ESOP Sustainability: Keeping Your Plan in the Green

Prudent & Strategic Management of Compliance, Fiduciary and Financial Requirements for Mature ESOPS

ESOP Association Tri-Chapter Regional Conference
March 25 – 27, 2012
Pinehurst Resort, North Carolina

Agenda for Our Conversation

A. Companies operating maturing ESOPs already know the basics. Beyond that, there is a real need to understand both the array of operating rules and, most of all, how to <u>coordinate</u> their application.

B. The important issue is the sometime surprising way the factors affecting sustainability interact with each other.

C. We will briefly review the strategies and mechanisms available to maturing ESOPs which can support the optimal financial and 'psychological' health of a plan.

D. The floor is open to questions at any time during our conversation. The 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.

Like Some Golf Pros, ESOPs Don't Always Sustain Performance or Age Well

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

After observing hundreds of ESOP companies over more than two decades, we would note:

1. **Many times corporate officers and managers simply do not know their available options in properly 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. **The cost and complexity of IRS/DOL compliance is increasing.**
4. **And, 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 Concepts

The Best and Most Sustainable ESOPs Should Generally:

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.**
4. **Have distribution rules which are clear and understood by management & participants; flexibility is key.**
5. **Have advisory professionals for administration, plan compliance monitoring, valuation and other functions who <u>work together.</u>**

Not So Green: What One Company Did

1. Established an ESOP in 2000, over time acquired 68% of the shares, paid off the ESOP loans and grew to have 200 employees.
2. Had a share price appreciation which averaged exactly 40% for six of the next eight years (prosperous defense contractor).
3. Had an average participant age of 49.3, a vesting schedule which provided 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. Had a valuation which mentioned the 'repurchase obligations,' but with no definitive projections.
6. And then, after the nice years of high earnings and share price appreciation, they saw the profits flatten out at a level which could not support the existing ESOP payout policy and capitalize further high levels of growth.

Sustainable?

Some 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**

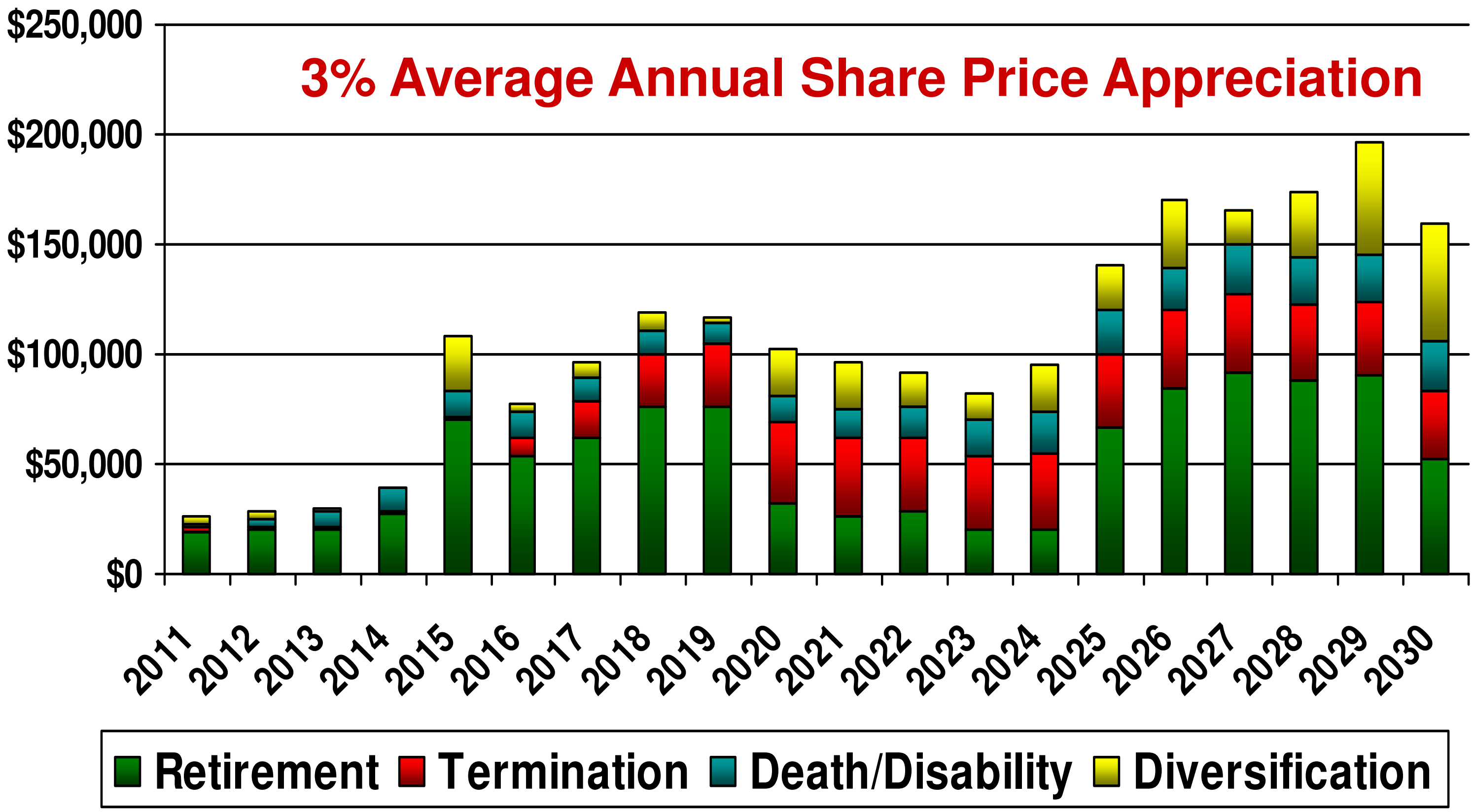
Setting the Stage: Strategies vs. Tactics

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.

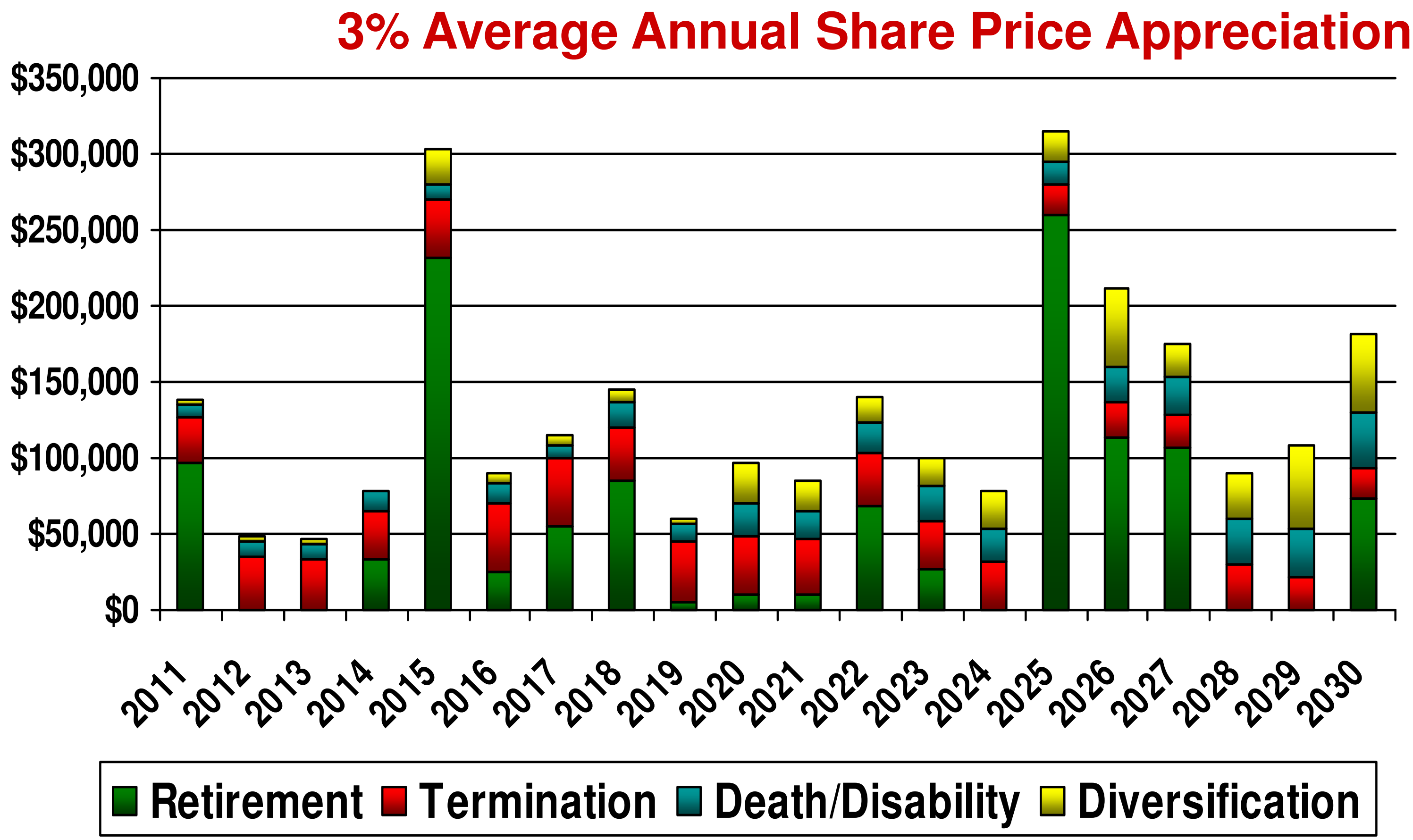
3. In the second case, all terminee accounts are converted to appropriate "Other Investment Accounts" – thus requiring immediate liquidity.

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



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?

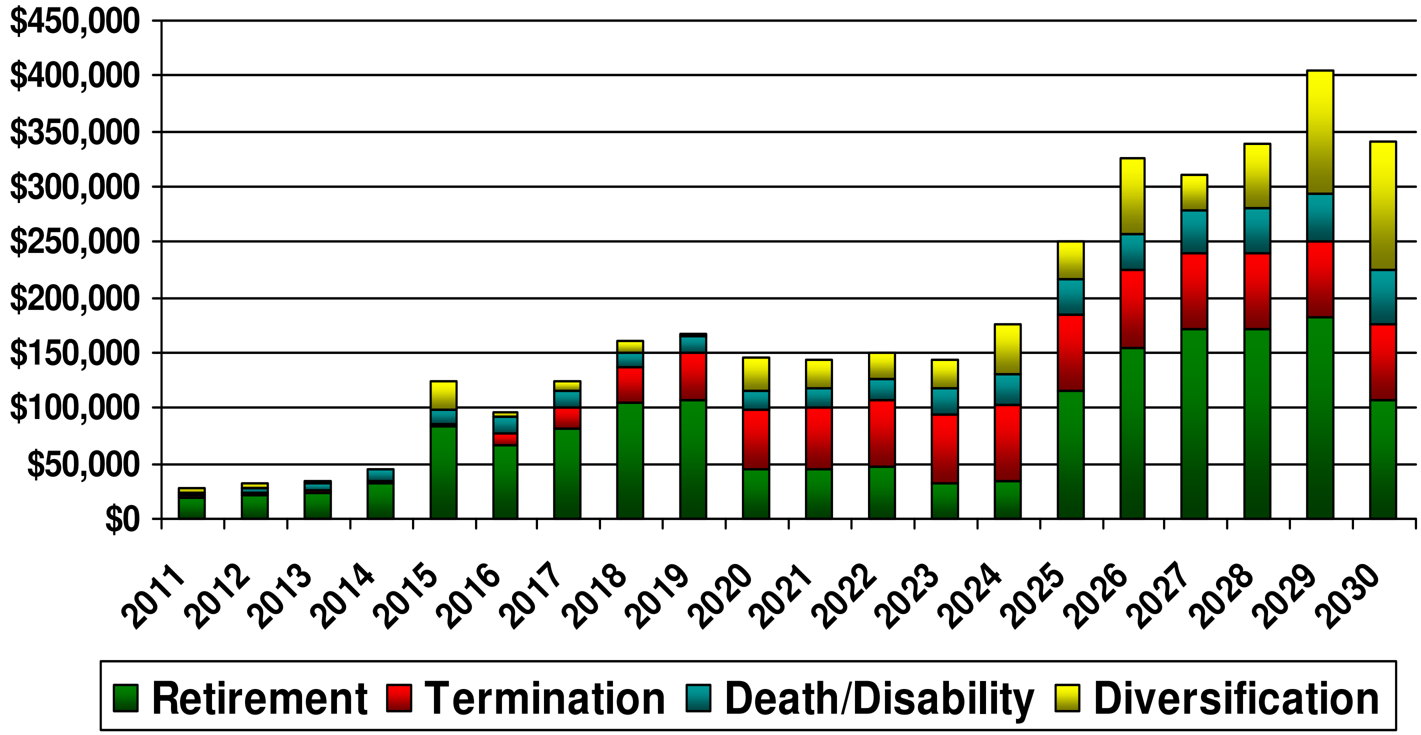
Cumulative Payouts Through Years==>	2015	2020
I. Restrictive Rules 3% Growth Baseline	$ 232,099	$ 743,530
II. Liberal Payouts 3% Growth Baseline	$ 615,155	$ 1,121,222

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 the Recycling Shown in the Graphs

1. Share Recycling in the Plan:

- An exchange of other investments for employer securities so that participants receiving distribution can be paid in the form of cash.
- That means 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.
- But 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.***

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

Principal Challenges to Mature ESOPs from a Legal Perspective

- Fiduciary Concerns
  - Prudence
  - Reshuffling/Rebalancing
  - Involuntary Cash Conversions
  - Loan Extensions
  - Distribution Policies
  - S corporation election

Fiduciary Obligations

- **ERISA's fiduciary duties require:**
  - **operate plan *solely* in the interest of participants and beneficiaries**
  - **for the exclusive purpose of providing benefits and defraying reasonable expenses**
  - **with the care, skill, prudence and diligence of a prudent person *familiar with such matters***
    - **"reasonable expert standard"**
  - **reduce risk by diversifying**
    - **"Employer stock" exception**
  - **in accordance with the plan documents**
  - **trustees <u>and</u> board members are fiduciaries**

Fiduciary vs. Settlor Functions

- ERISA's fiduciary duties do not cover all matters affecting ESOPs, only those which involve plan investments and administration
- Therefore, decisions affecting design of the plan are "settlor" functions as they do not involve administration directly and are not governed by ERISA fiduciary rules

Fiduciary vs. Settlor Functions

- Managing a mature ESOP requires identifying whether a proposed course of action involves settlor functions, not governed by fiduciary obligations, fiduciary obligations or both.

Rebalancing/Reshuffling

- Mature ESOPs often wrestle with a “have and have not” problem
  - 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 popular techniques for managing the “have and have not” problem
  - “Rebalancing” is a 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” is a 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 has informally approved of both these techniques provided:
  - must have plan provisions that authorize such actions and have a definitive formula for determining how many shares are to be rebalanced/reshuffled, how the price at which such transaction will be determined, and to whom the shares are to be allocated
  - the formula must be nondiscriminatory
    - thus 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 on a leveraged basis, allowing new shares to be allocated to future participants.
- Issue: after the transaction and due to the new debt incurred, the per share price of the 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 to leveraging which doesn’t affect price as drastically is to have the company repurchase the employer securities from the ESOP and re-contribute a portion of them 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
- DOL Field Assistance Bulletin 2002-1
  1. Loan extension is a fiduciary decision
  2. Must consider all facts and circumstances
     - consistent with the documents and instruments governing the plan,
     - extent to which such an extension is consistent with the reasonable expectations of the plan's participants and beneficiaries
     - 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?
     - must focus on benefits to current participants, not future participants

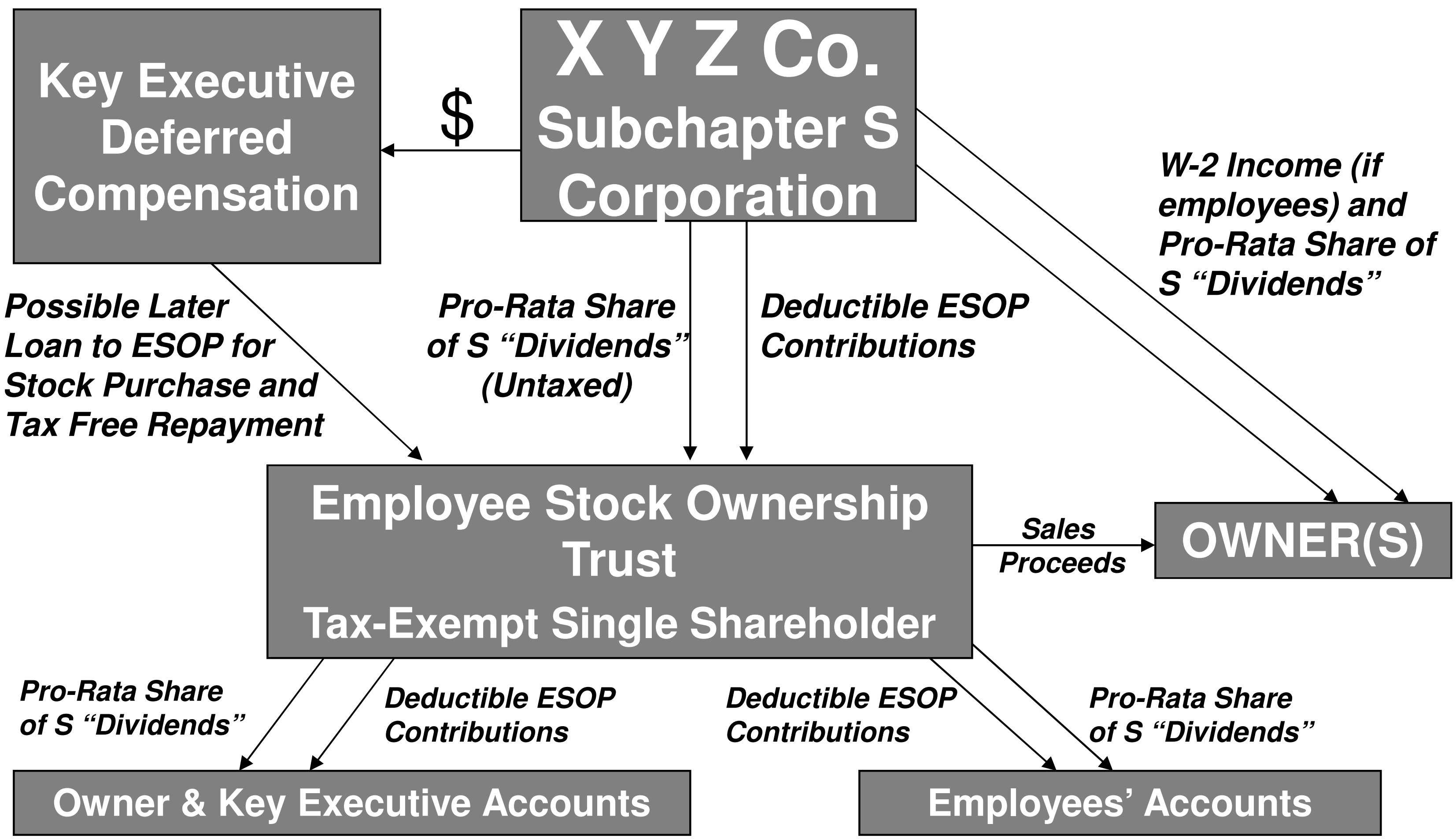
S Corporation Election

- 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

The Subchapter S ESOP

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



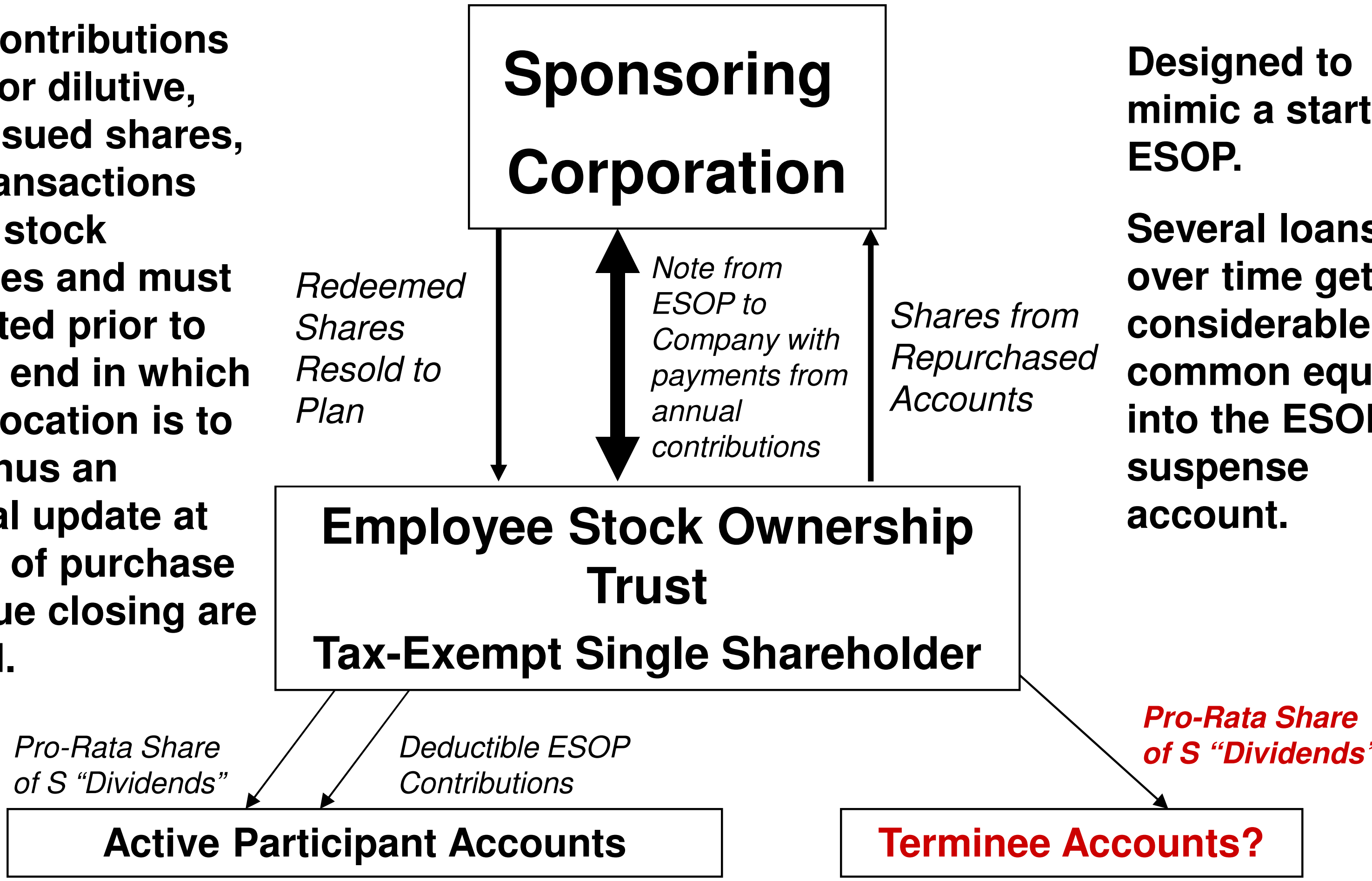
The IRS counts key executive deferred compensation as a type of 'synthetic equity'. This is not typically an issue for well designed plans with over 30 participants. For smaller plans, both the qualified (ESOP) plan and the non-qualified plan often need careful future coordination to comply with this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