BTA | BUSINESS TRANSITION ADVISORS

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ESOP CONNECT

MANAGING THE ESOP REPURCHASE OBLIGATION

To ensure the success of an Employee Stock Ownership Plan (ESOP) as an employee motivational tool and as a means of corporate finance and succession planning, a company sponsoring an ESOP must "make a market" for vested plan participants who are entitled to receive distributions from the ESOP. This "Repurchase Liability" is a federally mandated required stock buy-back incumbent upon non-public ESOP companies whose employees do not have a ready and willing public market for the company stock held in the ESOP. IRC section §409(h) provides a "put option" enabling participants to sell shares back to the company.

A company sponsoring an ESOP must "make a market" for vested plan participants.

The ESOP Trust, rather than the sponsoring employer, may purchase the stock back from the participant if it so chooses, however the obligation ultimately rests with the company. In fact, Treasury Regulation Section 54.4975 - 7(b)(10) states, "under no circumstances may the 'put' option bind the ESOP."

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 and become unmanageable if ignored. The timing of funding the obligation is determined by the plan document provisions, distribution policy and planning for the repurchase of stock.

To ensure the company can make the repurchases as required and the participants' distributions can be handled in a legal and timely manner, several questions must be addressed.

Size	How large are the repurchase obligations?
Timing	When do they occur? How do the obligations vary over time?
Form	Will the ESOP make distributions in stock or cash?
Funding	How are the repurchases best funded?
Method	What is the best way to handle repurchases (redeem or recirculate)?

Quantifying the Repurchase Obligation

A Repurchase Liability Study quantifies the emerging repurchase liability based on the characteristics of the company. The study considers factors such as age of the participants, nature of the business, plan documents, loan terms and workforce assumptions regarding mortality, disability and turnover. The purpose of the ESOP Repurchase Liability Study is to project both the magnitude and the timing of the required cash flows to meet the obligation.

As part of Business Transition Advisors, Inc.'s (BTA) standard ESOP implementation services, a customized Repurchase Liability Study based on the company's specific plan features and participant demographics, is provided with every new ESOP installation. It is also recommended for ESOP companies to have an updated study completed every few years and more frequently if there are any significant corporate changes.

FACTORS AFFECTING THE REPURCHASE OBLIGATION

The actual cost of repurchase is affected by many factors including, but not limited to:

- Redemption of repurchased stock into treasury vs. Recontribution/Recirculation of the stock in the ESOP.
- **Per Share Value**: Redeeming increases the value of outstanding.
- **Tax Savings**: Recirculation method buys shares with before-tax dollars.
- **Plan Contributions**: How large are the potential annual contributions and how long will the employer contribute to the ESOP?
- **Timing of Contributions**: Funding prior to distribution may reduce the overall cost of repurchase.
- **Loan Repayment**: If the ESOP is leveraged, how is the loan amortized; what is the loan interest rate; how are shares released from the suspense account, etc.?
- **Participant Demographics**: Employee ages, retirement ages, experience for death, disability and turnover all impact repurchase costs.

REPURCHASE OBLIGATION TRIGGERS

There are five events that may trigger the obligation of the company to repurchase allocated and vested stock from ESOP participants each with separate degrees of flexibility in timing and method of payouts as set forth by federal law and the ESOP plan document itself. ESOPs fall under all the same participant protections afforded all qualified retirement plan participants in respect to timing, payout provisions, notification and discrimination.

THE FIVE TRIGGERS

1. Retirement At retirement, distributions must begin within one year of the Plan year in which the participant retires. Generally, the distribution can be made in five installments spread over a maximum of five years.
2. Death Generally, the same as retirement.
3. Disability Generally, the same as retirement.
4. Termination (either voluntary or involuntary): Distributions can be deferred for the greater of six years or until an existing ESOP loan is repaid. The longer deferral is only applicable for stock acquired with that loan. After the loan period has ended, the distribution can be spread over up to a five-year period of six installments. Under certain circumstances, even distributions resulting from death, disability or retirement can be deferred until after the loan is repaid.
5. Diversification After 10 years participating in the ESOP and reaching age 55, participants have the option to diversify up to 25% of their ESOP account. At age 60, this option expands to 50% diversification of their ESOP account. The diversification option can be satisfied by either making a cash or stock distribution from the ESOP, allowing the participant to elect from three investment options other than company stock inside the ESOP or transferring the diversification funds to another qualified plan that provides at least three investment options other than company stock.

RISKS OF IGNORING THE REPURCHASE OBLIGATION

Companies that have not properly forecasted the repurchase obligation and established a financial plan to deal with the emerging obligation may face the following problems:

- Significant devaluation of company stock.
- Forced sale of the company.
- Erosion of employee moral due to a drop in the market value of company stock.
- Negative effect on the company's ability to secure bank and trade credit.
- Potential personal liability for ESOP Fiduciaries.
- Possible insolvency as a result of unexpected cash flow demands. Poor employee morale because of the uncertainty of funding.
- Increased costs of capital.

With proper planning these potential repurchase obligation issues can be substantially mitigated.

Funding the Repurchase Obligation

A variety of funding options are available to fund the repurchase liability. Often a combination of funding methods is the best solution. The challenge is to find the mix that best fits the company's situation considering available current and future cash flow, current and future debt availability, the extent of future repurchase liabilities and long term plan for corporate ownership and repurchased shares. There are several methods of dealing with the repurchase obligation.

CURRENT CASH FLOW ("PAY AS YOU GO")

This is one of the most commonly used funding methods and the default for companies that do no pre-planning with repurchases handled as they occur.

WHEN TO CONSIDER

- Projected obligations are a minimal percentage of cash flow.
- Repurchase obligations are evenly distributed.
- Combined with other funding methods.
- Future earnings are likely to be stable.

ADVANTAGES

- No pre-funding required.
- Cash can be used for other corporate purposes.
- Retains flexibility to recirculate or redeem shares.
- Contributions are deductible up to qualified plan limits.

DISADVANTAGES

- Does not allow for contingencies such as unexpected demands on cash flow.
- May hinder future growth opportunities.
- Timing of unanticipated large payments due to the death, disability or retirement of key employees.
- No current tax advantages.

ESOP SINKING FUND

This method supports a recirculation strategy and involves building a cash position in the ESOP by maximizing cash in the ESOP to fund future repurchases. The ESOP assumes the obligation to buy the stock, even though the ultimate obligation to repurchase remains with the employer.

WHEN TO CONSIDER

- Repurchase obligations are manageable as a percentage of cash flow.
- Liability is evenly distributed.
- Company is generating significant cash in excess of total corporate needs.

ADVANTAGES

- Contributions are deductible within limitations.
- Tax-deferred growth.
- Cash is protected from creditors.
- Spreads out the funding of repurchase obligations.
- Provides comfort to plan participants.
- Useful if the company chooses to recirculate the ESOP shares.
- Maintains the ESOP's percentage of ownership.

DISADVANTAGES

- Limited flexibility, only useful for recirculation.
- Reduces working capital.
- Company still has ultimate legal obligation to repurchase stock despite the ESOP's cash position.

CORPORATE SINKING FUND

The corporate sinking fund method involves the systematic accumulation of funds at the corporate level that are earmarked for the repurchase obligation.

WHEN TO CONSIDER

- Desire to retain maximum flexibility.
- Need to have access to earmarked cash for other potential corporate purposes.

ADVANTAGES

- Retains flexibility to either redeem or recirculate shares.
- Smooths cash flow requirements of repurchase.
- Keeps assets on the corporate balance sheet.
- Potential deduction if stock is subsequently re-contributed to the ESOP.
- Provides comfort to plan participants.

DISADVANTAGES

- Contributions to the sinking fund are not deductible.
- Investment yields may be taxable.
- Removes assets from working capital.
- May increase the stock value.
- In the event of a bankruptcy, assets in a corporate sinking fund are not protected from creditors.

EXTERNAL DEBT

Debt can be used as a fallback strategy when other funding is inadequate or unforeseen circumstances occur.

WHEN TO CONSIDER

- Repurchase obligations are very high for one or a few years.
- There is not enough time to accumulate a sinking fund.
- The corporation cannot meet repurchase obligations from cash flow.

ADVANTAGES

- May be less expensive than pre-funding or current cash flow, depending on internal rate of return on capital.
- The corporation may be able to deduct interest expenses.

DISADVANTAGES

- Financing may not be available when needed.
- Lender fees and interest expense may add additional costs.
- Debt doesn’t solve the liability issue, simply refinances it.

CORPORATE OWNED LIFE INSURANCE

Life insurance funding may be used to provide death benefits, as a compliment to other investments in a sinking fund, or for "cost recovery" funding.

WHEN TO CONSIDER

- The company needs to ensure funding for large account balances.
- Combined with other funding methods.
- Written ownership policy commits the ESOP to be maintained longer than the lives of the current participants.

ADVANTAGES

- Pre-retirement death benefits reimburse the company for the loss of key employees.
- Life insurance cash value is an asset on the corporate balance sheet.
- Potential to smooth cash flow requirements.
- Provides liquidity in the event of unanticipated deaths.
- Death proceeds and cash value growth are income tax-free.
- Potential recovery of repurchase and premium costs if held to death.
- Retains flexibility to repurchase or redeem shares.
- May provide additional financing and cost recovery options for other executive benefits.

DISADVANTAGES

- Expense and mortality costs associated with insurance.
- Life insurance premiums are not tax deductible.
- Investment return may be lower if policy is surrendered before death.
- For "C" corporations, cash values and death benefits may be subject to corporate Alternative
- Minimum Tax (AMT).

GO PUBLIC

A company can take its stock public and become publically traded through standard initial public offering (IPO) procedures.

WHEN TO CONSIDER

- Company is large enough for a public market.
- When an IPO is cost effective.

ADVANTAGES

- Eliminates the corporate repurchase obligation due to public market.
- Repurchases use non-corporate cash.
- May increase participants' account balances.

DISADVANTAGES

- Company subject to public company rules, disclosures and filings.
- Continuous pressure to increase stock value.
- Potential changes/elimination of employee jobs, compensation and benefits.
- Elimination of sellers' perks

LIQUIDATE COMPANY/FILE BANKRUPTCY

When all other reasonable options have been exhausted, the company may have to close its doors through liquidation and/or file bankruptcy.

WHEN TO CONSIDER

- No other option.

ADVANTAGES

Eliminates the corporate repurchase obligation due to devalued or worthless stock.

DISADVANTAGES

- Employee ESOP accounts may be worthless.
- Potential legal problems for Board of Directors.

Repurchase Obligation's Effect on ESOP's Legacy Full Circle

Many owners want their children and/or management to eventually run and own the business, but they cannot afford to purchase the business nor obtain adequate financing to do so. The ESOP can preserve a family legacy by managing the repurchase obligation accordingly. Corporate control, salary and benefits can be maintained by children and/or management with even a very small interest. Frequently, sellers sell less than 100% of their stock to an ESOP and gift or sell some minimal amount of shares to children or key management. To increase actual direct stock ownership, the company simply uses corporate cash to purchase participants' ESOP shares as they leave the company and retire them into treasury. As the overall outstanding shares decreases, the percentage of ownership that is held by outside the ESOP increases. In theory, when the last share is repurchased and retired, the shares held outside the ESOP by the children and/management represents 100% of the value of the company.

In Summary, although an ESOP may be a tremendous tax advantaged business succession and employee benefit vehicle, the resulting repurchase liability is a legal and moral obligation of the company to understand, prepare and manage. With proper repurchase obligation planning and assistance from qualified professionals, a company can be confident that the ESOP will provide the desired results for the sellers, company and ESOP participants for years to come.