Did You Know That...?

Playbook for ESOP design, administration and strategic planning: How <u>not</u> to be a kids' soccer team.

?

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Agenda for Our Conversation

A. **Unsuccessful ESOP teams often make up plays as they go along (think, “Hail Mary” pass). Successful ESOP teams have a pro-active strategy that their team.**

B. **The ESOP operational accounting for participant statements each year is quite complex. Incorrect recordkeeping of plan loans, the identity and cost basis of shares will cause a fumble, perhaps a turnover or defeat.**

C. **Companies operating maturing ESOPs are veteran athletes and know the basics. Still, there is a real need to understand the wide range of strategies to manage both cash and stock flows. This includes techniques to coordinate the funding of the stock repurchase obligations with the corporate finances.**

D. **While most understand the impact of rising or falling share prices on benefits, the effect of distribution policies defining when and how benefits are paid to plan participants is sometimes greater. There are strategies to both benefit participants and protect the company cash flows from overloads or unforeseen costs.**

Did You Know: Like Some NFL 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 are another issue.
3. The cost and complexity of IRS/DOL compliance is increasing.
4. ESOP stock repurchase obligation <u>management</u> is frequently misunderstood. Understanding the repurchase liability will clarify a host of other issues.

Did You Know What Is Key to Sound ESOP Management?

The Best and Most Sustainable ESOPs Should:

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 account balances.
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, repurchase funding and other functions who work together.

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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

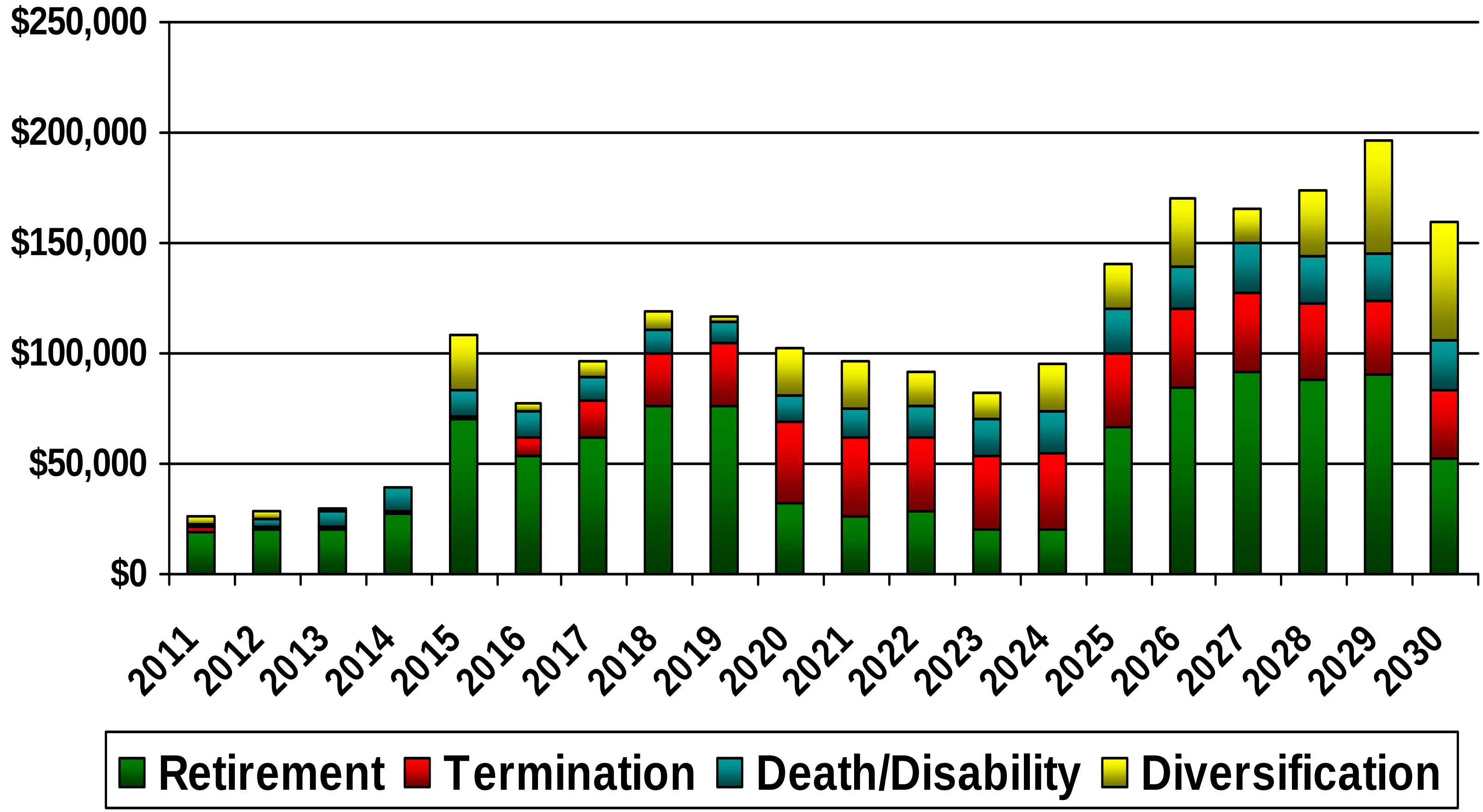
On the Playing Field: Strategies vs. Tactics

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.

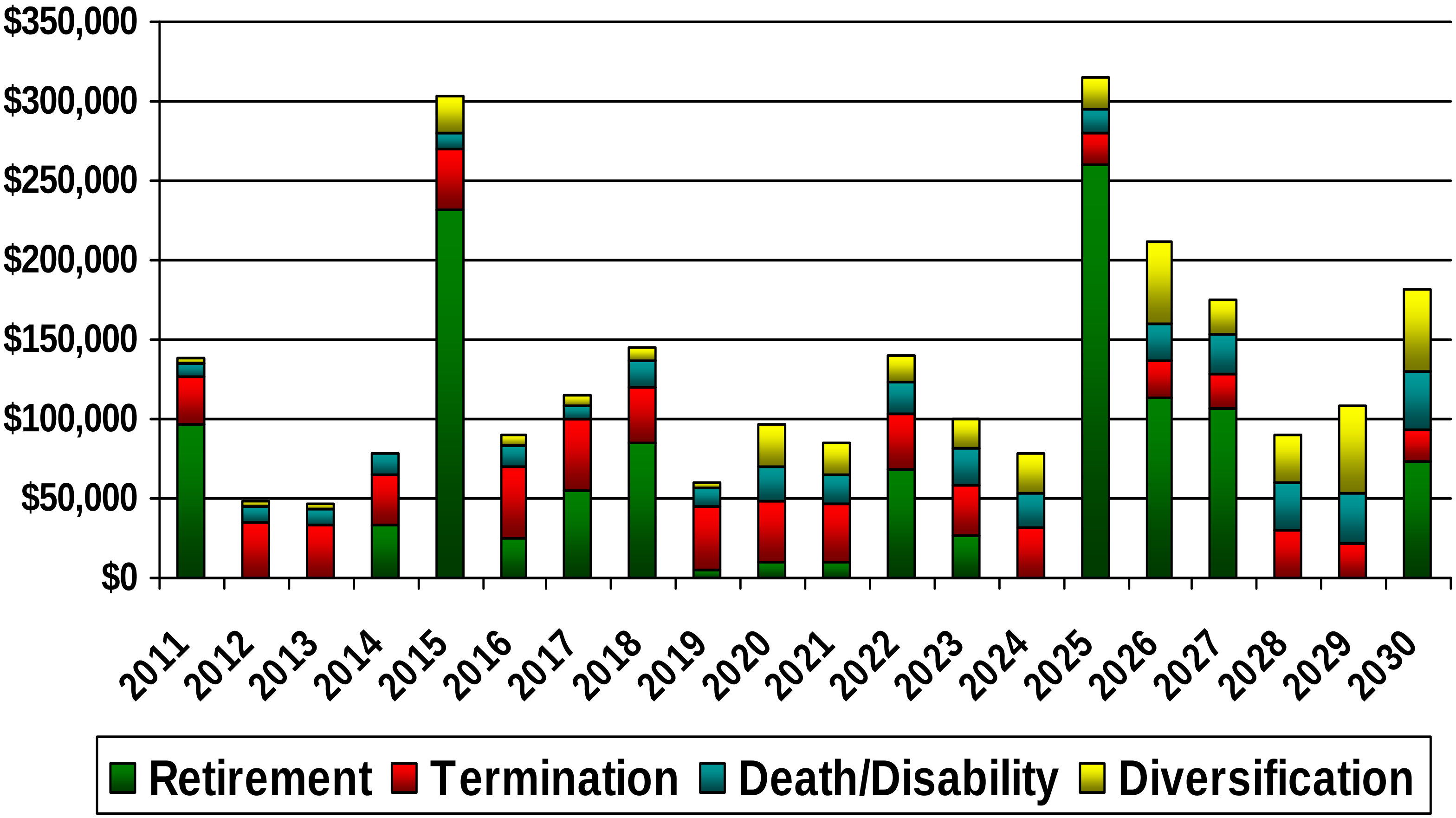
3. In the second case, all terminee accounts are converted to appropriate "Other Investment Accounts" – thus requiring immediate liquidity.

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



<u>Maximally Restrictive Distribution Rules</u>

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?

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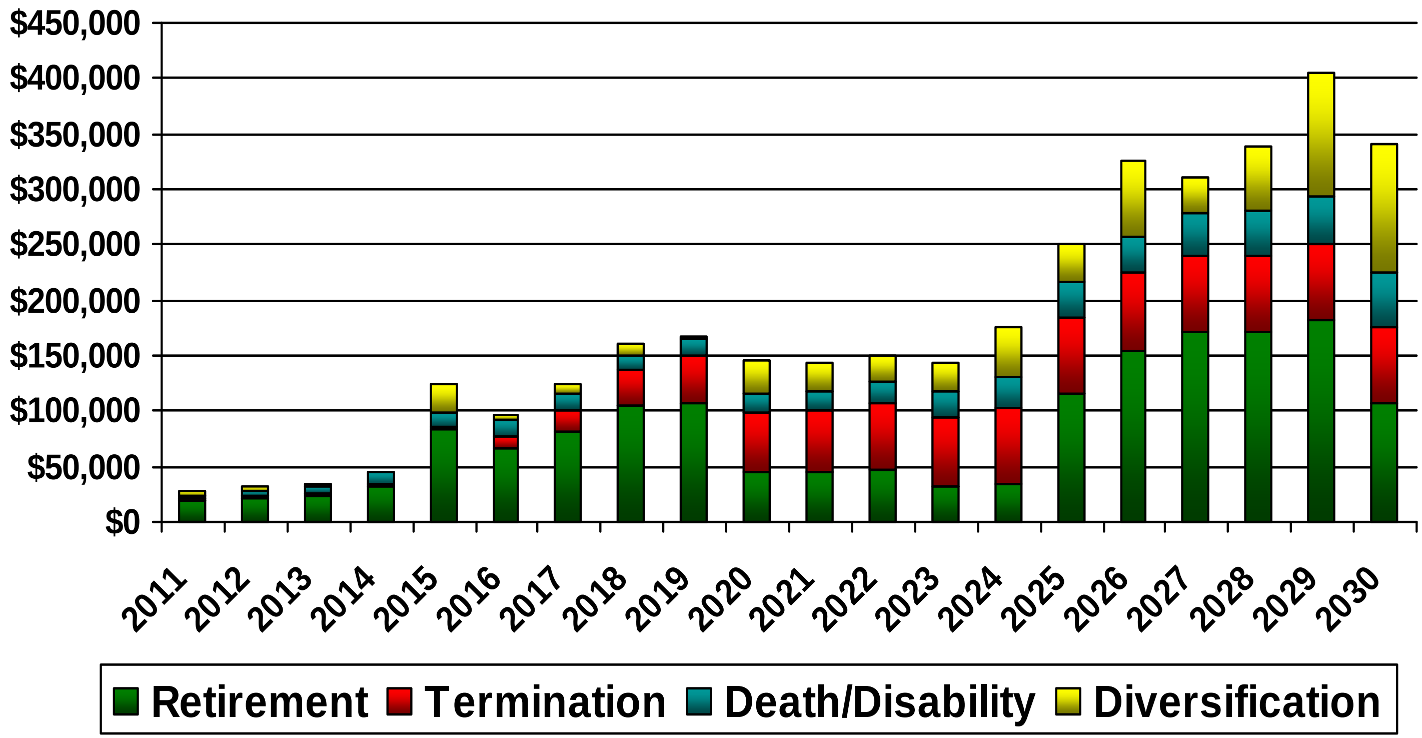
Suppose They Grow at 7%?

(Did You Know: 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.*

Did you Know The Mechanisms for Adjusting Share Accounts in an ESOP?

1. Recycling Shares through the Plan (What Most Do)
2. Rebalancing Shares and Cash in the Plan
3. Expanded Diversification Rights
4. Corporate Redemptions from Departing Participants (Shrink the ESOP? Taxes?)
5. Also, Re-leveraging Shares into the Plan

Share Contributions (Even with 100% ESOP)

1. Contribute Newly Issued Shares
   a) Causes some dilution to previously allocated equity
   b) Consider skewing allocations to newer participants
   c) Shares do not go to terminees
   d) Share price appreciation should justify dilution

Refinancing

1. Releverage the ESOP to buy new shares

   a) ESOP purchases newly issues shares

   b) Loan repaid with regular annual contributions – can be internal loan only between company and ESOP

   c) Impact on previously allocated shares typically dilutes value

   d) “Layering” several loans over many years purchasing new shares can get a significant block of the common equity into a suspense account – balancing “oldies” and “newbies” accounts.

   e) Strategy must be tailored to share price appreciation, valuation, participant expectations, etc.

Did You Know?

The Cost Basis of ESOP Stock?

Why You Must Keep Your Eye on the Ball and Track these Numbers

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Did You Know?

- Cost basis of each share bucket should be tracked:
  - Cost disclosure is required for plan audit
  - Certain participants who receives a ***lump sum*** distribution of stock may be able to get preferential tax treatment on Net Unrealized Appreciation (NUA)

Did You Know?

- *If* an S corporation distributes shares as part of a lump sum distribution, “cost” is ***NOT*** the original historic cost of the shares when acquired by the ESOP

- S corporation cost basis is adjusted annually for NUA reporting purposes

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ESOP Loan Topics

You Probably Know….

- Shares acquired with loan proceeds are held in a Suspense account
- As the ESOP loan is repaid, shares are released from the Suspense account and allocated to participant accounts
- Two share release calculation methods –
  - Principal-Only method
  - Principal and Interest method

Principal Method Example

Principal current year x Suspense = Released Shares
Principal current year
Plus future principal
payments

Example: 100,000 shares in Suspense

$100,000 principal paid/$1,000,000 current + future principal due x 100,000 shares in Suspense =

10,000 shares released

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Did You Know?

- The Company may have borrowed money from a Bank **(outside loan)** and then used those proceeds to make a stock acquisition loan to an ESOP **(inside loan)**
- Term, payment frequencies, interest rates on the inside and outside loans may be different – so the accounting for each needs to be handled separately

Did You Know?

- An IRS Technical Advice Memorandum (TAM) dated 1/5/2010 says:

  "An ESOP contribution or loan repayment may **not** be done as a cashless transaction."

- Focus points for IRS/DOL exams:
  - Loan documents
  - Compliance with repayment terms
  - Accuracy of the share release calculation

Did You Know?

- Loan refinancing, extensions, modifications to repayment terms come under the guidelines of DOL Field Assistance Bulletin 2002-1
- **"Primary benefit rule"** applies
- Employer may need to offer some **inducements** to the plan as consideration for agreeing to loan modifications
- Trustee may require a written proposal

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Did You Know?

- Loan prepayments can cause issues, too!
- Loan documents will specify if repayments are permitted
  - Loan documents may say prepayments are applied to the *last* principal payment due – read the agreements!
  - DOL has raised fairness issue when prepayments are made/shares released right before key employee(s) retire
- DOL may consider deviation from loan repayment terms to be a prohibited transaction.

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Did You Know?

- Examples of different share buckets that should be tracked
  - Initial cash transaction shares
  - Shares from an initial ESOP loan that have been released
  - Shares from a second ESOP loan transaction (you get the idea)
- Reasons for separate tracking
  - Allocation of Dividends/S-Earnings
  - Identification of Cost basis
  - Value test
  - Distribution timing

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How Should You Proceed?

1. As prudent managers and fiduciaries, thoroughly review your ESOP at least twice a year…with competent professionals…be ready for a DOL plan audit.
2. Take the step of estimating the buyback obligations, either through your own HR department or using outside consultants. A repurchase study is typically one of the least expensive things you have to do for your ESOP.
3. <u>Become educated on the strategies available</u> and start some funding program – however minimal.
4. Coordinate the corporate financials and valuation with the (unreported) repurchase obligations in your planning.
5. Be careful to apprise all advisors (TPA, ERISA counsel, consultants, appraiser) of your intentions in a timely fashion.
6. For specific situations, please consult very experienced, and where appropriate, licensed practitioners. Folks who have been-there-done-that are invaluable.

Thank You!

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