ISSUE BRIEF #5

ESOP Repurchase Obligation Requires Advance Planning

Introduction

For a closely held company sponsoring an ESOP, the repurchase obligation is an ongoing requirement to repurchase its stock from former ESOP participants and their beneficiaries, or “create a market” for their stock. Public companies don’t have a repurchase obligation because a liquid market exists to trade their stock. To insure the success of the ESOP as a motivational tool and as a means of corporate finance, the ESOP sponsor in a privately owned company must develop a plan for funding its emerging obligation to repurchase its stock. A recommended first step to address the repurchase obligation is that a comprehensive actuarial repurchase obligation study be done to forecast the company's repurchase obligation over several years into the future.

An ESOP’s repurchase obligation is triggered when distributions are made to vested participants who have retired, died, become disabled, or terminated employment. (We will address ESOP distributions separately in a future ESOP Issue Brief. Plan sponsors should consult their Plan Document and plan administrator to understand in detail how distributions impact repurchase obligations). IRC section 409(h) provides, in general, that a vested participant who is eligible for a distribution must be given a “put option” enabling him or her to sell shares back to the company. In the early years of an ESOP, these obligations are typically small and generally easy to deal with. However, as the number and value of the ESOP shares grow, the repurchase obligation can mushroom to alarming levels.

It is important to note that repurchase is the obligation of the sponsoring employer and of the ESOP trust. The ESOP trust, rather than the sponsoring employer, may purchase the stock back from the participant if it so chooses. The obligation ultimately falls on the company, however, should the plan fail to have sufficient assets to make the purchase.

Events That Trigger the Repurchase Obligation

Four events trigger the repurchase obligation. They are:

A. Retirement

Distributions must begin within a year after the end of the plan year in which the participant retires, and can generally be spread over a maximum of five years (six installments).

B. **Death or Disability**

Distribution requirements are the same as above.

C. Termination (voluntary or involuntary)

Distributions can be deferred up to six years or until an existing ESOP loan is repaid and then can be spread over a five-year period.

D. Diversification

When an ESOP participant who has at least 10 years of participation in the ESOP reaches age 55, he or she must be given the option of diversifying his or her ESOP account up to 25 percent of the value. Diversifying" means converting the beneficial interest in the value of the employer's stock to another investment option within the ESOP. This option continues until age 60, at which time the employee has a one-time option to diversify up to 50 percent of his or her account. This requirement applies to ESOP shares allocated to employee's accounts after December 31, 1986.

Effects of Ignoring the Repurchase Obligation

If the sponsoring employer has not properly forecasted the repurchase obligation and established a financial plan to deal with the emerging obligation, the company may face the following problems:

(1) Significant devaluation of company stock;

(2) Erosion of employee moral due to a drop in the market value of company stock;

(3) Negative effect on the company's ability to secure bank and trade credit;

(4) Potential personal liability for ESOP Fiduciaries;

(5) Possible insolvency as a result of unexpected cash flow demands.

It's easy for a company with a newly implemented ESOP to ignore the repurchase obligation because it is minimal in the early years. However, as the individual ESOP account balances grow and the stock value increases over time, the obligation can grow exponentially. Some companies with established ESOPs have a false sense of security because they are currently handling their liability without a problem but they may not be aware of the extent of their repurchase obligation into the future. Participant retirements are fairly easy to predict, but deaths, disabilities and terminations are impossible to predict. Mismanaging the planning and funding of the repurchase obligation can force a termination of the ESOP, liquidation of the company, an expensive IPO or a merger with another larger company.

Many well-intentioned CEOs, who have formed ESOPs to make a market for their shareholders, have created significant problems by failing to back up their ESOP stock purchases with an appropriate repurchase funding plan. Companies that have not studied their repurchase obligation – a vital duty in annual financial planning -- may experience difficulty in their banking relationships along with severe cash flow problems. As a result, many banks now require actuarial studies by business customers with significant ESOP stock ownership.

Alternative Funding Methods

A repurchase liability study forecasts the emerging repurchase obligation based on various characteristics of the company and the workforce. The study considers factors such as employee census and salary information; plan design, ESOP loan terms and participant projections regarding mortality, disability and turnover. Once the study is completed, the company will select a funding approach. The following table summarizes the advantages and disadvantages of various funding strategies:

Summary of Repurchase Obligation Funding Strategies

Action	Advantages	Disadvantage
Repurchasing shares from current cash flow; "pay as you go"	• Flexibility: make cash contributions to ESOP or buy back and retire shares as required • Cash can be used for other purposes when not required to repurchase shares	• No scheduled or disciplined preparation • High risk for future conflicts with other cash needs • No current tax advantage • Future cash flow adequacy uncertain
Corporate-Owned Life	• Creates immediate liquidity to	• Policy issue and possibly

Insurance "insured sinking fund"	respond to deaths • Life insurance death benefits are tax free (subject to AMT) • Creates a "tax deferred sinking fund" • Creates a cash pool available for other needs • Retiring ESOP shares reduces outstanding shares • Terminates obligation according to plan • Pre-funding increases employee security	underwriting process required • Premiums require a commitment of future cash flows • Not protected from creditor claims
Sinking Fund Outside the ESOP	• Flexibility: make cash contributions to ESOP or buy back and retire shares as required • Creates a cash pool available for other needs • Pre-funding increases employee security	• Not protected from creditor claims • No tax advantage
Cash Contributions to ESOP	• Cash contributions to the ESOP are currently tax deductible • Pre-funding increases employee security	• Cash is "locked up" in the ESOP • Reallocating repurchased shares within the ESOP perpetuates the liability • Reduces working capital • After-tax profits are reduced
Stock Contributions to ESOP (creates a tax deduction – use the tax savings to repurchase shares)	• Creates a tax deduction • Increases employee participation in ESOP • Neutral effect on working capital	• Obligation perpetuated indefinitely/infinitely • Potential for dilution • Tax savings will vary
Distribute stock and exchange stock with a note	• Defers cash payment to future • Enables corporation to handle large cash outlays over a short period of time	• Employees may view this approach negatively • Defers cash payment to future • Increase debt on the balance sheet

ESOP Loans	• Principal and interest deduction for ESOP loans • Cash can be used for other purposes until loan is required	• Commitment of future cash flows • Increase debt on the balance sheet • Not reliable – future financial conditions may not make the loan feasible
Initial Public Offering "Go Public"	• Terminates obligation immediately • Raises new funds for business	• Reporting and regulation • IPO expense • Creates exposure to financial market conditions • Introduces new shareholders • Not available to all companies • No tax advantage
Sell the Company	• Terminates obligation immediately • Cash for all shareholders	• Creates exposure to financial market conditions • Difficult process • Introduces new owner • Not available to all companies • No tax advantage • Employee morale/uncertainty

ESOP Advisors Group provides one stop ESOP design formation and implementation services. Visit the ESOP Advisors Group website at ***www.esopadvisorsgroup.com.*** *Or call Mel Duffey (650) 468-5465.*

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