ESOP ECONOMICS
REPURCHASE OBLIGATION EXPERTS

MANAGING REPURCHASE OBLIGATIONS THROUGH ESOP PLAN DESIGN

When companies think of repurchase obligation, they are usually focused on the “when” and “how much?” It is less often that companies examine how they are administering their ESOPs and various ESOP plan design features that can impact their future repurchase obligations. However, plan design features can have significant impacts on repurchase obligations. Ideally, if companies are proactive in examining and designing their plan provisions and contribution/distribution policies, diligent in their administration, and understand the impact of these issues on future repurchase obligations, they will be better equipped to manage their obligations over the long-term.

INTERNAL ESOP LOAN AMORTIZATION

Pre-paying the internal loan between the ESOP and the company (or between the ESOP and a selling shareholder) may seem like a good idea, specifically for a C corporation that is looking to maximize its tax-deductible contributions. However, accelerating payments on the ESOP loan can lead to prematurely allocating all of the ESOP’s stock, thus creating a “have/have-not” situation where participants employed during the years when the loan is being repaid accumulate much larger account balances (or all of the stock) than participants who enter the plan later. This also has consequences for repurchase obligations; the build-up in account balances leads to larger repurchase obligations that occur sooner. Additionally, repurchase obligations may become more volatile from year to year, as a consequence of the concentration of shares.

Allocating shares more slowly can help the company smooth out and better manage the timing and amount of repurchase obligations, as well as avoid a “have/have-not” situation.

ELIGIBILITY & VESTING

Eligibility

When considering the eligibility rules for your ESOP, there is some flexibility, but generally you cannot make employees wait more than two years to enter the plan.
It may seem attractive to allow immediate eligibility, i.e., an employee becoming eligible on his/her date of hire, since this would increase the “eligible compensation” on which the maximum allowable contributions are measured.

However, immediate eligibility may result in larger account balances and potentially higher repurchase obligations sooner, especially in companies with relatively low turnover rates.

Vesting

Typically companies choose between a six-year graded or a three-year cliff schedule. However, some companies have schedules that differ slightly from those two, and some even allow immediate vesting. Generally, more rapid vesting schedules lead to higher vested balances and higher repurchase obligations sooner.

When selecting a vesting schedule, a company should understand the turnover patterns in its participant population and consider the benefit levels that the company wants to provide to short-term employees vs. its long-term employees.

Another consideration is whether years of service prior to the ESOP will count for vesting. Including prior years of service for vesting can significantly increase repurchase obligations in the early years of an ESOP.

DIVERSIFICATION & IN-SERVICE DISTRIBURTIONS

Diversification

Diversification rights are required by current law to be made available to participants who have attained age 55 and ten years of participation in the ESOP. Whether distributed to the participant or transferred to a 401(k) plan, diversification distributions are paid in a lump sum.

Some companies implement an enhanced or liberalized diversification provision, in an effort to liquidate large accounts earlier, reduce retirement distributions in later years, and perhaps to make shares available for reallocation. Enhanced diversification rights will accelerate repurchase obligations.

In-Service Distributions

Some ESOPs also provide for in-service distributions, in addition to the statutory diversification rights. In many cases, companies design such provisions to allow participants who have reached retirement age to elect in-service distributions, so that they can receive benefits from their ESOP accounts while still working.

In-service distribution provisions can be designed in a number of ways based on age and length of service. Sometimes, a one-time in-service distribution opportunity is offered when the company has extra cash available.

While an in-service provision may help liquidate large accounts earlier and reduce retirement distributions in later years, it will also accelerate and increase overall repurchase obligations if shares are recycled. In-service distributions are sometimes combined with releveraging to avoid the immediate reallocation of a large number of shares.

DISTRIBUTION POLICY

Immediate & Lump Sum Payouts vs. Delays & Installments

In general, distributions from an ESOP may be paid in installments over no more than five years, beginning no later than the end of the year after death, disability or retirement, and after the fifth year following other terminations. More rapid distributions are permitted.

Distribution policies that provide for immediate payouts will accelerate repurchase obligations. If combined with lump sum distributions, this can result in repurchase obligations that vary considerably from year to year and leave the company with a short planning horizon.

It may seem like an attractive option to pay participants out as quickly as possible, especially in periods of rising stock values, when delays and installment payouts could result in higher repurchase costs. However, delays and installment payments are protective of the plan sponsor, as they provide companies a longer planning horizon and may help smooth out the year-to-year cost of repurchase obligations and the reallocation of shares.

Financed Securities Exception

Section 401 (o)(1)(A) of the Internal Revenue Code ("IRC" or the "Code") permits C corporations sponsoring an ESOP to delay the distribution of employer securities acquired with a loan, until the ESOP loan, as described in Section 404(a)(9) of the Code, is paid in full. This delay can apply to all termination reasons, including death, disability, and retirement. It is not clear whether this applies only to C corporations or to S corporations as well; however, many professionals in the ESOP community agree it does not apply to S corporations.

Delaying distributions until the ESOP loan is fully repaid may seem attractive or may be necessary for companies facing issues funding the ESOP within the IRC §404(a) deductible limit during the period while the loan is being repaid. However, it also results in terminated participants benefiting from the increases in stock value for potentially a long period of time, resulting in a large repurchase obligation immediately following the loan repayment. Additionally, a large percentage of the shares in the ESOP may be held in the accounts of terminated participants, reducing the benefit to active participants.

Segregating Accounts

Segregating is a technique that involves converting terminated participants' accounts from employer stock to cash over a period of one or more years; the segregated balance is then invested in other investments until it is finally distributed.

Segregating may be an attractive option for a company whose share value is increasing rapidly, as this allows a company to maintain its distribution policy which may contain delays and installments without having terminated employees participate in increases in the company's stock value. In situations where terminated participants are not consenting to take distributions, segregating can also be useful for avoiding or mitigating a "have vs. have-not" situation, by making shares available for new participants.

Keep in mind that segregating accounts entirely in the year following termination is, from a cash-flow perspective, equivalent to paying immediate lump sum distributions. It accelerates repurchase obligations and creates a limited planning horizon; potentially putting the company at risk in a financial downturn. To mitigate this, consider segregating in installments, or limiting segregation to the amount of cash available in the trust.