first payment for early death or disability.

For ensuring the company's survival as an employee-owned enterprise, the most prudent strategy is to delay and spread ESOP benefit payments to the maximum extent of the law.

For other terminations prior to retirement (quit, fired, layoff, etc.), a government rule specifies that the first payment must occur prior to the end of the plan year after the completion of five full years of break-in-service for the ESOP participant. In practice, under this rule, the employee waits about six years before the ESOP benefit distribution commences. Companies can start the ESOP benefit distribution earlier than the six-year wait, but the shorter the waiting period, the less time available to plan for the cash disbursement. An immediate commencement of payments means that the first payment is a surprise. A lump sum payment means that the entire payment is a surprise. A company wanting to minimize ESOP repurchase obligation surprises would take full advantage of the six-year wait.

For companies having an outstanding ESOP note, the company has the option to delay ESOP benefit distributions for other terminations until the ESOP note has been paid off. Using this option eliminates surprise expenses from other terminations, but it creates a balloon ESOP repurchase obligation to deal with after the ESOP note is paid. Not every company will have sufficient cash or borrowing capacity to meet the balloon payment.

Form of ESOP Benefit Distribution

For death, disability, and retirement, government rules prescribe that the ESOP benefit distribution must be completed within five years of the date of the event. Company plans can make the distribution more quickly, but the shorter the timeframe for the payout, the larger the surprise factor.

For other terminations, government rules prescribe that the ESOP benefit distribution must be completed within 5 years of the date of the first payment and that the payments must be in the form of substantially equal payments made at least annually. With really large ESOP accounts (greater than $985,000), payments can be extended an additional year for each $195,000 in the account balance up to a maximum payment term of 10 years. Again, companies can make the benefit distribution more quickly, but the shorter the timeframe for the payout, the larger the surprise factor.

During the waiting period and during the installment distribution period, some company plans convert each ex-employee's ESOP account from company stock to cash to lock in the price per share so that the ex-employee does not suffer from stock price decreases or benefit from increases. However, this situation is the same as an immediate lump sum payout of benefits as far as its impact on the company's available cash is concerned. In both cases, the company (or ESOP) must come up with the entire amount of the employee's ESOP benefit in cash immediately upon termination of employment. That makes for a 100% surprise and creates a nearly impossible problem for successful sustainable financial management.

Minimizing Surprises

For ensuring the company's survival as an employee-owned enterprise, the most prudent strategy is to delay and spread ESOP benefit payments to the maximum extent of the law. This approach also facilitates the objective of having the ESOP at all times (good economy, bad economy - young ESOP, old ESOP - new employee, experienced employee – executive manager, lowest paid employee) provide an incentive for employees to strive for the long-term success of the company. The health of the company is a benefit for all the employees, future as well as current retirees.

Specifically, companies should commence the payment of ESOP benefits for death, disability or retirement with an initial payment equal to the value of one sixth of the common stock in the participant's account made within one year of the event and then make five additional annual installment distributions so that the entire distribution is completed within five years of the date of the event. Each installment distribution would be equal to the value of one sixth of the shares of stock. The amounts paid each year would vary with the stock price.

To minimize administrative costs, companies can set

dollar limits for the number of years of account distribution. For example, an account under $25,000 might be paid in one lump sum; accounts of $25,001-$50,000 might be paid in two installments (one immediate and one a year later); $50,001-$75,000 in three installments; $75,001-$100,000 in four installments, $100,001-$125,000 in five installments; and accounts above $125,000 in six installments over the five years.

For other terminations prior to retirement, companies could commence the payment of benefits after the 6-year wait, then pay out the balance over a 5-year period (up to 10 years for really large accounts). The installment distribution could occur in the same manner as described for death, disability and retirement.

Do companies adopting these provisions avoid repurchase obligation surprises completely? No. Death, disability and unplanned retirements are still surprises. However, the first year payment is only one sixth of the total payout; so five sixths of the payouts due to death and disability has been removed from the surprise factor and can be planned for in subsequent years. Planned retirements are not surprises at all. The surprise factor for other terminations, though, is completely removed. By delaying the commencement of ESOP benefit distributions for six years, the company can plan for them in the comprehensive corporate financial plan.

By adopting these benefit payout provisions into their ESOP plan, companies will not only minimize their repurchase obligation surprises but they will also minimize the potential financial stress of making large cash payments in a single year because of repurchase obligations. What is more, ESOP participants will not be subject to the vagaries of ESOP stock prices. They won't have an incentive to leave and take advantage of an exceptionally high stock valuation. They also won't benefit unjustifiably if, after a wait, a lump sum distribution is made when the stock price is unusually high. Nor will participants suffer unfairly if that lump sum payment is based on a low stock price.

Minimizing surprises should also minimize the need for funding tools that are geared toward enabling a company to handle surprises. Corporate owned life insurance (COLI) and key person life insurance policies should be less necessary with fewer surprises on the horizon.

Modeling future repurchase obligations is an excellent way to explore a company's risk picture and plan for the future. Many managers use their own spreadsheets for their projections; however, there is excellent repurchase obligation software available. *Telescope*™, from ESOP Economics, and Principal Financial Group's *My Principal ESOP Repurchase Liability Solution*℠ (*My PERLS*℠) are the two pre-eminent software packages available today. *My PERLS*℠ is available at no direct cost only to Principal Financial Group's ESOP administration clients. Alternatively, service providers can be hired to prepare ESOP repurchase obligation projections. No matter how it is prepared, a projection of ESOP repurchase obligations will take much out of the realm of the unknown and put in into the category of the known.

With ESOP Plans structured to minimize repurchase obligation surprises, companies can use repurchase obligation software models to more accurately project future repurchase obligations and to include those obligations in the comprehensive financial plan for the company. Successful management of the ESOP repurchase obligation and successful financial planning support the sustainable growth and success of the company.

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How Philosophy of Repurchase Obligation Affects Sustainability Practices

	Philosophy: We want to be an employee-owned company, not a company owned by former employees.		**Philosophy: We want to manage our ESOP repurchase obligation successfully by minimizing surprises.**	
ESOP Benefit Distribution	Death, Disability or Retirement	Other Termination	Death, Disability or Retirement	Other Termination
Date for First Payment	Immediate	Immediate	Within 1 Year	After 6-Year Wait
Form of Payment	Lump Sum	Lump Sum	5-Year Installment Distribution	5-Year Installment Distribution
% of Payments that are Surprises	100%	100%	17%	0%
Prognosis	**Cash Crisis, Bankruptcy or Unplanned Sale of Company**		**Successful ESOP & Company Sustainability**	