

**21st Annual OEOC CONFERENCE**  
**April 17, 2009**

# Legal Framework for ESOP Repurchase Obligations

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# ESOPs and Liquidity

- Most ESOPs created in part to solve liquidity issues for shareholders of privately-held companies
- No liquidity solution is permanent—all privately-held companies will be sold or transferred
- ESOP-owned companies face same general liquidity issue for shareholders as other privately-held companies

# ESOP Repurchase Obligation

- Unique aspect of shareholder liquidity for ESOP-owned companies is statutory scheme (ERISA) which mandates liquidity events for ESOP participants – these liquidity events are generally described as an ESOP company's repurchase obligation

# Repurchase obligation defined

- The repurchase obligation is a legal obligation imposed on the sponsor of an ESOP to provide cash to participants who are entitled to a distribution in connection with employer stock held in an ESOP account
- It occurs as a result of distributions being made from the ESOP due to
  - Termination of employment
  - Exercise of diversification rights
  - In-service distributions

# Repurchase Obligation Legal Background

- ESOPs invest primarily in employer stock
- Plan must offer distributions of participant accounts in form of employer stock (IRC Sec. 409(h)(1)(A)) or cash equivalent
- Participant has right to sell distributed shares to employer “under a fair valuation formula” (IRC Sec. 409(h)(1)(A)) = “repurchase obligation”

# Repurchase obligation Parameters

- Timing is affected by
  - ESOP distribution policy
  - Employee demographics
- Amount is affected by
  - Account balances
  - Stock value

# ESOP Distributions

- ESOPs required to distribute participant accounts after death, disability, normal retirement, separation from service (IRC Sections 401(a)(9), 409(o))
- ESOPs also required to make distributions to 5% shareholders at age 70½ (IRC Sec. 401(a)(9)(C)) and may make distributions in satisfaction of diversification requirements (IRC Sec. 401(a)(28)(B))

# ESOP Distribution Timing

- Distributions must commence under IRC Secs. 401(a)(9), 401(a)(14) and 409(o) during plan year following death, disability or retirement after normal retirement age
- Distributions must commence under IRC Sec. 409(o) by close of fifth plan year following plan year of any other termination

# ESOP Distribution Timing (cont.)

- In “C” corporations, distributions to terminated employees may be delayed until repayment of stock acquisition loan used to acquire stock to be distributed
- Diversification (25% of post-'86 stock) after age 55 and 10 years of participation in plan

# ESOP Manner of Distribution

- Distribution may be lump sum or periodic payments over up to five years, extended for large (>\$985,000) accounts (IRC 409(o))
- If lump sum distribution of stock, Company may honor put option with five year note at reasonable interest with “adequate” security

# Repurchase Transactions

- Company repurchase from participant
- Company repurchase from trust; ESOP cash distribution to participant
- Company funds ESOP; ESOP repurchases from participant
- Company funds ESOP; ESOP cash distribution to participant

# Company Repurchase from Participant

- No direct fiduciary action; ESOP is not party to transaction
- Purchase price is “fair valuation formula” (IRC Sec. 409(h)(1)(B))
- Fair valuation formula should mirror ESOP independent appraisal and usually relies on ESOP valuation

# Company Repurchase from ESOP: ESOP Cash Distribution

- ESOP must rely on independent appraiser (IRC Sec. 401(a)(28)(C))
- ESOP fiduciary must determine tender to company is appropriate under ERISA Sec. 404 (exclusive purpose & prudence)
- ESOP sale to company must be for “adequate consideration” (ERISA Sec. 408(e)(1))
- DOL 1988 proposed adequate consideration regulations generally apply

# Company Repurchase from ESOP: ESOP Cash Distribution (cont.)

- Adequate consideration regulations require fair market value determined as of date of transaction
- Adequate consideration regulations may not require a control premium for small repurchase from controlling ESOP but ERISA Sec. 404 probably does

# Company Funds ESOP: ESOP Repurchase from Participant

- Independent appraisal and ERISA fiduciary requirements apply
- Adequate consideration requirement doesn't apply unless participant is "party in interest" (company officer, 10% shareholder, fiduciary, etc.)

# Company Funds ESOP: ESOP Cash Distribution to Participant

- Distribution must be based on independent appraisal per IRC Sec. 401(a)(28)(C)
- No fiduciary act if fiduciary has no discretion and acts on instruction of plan administrator concerning distributions

# ESOP Repurchase Obligations (cont.)

- Conventional shareholder liquidity alternatives are:
  - Company sale to outside party
  - recapitalization, or
  - internal buyout by management and/or employees
- ESOP-owned companies typically confront shareholder liquidity issues in bits and pieces through repurchase obligations based on individual participant decisions rather than as large event for one or a few shareholders

# Redeeming vs. recycling

- We need to understand the differences between handling repurchases by redeeming shares vs. recycling, to inform the rest of our discussion
- Definitions:
  - Recycling: Repurchases are handled within the ESOP (using cash contributions, dividends or earnings distributions), shares stay in the trust and are reallocated to remaining active participants
  - Redeeming: Repurchases are handled by distributing stock from the ESOP which is then purchased by the company

# Redeeming vs. recycling - consequences

## ■ Redeeming

- # of shares in ESOP declines
- ESOP's ownership % declines (if <100%)
- No additional shares added to individual accounts
- Redemptions are not deductible
- Lower # of shares repurchased over the long term
- Tends to result in higher share value than recycling

## ■ Recirculating

- # of shares in ESOP unchanged
- ESOP's ownership % unchanged
- Continuous but irregular new allocations of company stock to active participants
- Contributions are deductible
- Higher # of shares repurchased over time
- Higher compensation expense may be dilutive to value

# Some Recycling Problems

- Recycling shares may result in ongoing share allocations to ESOP participants in excess of reasonable benefit levels—dilutive effect reduces reported earnings, depresses valuation and may be unfair to participants with significant existing ESOP balances
- Creates impetus for sale to third-party to “unlock” true shareholder value for participants

# Some Redemption Problems

- Redemptions create have/have-nots—new employees do not receive share allocations (may also be a problem in recycling with low turnover)
- Anti-dilutive effect concentrates ownership and exacerbates cash flow requirements to deal with significant departing stakeholders – undermines ability of company to fund shareholder liquidity in bits and pieces

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James Steiker is Chairman and CEO of SES Advisors, Inc. and founding partner of Steiker, Fischer, Edwards & Greenapple, P.C. Jim is a corporate, pension and tax attorney with more than twenty years of experience as a legal and financial advisor in Employee Stock Ownership Plans and other employee ownership matters, focusing primarily on ESOP design, installation and transactions in privately-held companies.

Jim is a trustee of the Employee Ownership Foundation, a member of the Finance Committee of The ESOP Association and serves on the board of the National Center for Employee Ownership. He is a frequent speaker and author on ESOP matters, serves as a director of eight employee-owned companies, and is a member of *Vistage*, an organization of CEOs.

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