Choose Wisely In Electing Your ESOP Repurchase Strategies!

Prudent & Strategic Management of Stock and Cash Flows for Maturing ESOP Companies.

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Sustainability as Seen Through the Eyes of an:

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Agenda for Our Conversation

A. What does sustainability mean?

B. What drives repurchase obligations?

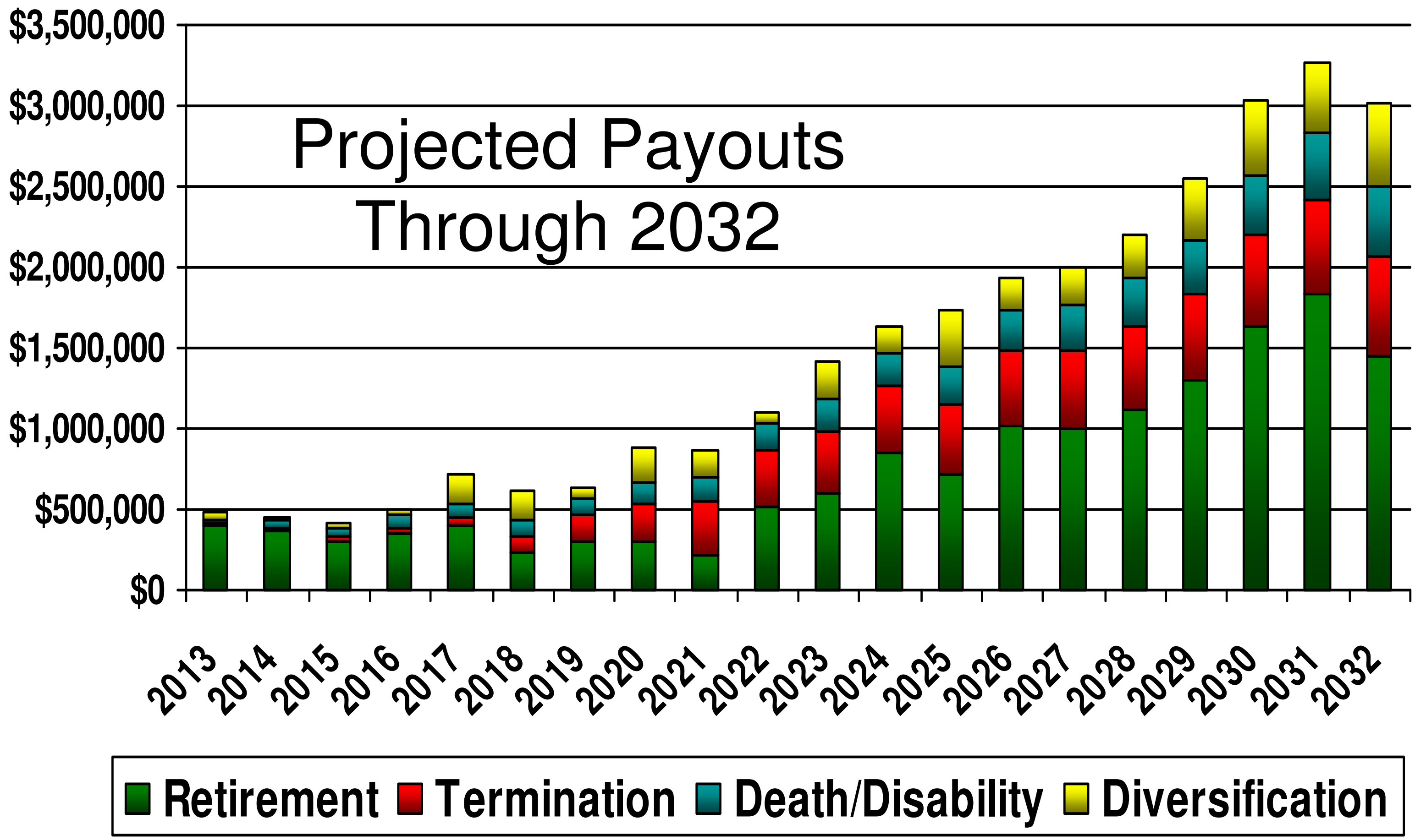
C. How is repurchase obligation planning coordinated with distribution operating rules?

D. Strategies and mechanisms available to maturing ESOPs which can support the optimal financial and ‘psychological’ health of a plan.

E. The floor is open to questions at any time during our conversation. Take-aways are: 1) A broader understanding of coordinated strategies, 2) Knowing what questions to ask of whom, and 3) Some specific rules relative to plan operation.

What is Sustainability?

A plan that delivers Employee Ownership for our Company for *the long term*.



What are the Obstacles?

- Corporate cash flow
- Contribution limits
- Turnover
- Getting shares to new participants after an ESOP loan is repaid
- Managing repurchase obligations in a way that enables and supports sustainability

What is the Repurchase Obligation?

- A measurement of the responsibility to cash out participants after:
  - Retirement
  - Death
  - Disability
  - Other termination of employment
  - Diversification

Repurchase Obligation Study

- Long-term projection of ESOP distributions and cash requirements
  - Based on demographics, turnover and retirement assumptions
  - Based on share value assumptions
  - Based on Plan rules – eligibility, vesting, normal and early retirement age
  - Integrated with a Plan's Distribution Policy and Plan provisions for timing, form and method of payout

Key Factors Driving the Magnitude of the Obligation:

1. Company performance
2. Share price
3. Plan provisions
4. Administrative distribution rules for payouts
5. Number of shares issued and outstanding
6. Mechanism used for share purchases and repurchases (corporate redemption, recycling in the ESOP, leveraged repurchases)
7. Rate of share allocations in a leveraged ESOP
8. Rate of new share contributions

What Questions Does the Study Answer?

- How big are the repurchases?
- What actuarial and plan factors are most responsible for the costs?
- When will they occur?
- Is our Company’s funding strategy on target?
- What are the implications if we change our Distribution Policy?

TPA Perspective – ESOPs Don't Always Sustain Performance or Age Well

But beyond the economic performance of the sponsor, why is that…?

- Paying down ESOP debt too quickly, allocating shares too quickly
- Postponing the repurchase study
- Ignoring the demographics – like an aging population
- Some ignore clusters – participants estimated to reach Retirement Age at the same time
- Inaccurate or inadequate assumption development

TPA Perspective – ESOPs Don't Always Sustain Performance or Age Well

- Without good assumptions, the study is flawed
- Without careful review, analysis and discussion, the study is a waste of time
- The study can drive repurchase obligation management and funding decisions
- The study should be viewed not just as a measure of costs, but as a sensitivity analysis to understand the real drivers and make the best decisions.

Analyst's Perspective –

1. Corporate officers and managers may not know their available options in dealing with stock value declines (or increases) or the many variables in the ESOP 'system.'

2. There are sometimes no discussions or solid understanding of best practices for managing <u>stock</u> flows…most companies can manage <u>cash</u> flows. Handling stock flows and fiduciary concerns is another issue.

3. ESOP stock repurchase obligation <u>management</u> is frequently misunderstood. We'll start there…understanding the repurchase liability will clarify a host of other issues.

Key Ideas:

The Best, Most Sustainable ESOPs:

1. Have operating management with a clear and effective operating philosophy.

2. Operate in a 'slow-burn' and (hopefully) predictable mode without sudden spikes or drops in <u>account balances</u>.

3. Have a well-understood and (at least) partially funded ESOP buyback obligation, using cash either in the ESOP or the company.

The Best, Most Sustainable ESOPs:

4. Have distribution rules which are clear and understood by management & participants.

5. Have adaptable strategies for managing cash flows, stock flows and plan operating rules external to the plan document itself.

5. Have advisory professionals for administration, plan compliance monitoring, valuation and other functions who <u>work together.</u>

Not Optimal: What One Company Did

1. Established an ESOP in 2000, over time acquired 68% of the shares, paid off the ESOP loans, grew to 200 employees.
2. Share price appreciation averaged 40% for six of the next eight years (prosperous defense contractor).
3. Average participant age 49.3, vesting 100% after one year of service and immediate eligibility upon employment.
4. All terminee accounts were converted to cash ("other investments") and recycled in the ESOP after one-year delay for distribution.
5. Valuation mentioned 'repurchase obligations,' but with no projections.
6. Then, after nice years of high earnings and share price appreciation, profits flatten out at a level which could not support the existing ESOP payout policy <u>and</u> capitalize further high levels of growth.

Sustainable?

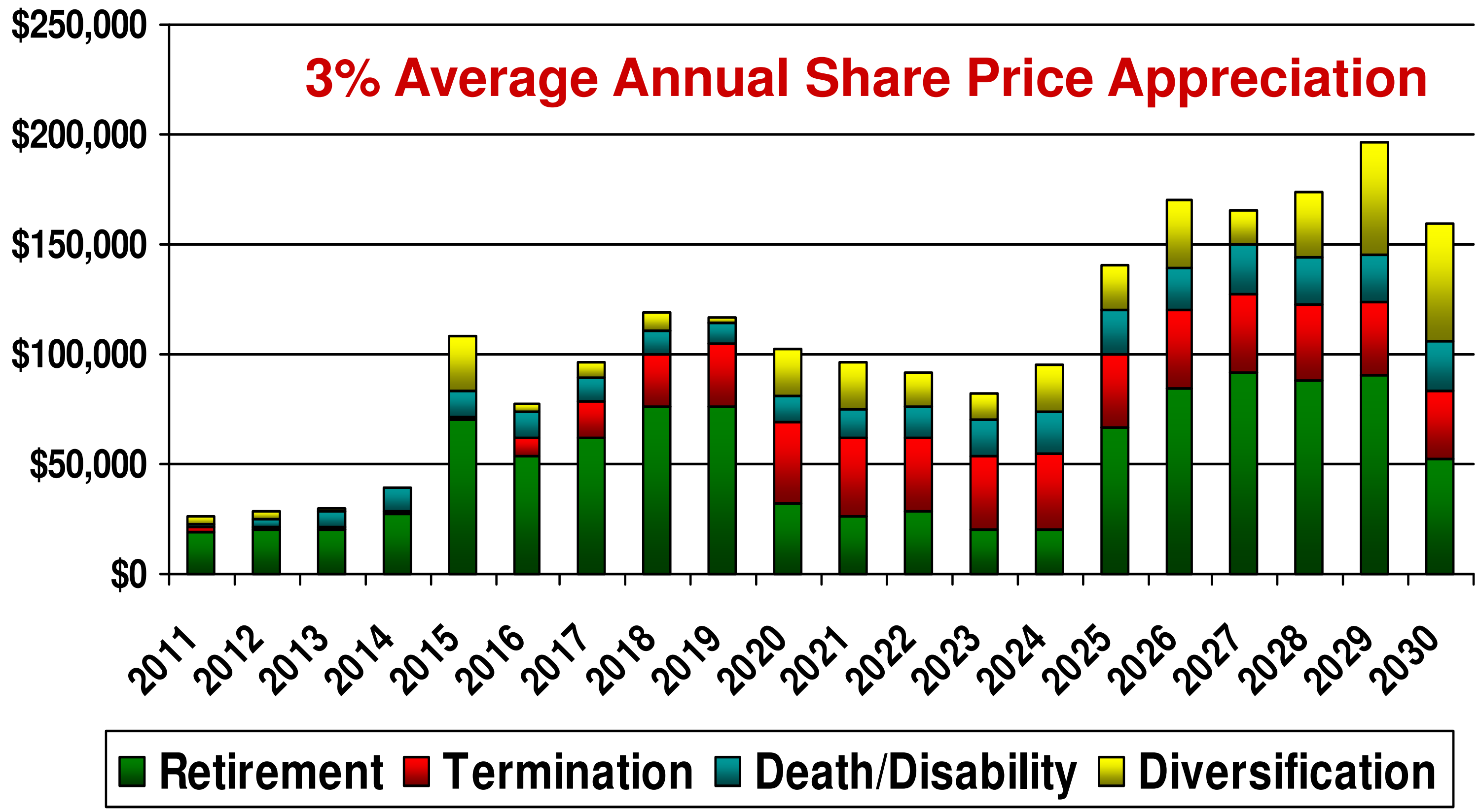
Setting the Stage: Strategies vs. Tactics

1. **The follow two slides show the same company with the same share price appreciation, same actuarial statistics and same recycling of shares in the plan, with only one difference.**

2. **The administrative distribution rules governing payouts from the plan are very restrictive (participant accounts held in stock) in the first case.**

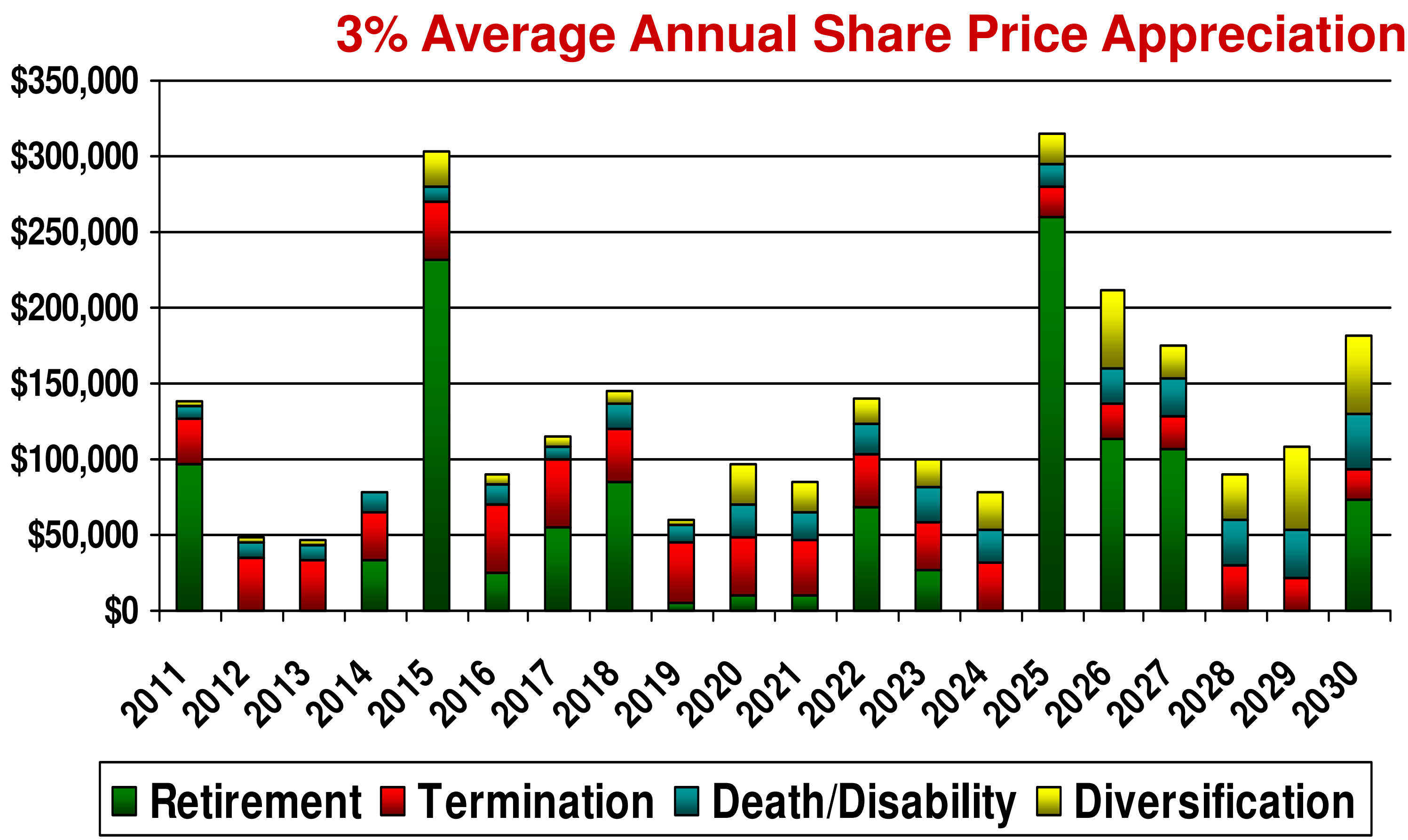
3. **In the second case, all terminee accounts are converted to appropriate "Other Investment Accounts" – thus requiring immediate liquidity.**

Case I: Repurchase Projections with Restrictive Distribution Rules – Delayed Payouts from Accounts Kept in Stock. Shares Recycled in Plan



Maximally Restrictive Distribution Rules

Case II: Same Company, Same Recycling, but With All Terminee Accounts Requiring Immediate Liquidity and Reallocation of the Shares from Terminee Accounts



The Price of Immediate Liquidity

What Is Happening Here? Why the Big Differences?

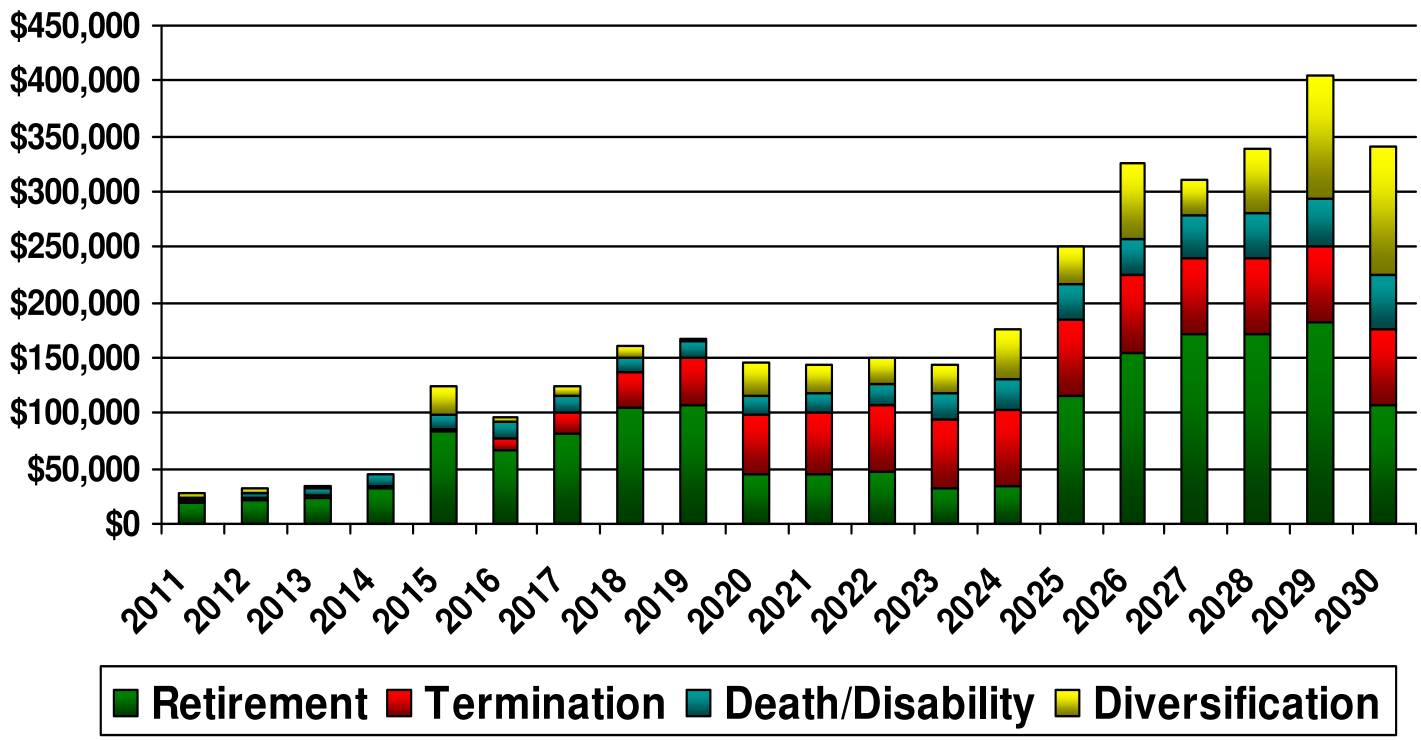
Cumulative Payouts Through Years==>	2015	2020
I. Restrictive Rules 3% Growth Baseline	$ 232,099	$ 743,530
II. Liberal Payouts 3% Growth Baseline	$ 615,155	$ 1,121,222

1. The conversion of stock to other investments means a faster reallocation of shares when stock is recycled in the plan…faster buyback of all shares.
2. This acceleration of the recycle rate can be costly and detrimental to long-term sustainability.
3. When should you have restrictive rules? Liberal rules?

Suppose They Grow at 7%?

(Fast Liquidity Can be Costlier Than High Stock Prices)

Cumulative Payouts Through Years==>	2015	2020
I. Restrictive Rules 3% Growth Baseline	$ 232,099	$ 743,530
II. Liberal Payouts 3% Growth Baseline	$ 615,155	$ 1,121,222
III. Restrictive Rules 7% Growth	$ 262,573	$ 954,552



Definition and Effects of "Share Recycling"

- An exchange of other investments for employer securities so that participants receiving distribution can be paid in the form of cash.
- There is cash in the plan to do this.
- The question is always one of the "recycle rate."
- The faster the rate, the higher the repurchase costs.
- A "slow rate" means accounts held in the form of stock for a longer period or some mechanism to re-allocate slowly.
- ***Financial applicability depends primarily on stock appreciation rate and distribution rules.***

Recycling

- Cash sources
  - – Current year cash contributions or cash allocated in prior years.
  - – Dividends
  - – Earnings

- Disbursement
  - – Checks are written from the ESOP for distributions/withholding.
    - Share count in the plan does not change!

Redemptions

- Redemptions are payments from the corporation to participants to redeem shares allocated in the plan.
  - Reduces the number of shares outstanding.
  - The shares can be contributed back to the Plan at a later date or not.
  - A stock ledger of redemptions should be kept and communicated to the CPA and record keeper each reporting period.

Distribution Policy

- **Managing repurchase liability often requires managing a plan's distribution policy.**
- **Unlike other types of qualified retirement plans, ESOPs are generally permitted to change the timing and form of payouts within certain parameters.**
  - **this allows ESOPs to manage repurchase liability by extending payment terms or limiting lump sum distributions.**

Distribution Policy

- **Consider whether changing a distribution policy is a settlor act or a fiduciary act**
  - **if a fiduciary act, must act *solely* in the best interest of plan participants and beneficiaries**
    - **is managing a company's repurchase liability in the interest of plan participants and beneficiaries?**
    - **Most courts have viewed that managing repurchase liability is an appropriate function of plan fiduciaries**
  - **amending a plan is generally a settlor function, not a fiduciary function.**
  - **conversely, establishment of a Distribution Policy pursuant to the terms of a plan is generally a fiduciary function.**

Fiduciary Concerns for ESOPs

- Prudence on the part of the Board of Directors and the Trustees
- Reshuffling/Rebalancing
- Involuntary Cash Conversions
- Loan Extensions
- Distribution Policies
- S corporation election (not an ESOP vote pass-through issue).

Rebalancing/Reshuffling

- ESOPs may wrestle with "have and have nots"
  - Longer term employees have employer securities, while newer employees (those hired after the debt has been repaid and shares fully allocated) do not have meaningful shares in the company.
- Two techniques for managing the problem:
  - "Rebalancing" - mandatory transfer of employer securities into and out of participant plan accounts, usually on an annual basis, to achieve the same proportion of employer securities in each participant's account.
  - "Reshuffling" - mandatory transfer of employer securities into or out of plan accounts, *not* designed to result in an equal proportion of employer securities in each account.

Rebalancing/Reshuffling

- **IRS approves - provided:**
  - **Plan provisions authorize such actions and have a definitive formula for determining how many shares are rebalanced/reshuffled, how the price at which such transaction will be determined, and to whom the shares are to be allocated.**
  - **Nondiscriminatory formula**
    - **Rebalancing which treats all participants the same is nondiscriminatory.**
    - **involuntary conversions of terminated participants' accounts to cash is nondiscriminatory because terminated participants are viewed separately from active participants.**

Rebalancing/Reshuffling

- Can’t use assets that have been diversified previously for reshuffling or rebalancing.
- Involuntary conversions to cash should afford participants with appropriate investment alternatives.
- Fiduciary concerns with selecting investments.

Second Phase Transactions

- Another approach to the "have and have not" problem is a second phase transaction
  - Company repurchases shares from existing participants and resells them to the ESOP on a leveraged basis, allowing new shares to be allocated to future participants.
- Issue: after the transaction and due to the new debt incurred, share price of employer securities held by the ESOP will decline.
  - Price protection/put options
    - Not second class of stock for S corporation purposes
    - Fiduciary issues?

Second Phase Transaction

- **An alternative which doesn't affect price as drastically is to have the company repurchase the employer securities from the ESOP and re-contribute a portion annually.**
  - Because shares are redeemed and fewer outstanding shares, the debt incurred by the company should not affect price.
  - Dilutive impact of annual contribution of shares will affect stock price minimally if the share contribution matches in value the principal repayment on the debt.

Loan Extension

- Extending a loan can resolve the “have and have not” problem by providing for a longer allocation period.
- It also will spread out repurchase liability.
- Guidance found in DOL Field Assistance Bulletin 2002-1

FAB 2002-1

Loan extension is a fiduciary decision which must consider all facts and circumstances:

1. Must be consistent with the documents and instruments governing the plan,
2. Determine the extent to which an extension is consistent with the reasonable expectations of the plan's participants and beneficiaries.
3. You should focus on the benefits of the refinancing transaction to the plan's participants and beneficiaries.
   – what inducements are given to the trustee for the ESOP participants?
4. must focus on benefits to current participants, not future participants.

S Corporation Election

- S corporation elections have become a very significant way of managing repurchase liability.

- S corporations are not taxed on their income for federal income tax purposes (and for purposes of most state income taxes).
  - income is instead attributed to the shareholders.

- Since an ESOP is a tax-exempt entity, there are no income taxes paid on the ESOP's share of corporate income.
  - These non-taxed funds are retained by the corporation or the ESOP and supply liquidly for satisfying repurchase obligations.

A Couple of Helpful Diagrams

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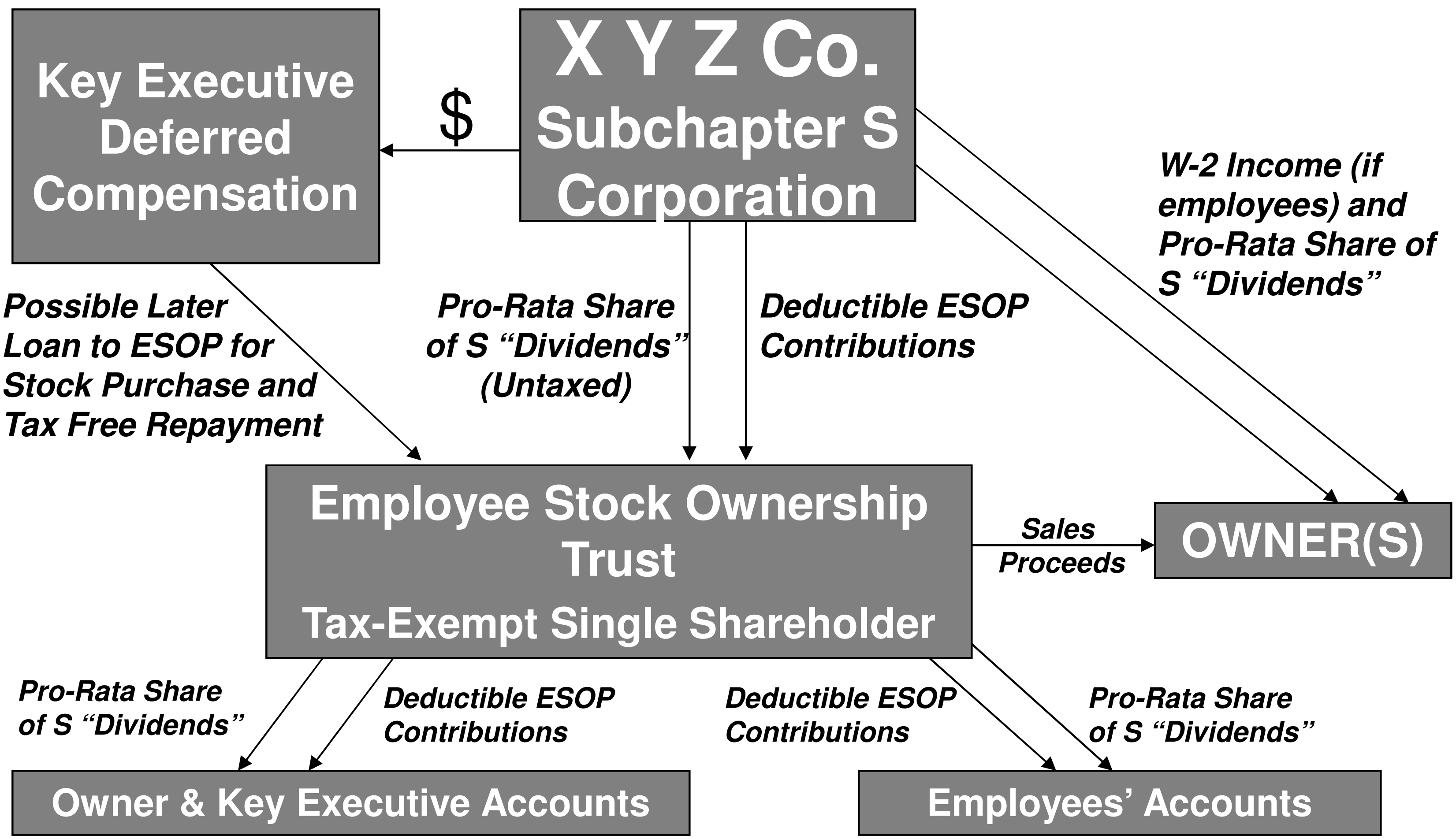
The Subchapter S ESOP

Tax Sheltered Stock Purchases + Build-Up of Key Executive Capital to Support Ownership Transition (Possible 100% Tax-Exempt Operation).

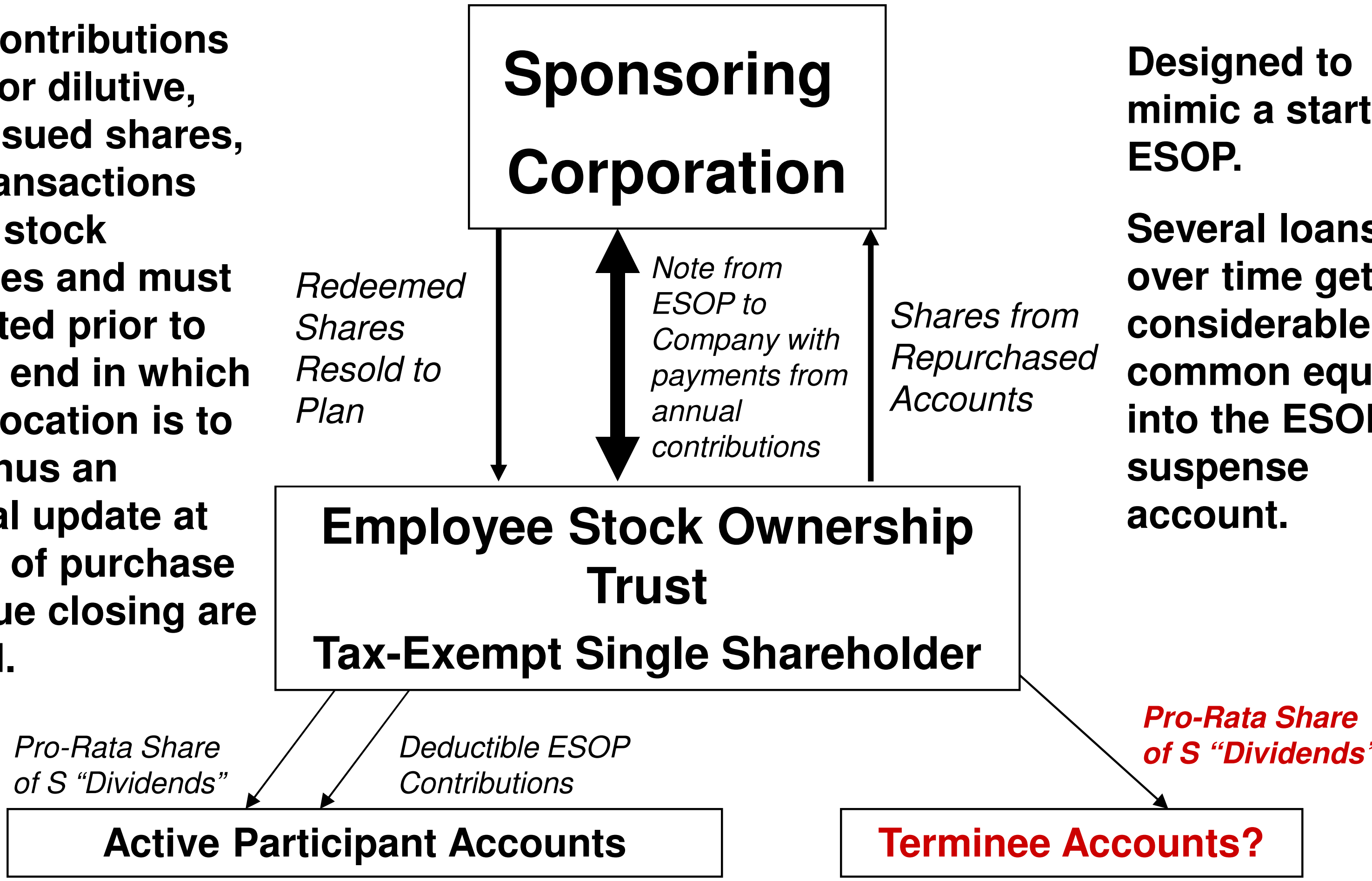


The IRS counts key executive deferred compensation as a type of 'synthetic equity'. This is not typically an issue for well designed plans with over 30 participants. For smaller plans, both the qualified (ESOP) plan and the non-qualified plan often need careful future coordination to comply with this provision of the IRC 409(p) anti-abuse rules.

Dealing with Large Distributions – Avoiding Immediate Allocations Technique for Releveraging Shares into the ESOP

Smoothing the Buybacks and Finding Shares for New Participants

Unlike contributions of cash or dilutive, newly issued shares, these transactions are true stock purchases and must be effected prior to the year end in which the reallocation is to start. Thus an appraisal update at the time of purchase and a true closing are required.



Designed to mimic a start-up ESOP.

Several loans over time get considerable common equity into the ESOP suspense account.

Understanding Releveraging and Possible S Dividend Utilization

Conclusion

- Successful ESOPs have management who educate themselves on optimal strategies for operation of the plan. Deliberate stock and cash flow management is key to balancing the competition for cash between the company and the ESOP.
- The Board of Directors should request formal repurchase liability studies regularly to measure the obligation and plan for future disbursements from the ESOP.
- Periodic evaluations by the Board of distribution policies and procedures should be done to make sure they meet the current needs of the company and the ESOP participants in a coordinated manner to make sure funds are available.

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