# A Few Pages on ESOP Stock Repurchase Obligations

(How to think about funding and managing long-term buyback liabilities)

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## First, a Cautionary Tale:

The call came from a concerned Board member of company with a 10-year old ESOP. After many years of average share price appreciation in the 5% to 10% range, the appraiser said their surprising 50% jump in earnings and better outlook would cause a 23% jump in stock value in the current year. With about 15% of all shares in terminee accounts and the ESOP loan long repaid, the increase would mean the \$1,000,000 in terminee accounts would grow more than \$200,000. The company had not converted terminee accounts to prudent cash investments and their Sub S status meant some additional earnings on shares (which the company planned to distribute) would flow to the terminees.

Rather than make a gift of \$230,000 to former participant accounts, we advised the Board to issue new shares (which the terminees would not receive) to their 80% ESOP, sufficient for the new stock contribution to result in: 1) A plan addition for new and current participants and, 2) A share price appreciation of 5% (instead of 23%) on all stock due to the dilution. The increase in the overall repurchase liability reflected in the new analysis showed the net present value of the buyback obligation was lower than before. The savings would not have occurred had the Trustees and the Board not thought to ask the question: "What are all our options as prudent fiduciaries?" This short-term tactic later was part of a longer-term strategy which goes beyond the scope of these notes. Suffice it to say that the ESOP obligations are now being managed and funded with due consideration for fiduciary prudence and corporate funds flows.

<u>Every case is different</u>. Some companies may need to leverage newly-issued shares into the plan; others may need to consider corporate redemptions; other new plans may just hold some cash. They all need to measure and understand the management of the buyback obligations.

### **Basic Considerations**

Employee stock ownership plans, as creatures of both the IRS tax code and Department of Labor regulations, typically provide exceptional tax favors and employee benefits. There is a price to pay, however. Sponsors of these plans have committed company stock to a tax-qualified profit-sharing plan. Thus, there is an obligation to cash out vested participants when they meet the plan distribution requirements, generally at retirement. Besides retirements, there are payouts for death, disability, vested terminations, and the ESOP diversification election.

Some of the issues for plan sponsors dealing with these long-term, emerging costs are:

 The obligation is real, but is actuarially determined and is not reflected in the company financials under Generally Accepted Accounting Principles (GAAP). There is no requirement to do so, even when the repurchase costs are high.

- Proper ESOP management requires that financial officers understand and manage not
  just cash flows, but stock flows in light of the requirements of fiduciary prudence to
  operate the plan for the exclusive benefit of the participants. While there is no guarantee
  that stock value will rise, fiduciaries must show they have acted in the best interests of the
  participants.
- We tend to agree with a December 2006 note in the newsletter of the National Center for Employee Ownership (<u>www.nceo.org</u>) that most ESOP valuations have not really addressed the impact of the repurchase costs on value: i.e. the value may be overstated.

That said, there is obviously a lot of room for interplay between the major variables affecting the financial health of the plan and its sponsor:

- 1. The independent ESOP stock valuation (often a multiple of a 'representative earnings base' earnings which are themselves impacted by the repurchase liability);
- 2. The ways a company spends its discretionary funds (key executive plans and possible sinking funds for ESOP stock buybacks, for instance) obviously affect value and the resulting buyback liability;
- 3. The direction of various stock flows, e.g. dilutive new share issues to the plan, repurchases of stock into the plan, or back into treasury (counter-dilutive); and
- 4. The plan distribution rules and administrative policies governing the way payments are made to former participants.

This summary is not designed to detail the many, and sometimes very creative, strategies which can coordinate these variables to keep a plan and its sponsor in the best financial position. A good ESOP repurchase study will help here (and, incidentally, represent important documentation of prudence on the part of the fiduciaries): It should not just measure the projected costs, but examine financial strategies for funding and cost containment. Our goal here is to bring a little strategic clarity to the governing philosophy which should inform the fiduciaries (Board of Directors and Trustees) responsible for an ESOP over the long term.

The central questions to address are:

- 1. Should the ESOP stock accounts subject the participants to the same risk in their retirement plan as the equity risk for outside stakeholders (as is the case when the ESOP relies entirely on current cash flows or has "buy-sell" funding roughly equivalent to that for other shareholders)?
- 2. If not, how should the risk be mitigated?
- 3. How does risk mitigation tie into repurchase funding and prudent fiduciary management of the plan?

When formulating the operational considerations for a retirement plan holding company stock under the direction of plan fiduciaries, the top-down list would be:

• The Risk  $\Leftrightarrow$  Reward trade-off is the one marriage that will never divorce in the world of capital...a simple law of financial physics. The stock in an ESOP retirement program should not, if possible, expose the participant accounts to the very same risk as an unfunded buy-sell for the non-ESOP shareholders.

- This implies some funding for the plan liabilities to reduce the risk of impaired payment ability (obviously, an ESOP fully funded with cash would represent nearly zero risk but then, that wouldn't be an ESOP). If there is cash beyond working capital needs in the plan or on the balance sheet, then the risk of an account not being paid out is reduced.
- The real issue is the Risk  $\Leftrightarrow$  Reward balance. There is a kind of competition for capital between the goals of: 1) Supporting the ESOP, and 2) Growing the company. At the extremes, the ESOP could either bear the same risk as non-ESOP shareholders and rely entirely on current cash flow/leverage to handle stock purchases...or...all the available funds could be directed to supporting the plan, reducing the risk greatly. This could compromise growth or even the company itself. Prudent fiduciaries should land in the middle of this 'bell curve.'

Since the planning time horizons extend out over a decade and many long-term estimates show large numbers, the bulk of the funding will come from current cash flows and the ability to leverage, if the costs grow very large. The purpose of any pre-funding over that long a timeline should be to accumulate sufficient dollars to handle part of the obligation, for example, a couple of years of the largest estimated obligations in the next decade or so.

#### Some basic recommendations:

- 1. Fiduciary prudence requires that the directors do something to measure, fund, and diversify some of the risk inherent in the long term buyback obligations. Run the repurchase analyses for a set of various financial and benefit inputs to understand the sensitivity of the long term payouts to factors the company can control.
- 2. To achieve some balance in the above 'competition for capital' and demonstrate fiduciary prudence, the Trustees should have their valuation firm provide some estimates of the effect of various set-aside amounts for the ESOP buybacks on the ESOP share price. No decision should be made without knowing that approximate range.
- 3. Coordinate corporate pro-formas with ESOP repurchase studies again, have the valuation firm at least aware of the costs; many appraisers will adjust the lack of marketability discount (deeper discounting) for the stock appraisal to better take the repurchase obligation into account.
- 4. Don't rely on single-solution financial product providers for the answers, for example, stockbrokers or life-insurance agents for whom mutual funds or insurance is always the answer, irrespective of the question.
- 5. And, do start the funding, even with just a small amount. Whether on the balance sheet or in the plan depends on many factors like corporate taxes, age of the plan, etc. But save something. Note that you can 'save' some money in key executive plans which the key players can receive if the buybacks are covered, or which can be used to pay the obligations if cash flows are light.

## How to Fund the Obligations?

This question is the topic of entire booklets by the professional ESOP associations, but a few points should be noted.

Contributions of cash to the plan are deductible and fine in the early years of an ESOP when attrition of the trust assets due to retirements and other payouts is small. In later years, excess cash in a plan can result in a 'bleeding ESOP,' i.e. one that bleeds cash – some of the cash in participant accounts is paid out without ever buying a share of stock.

- 1. To reduce the 'bleeding ESOP' effect where a plan sees some attrition of cash from dollars contributed in a profit-sharing mode, companies with mature ESOPs are often better served by keeping the cash on the balance sheet under corporate control for a variety of reasons even with the taxation triggered by retaining earnings. The bleeding effect can be exacerbated by IRC §409(p) anti-abuse rules for Sub S ESOPs.
- Cash efficient, corporately-owned life insurance can be a good idea: in the interest of
  assuring that the policies will stay in force, it is helpful to have a permanent insurance
  product with cash accumulation which could be invaded to help with buyback obligations
  or pay premiums. Insurance should always be owned <u>outside</u> the ESOP.
- 3. Fiduciaries of ESOPs have a need to look at planning timeframes extending well beyond a decade for a larger population of 'stockholders,' (the participants having a beneficial interest in the plan are not truly shareholders the shareholders are the ESOP Trustee(s). Once they have taken the essential step of estimating the future liabilities, they have to consider the effect of mortality/morbidity on ESOP payouts especially for the larger accounts of the highly compensated.
- 4. If there is high anticipated growth, for example, 12% for the next few years, rather than have higher buyback obligations consume more cash, set some dollars aside for the liability. This set-aside could result in a reduction from 12% average annual share price appreciation (to perhaps 10%) in future years, especially if this funding was coordinated with a key executive program. That means that the 10% is a less risky growth rate due to the funding.

I once asked some ESOP participants: "If setting money aside for your ESOP payout caused the share price to suffer from slightly slower growth, would you rather do that – or go for higher price appreciation and rely on the company current cash flows and borrowing when the time comes?" Nearly all rank-and-file folks said they preferred greater funding of the plan, even if the appreciation was 8% versus double digits. Some executives (about the top half) were of the go-for-broke school. The difference was that for the top end of the scale, the ESOP was 'risk capital,' while the worker bees were grateful for the stock, but a bit wary of 'risk capital' in their retirement plan. Both views are understandable, but fiduciaries should look out for participant interests.

We are advising clients to get ahead of the stock repurchase curve over the next several years by prudent, and hopefully increased, funding. Some alphabet agency or organization (DOL, IRS, AICPA) might actually say something about this in the next decade or two – and it might not be pretty for 'unfunded' ESOPs.

This general summary is not exhaustive and should not be construed as legal, accounting, valuation or investment counsel; it is based on rules in effect in 2012 and is intended for educational discussion purposes only.

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