



ESOP Check-Up: Evaluating How an ESOP is Working



Robert F. Schatz
ESOP Plus®

Schatz Brown Glassman LLP



Lisa J. Tilley, CPA
Corporate Capital Resources



Gregory J. Hogan, ASA
SC&H Capital

Areas of Consideration

Plan sponsors and fiduciaries have an obligation to continually monitor ESOP operations to make sure the plan is being operated for the exclusive benefit of the plan participants and meeting all regulations and current corporate strategic objectives.

Particular areas of responsibility include:

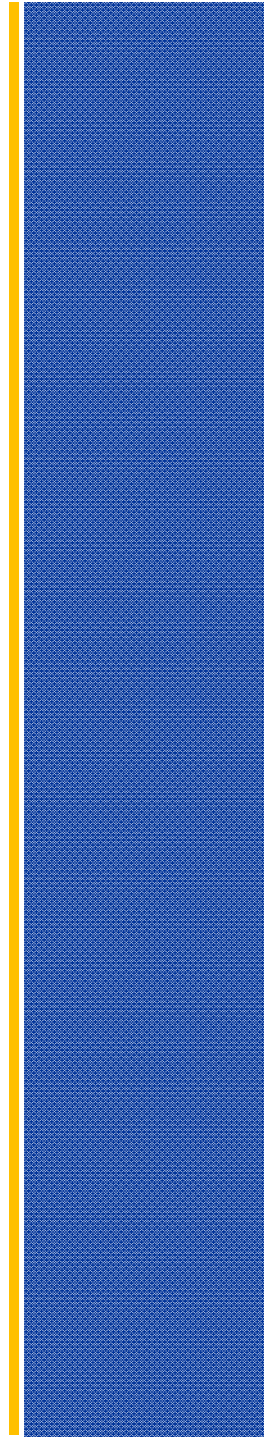
- Legal Compliance
- Valuation Related Items
- Employee Benefit Levels and education/communication
- ESOP Administration



ESOP Check-up: Legal

Robert F. Schatz

ESOP Plus®: Schatz Brown Glassman LLP



Overview: Legal Check Up

- Are Your ESOP Plan Documents in Compliance with Law?
- Are You Operating Your ESOP Consistent With Your Plan Documents?
- Is Your ESOP Exempt Loan in Compliance With Law and Regulations?
- Are You Reviewing Your Advisors' Services and Fees?

Legal Compliance

Notice 2015-84: List of Cumulative Changes

- E.g., DOMA: “Husband,” “Wife” and “Spouse” includes an individual legally married under state Law to a person of the same sex
- Your Company’s counsel should be monitoring the changes in ERISA and tax laws applicable to your Plan
- Seek advice regarding future compliance (post-2017) when Determination Letters for Plan restatements are no longer available (Note: Determination Letter applications on initial qualification and qualification upon Plan termination can be submitted)

A close-up photograph of a person's hands writing on a white document. The person is wearing a light blue, long-sleeved button-down shirt. They are holding a silver and black pen in their right hand, writing on the paper. Their left hand is resting on the document. The background is blurred, showing what appears to be a wooden chair back. The overall image has a soft, slightly desaturated color palette.

Are you operating consistent with your plan documents?

Operations

Most common issues:

1

Compensation

Is the TPA using correct wages? Is inclusion of overtime & bonuses discriminatory?

2

Contributions

S-Corps- 25% limitation includes interest

3

Allocations

If ESOP stock is purchased in stages, is the TPA maintaining separate stock accounts?

Operations

4

Vesting

Are “years of service” being calculated consistent with the Plan definition?

5

Distributions

Are shares redeemed from the ESOP based on updated appraisal?

6

Diversification

Calculated incorrectly (or not at all)

7

S-Corporation ESOPs

“Synthetic Equity” granted without “abuse avoidance” testing (NOTE: Cannot be fixed retroactively)

Operations

Mature ESOP Issues:

- Do you have an updated repurchase liability study?
- Have you analyzed benefit levels and available options?
 - Changes to distribution policy
 - Renegotiation of “Internal Loan” term
 - “Releveraging”
 - Segregation
 - Should diversification be made more liberal?
- Is the Company/ESOP effectively dealing with “have” and “have not” issues?

Exempt Loans – Common Pitfalls

Loan Documents:

- Acceleration of payment in full upon default
- Payment of legal fees and collection costs by ESOP
- Over collateralized – leveraged & non-leveraged shares
- Stock Release Calculation/Inconsistent provisions in Loan Agreement and Pledge Agreement

Purchase/Redemption Transactions

- Initial and/or redemption price exceeds “adequate consideration”
- ESOP note issued is in excess of a reasonable rate of Interest; transaction as a whole fails fairness test.

Insurance Coverage

Board Members and Trustees are Fiduciaries under ERISA and may become personally liable for a breach of fiduciary duty.

Fiduciary liability insurance

- Directors & Officers (D&O) and Employment Practices Liability (EPL) coverage is not sufficient.
- Fiduciary Liability Coverage may be a part of existing Commercial & General Liability Coverage.
- If not a part of your existing CGL coverage, a separate policy is required.

Insurance Coverage

How much coverage is enough?

- Many policies limit coverage to \$1 Million, on a “claims made” (not “claims incurred”) basis
- Is 30% – 40% of asset value sufficient?
- How much can you afford?
- Is fiduciary coverage separate or is shared with other coverage for limit purposes?

Advisors Services and Fees

Vendor Fee Disclosure to plan sponsor required when ESOP pays service providers from plan assets

- Covered Service Provider = Service Provider that enters into a contract with a covered plan and reasonably expects to receive at least \$1,000 in total direct and indirect compensation for its services
- Basic Rule: Use of plan assets to pay service providers is not a “prohibited transaction” if:
 - Contract or arrangement is a reasonable arrangement
 - Services provided are necessary for plan operation
 - No more than reasonable compensation is paid for the services

Advisors Services and Fees

Best Practices: Establish an objective review process to periodically review your service providers services and fees.

- Analyze for conflicts of interest among service providers
- “Benchmarking” – Compare competitor services and costs
- Analyze both direct compensation and 3rd party “indirect” compensation, if any (e.g., Trustee’s receipt of “float” re distributions and TPA “revenue sharing” re: KSOP mutual fund investments)
- Review scope and quality of the services to be delivered and reasonableness of the fees in relation to the services provided (e.g., consider periodic “peer review” of valuation)

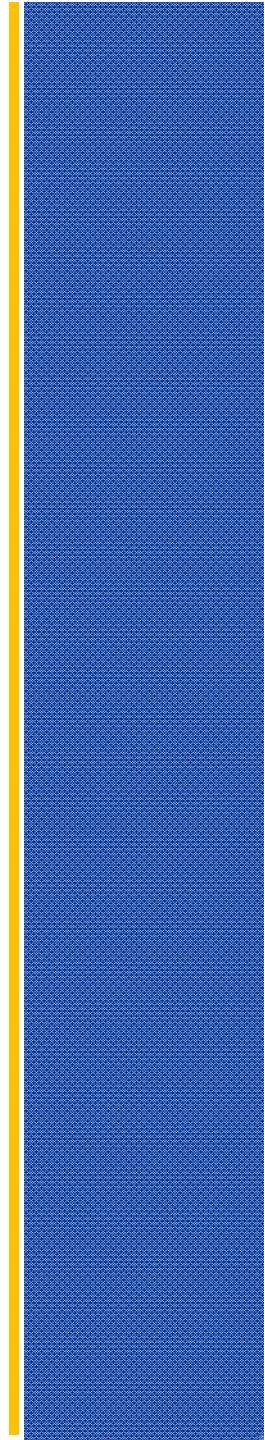
Advisors Services and Fees

- Disclosure of fees to ESOP participants may be required if the ESOP includes participant-directed investments (e.g., segregation of participant accounts or diversification payments going to investment options in the ESOP rather than going to another qualified plan (e.g., a 401(k) plan).
- Summary: The duty to monitor, negotiate and minimize expenses applies to any plan which uses plan funds to pay for services. Typically, but not always, ESOP expenses are not paid by or from the plan, but by the employer. Nevertheless, a regular review of plan expenses is part of prudent fiduciary process.



ESOP Check-up: Valuation

Gregory J. Hogan, ASA
SC&H Capital



Post-Transaction

- Have all transaction elements been addressed?
 - Retention SARs
 - Performance SARs
 - Warrants
 - Earn-outs
 - Performance bonuses

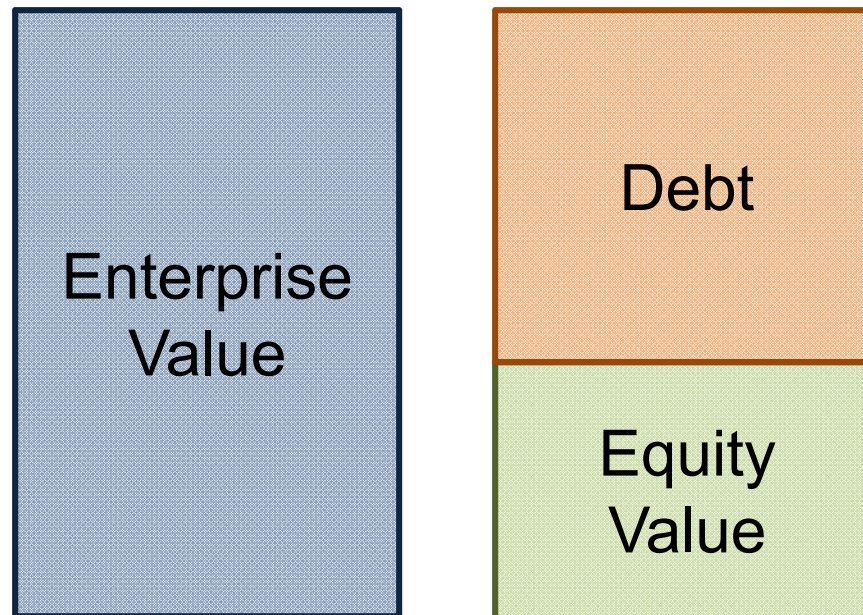
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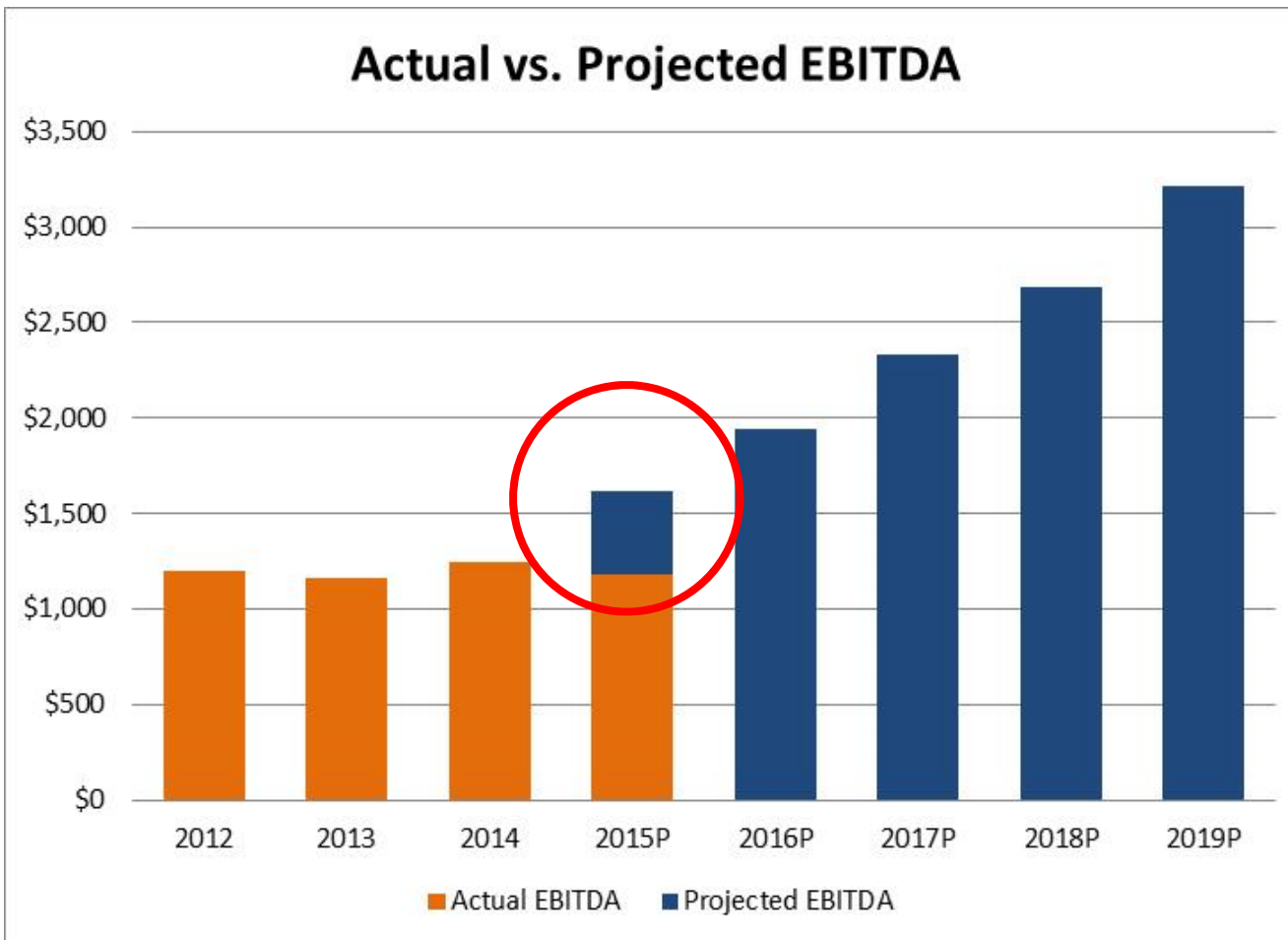
Post-Transaction Change in Value

- Enterprise value
- Equity value



Measuring Performance

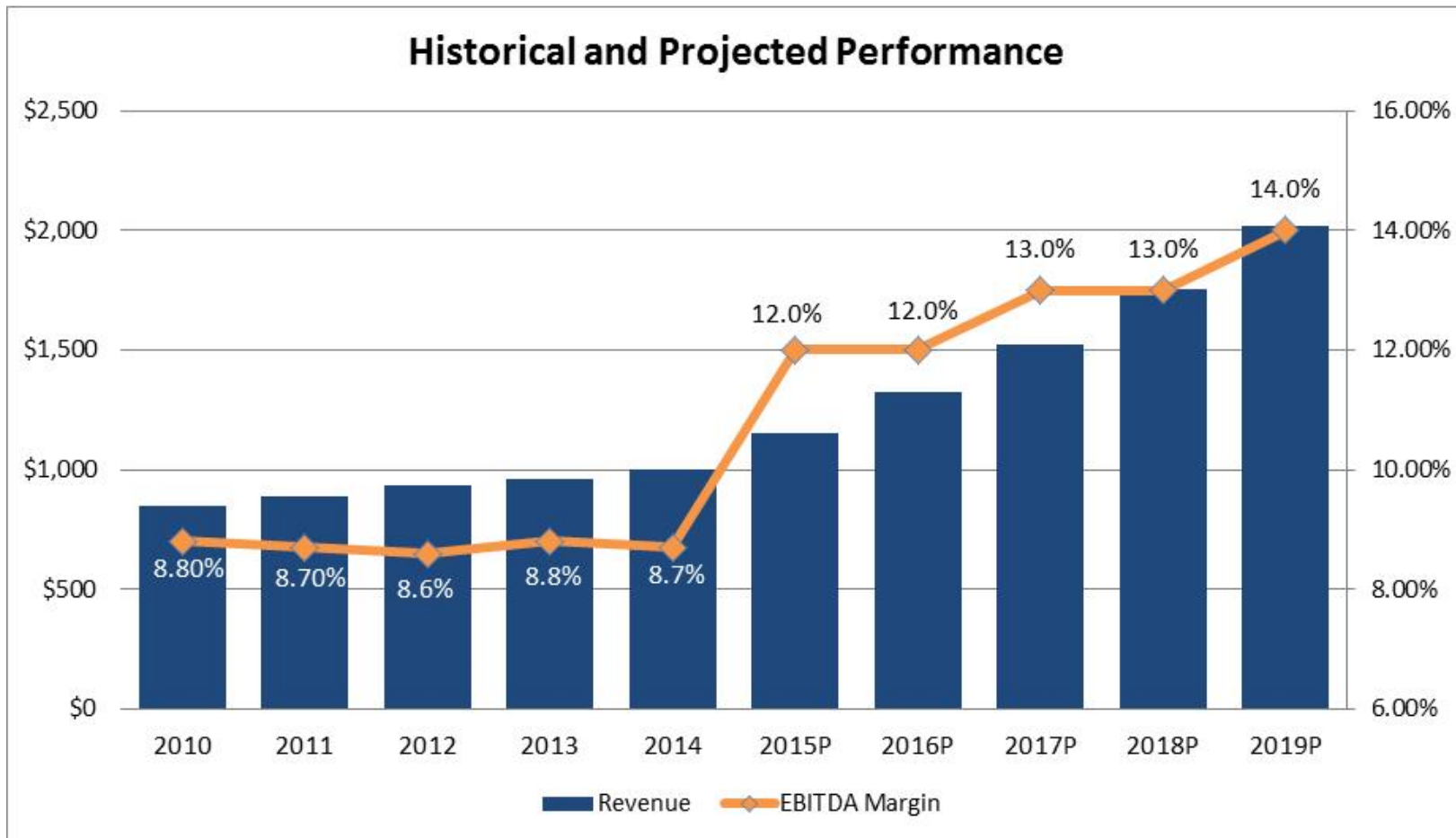
- How did the company perform against projections?



Understanding Projections

- Provide the most realistic projections possible
- ✓ DO provide backlog/sales report support
- ✓ DO provide detailed expense projections
- ✗ DON'T provide management goal budgets
- ✗ DON'T be overly conservative or aggressive

Understanding Projections



Consistency

- ESOP valuations should be prepared relatively consistently year-over-year:
 - Financial statement adjustments
 - Methods considered
 - Discount rate
 - Public comparable companies
 - Comparable transactions
 - Equity adjustments

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Impact on Employee Benefits

- Stock value may result in benefits that are higher or lower than target benefits

High Value

- Impacts Repurchase Obligation
- May set unrealistic benefit level precedent
- May impact ability to consider offer to be acquired

Low Value

- Poor employee morale
- Impact employee retention
- May need to supplement with alternate form of compensation

Administrative Processes

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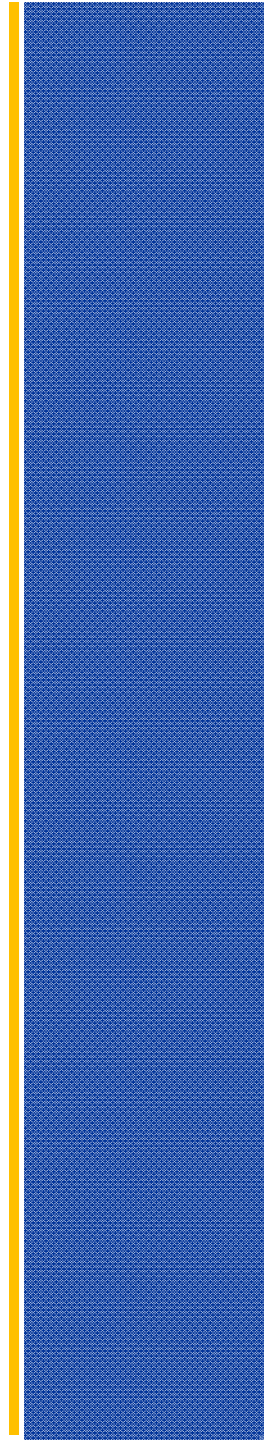
- Establish the proper processes
 - Exchange of information between appraiser, accountant, and Third Party Administrator
 - Release forms to protect confidentiality
 - Trustee valuation review process
 - Employee communication strategy
 - Review of compliance testing (409P issues, plan audit review, etc.)





ESOP Check-up: ESOP Operations

Lisa J. Tilley, CPA
Corporate Capital Resources



Benefit Levels

How do the annual additions to the ESOP compare to national averages for employer funded retirement benefits in the United States? In the region?

For this computation and comparison, annual additions include:

- Contributions
- Dividends or distributions of S-earnings
- Share appreciation
- Forfeitures

Proven ESOP Benefits

NCEO Studies over many years now show clear and compelling ESOP benefits:

1

ESOP participants have better job security

Layoffs in ESOP companies are only 1/4 – 1/3 of the layoffs in non-ESOP companies.

2

Higher rate of return

The aggregate rate of return from 1996 to 2010 for plans with over 100 participants was 6.9% for all ESOP (7.8% for leveraged ESOPs), while it was 5.8% for 401(k) plans.

The most successful ESOPs are in S Corporations.

Proven ESOP Benefits

3

Company dollars at work

Unlike 401(k) plans, the overwhelming bulk of the money in ESOPs is not employee deferrals, but company dollars.

4

Larger retirement accounts

In a study of retirement plans, it was found that ESOP accounts are about 2.2 times larger than for other comparable non-ESOP company defined contribution plans.

Benefit Levels

While employer contributions to retirement plans have been improving in the last two years, ESOP companies typically benefit the employee at a higher level.

Many ESOP companies sponsor a 401(k) plan as well and coordination of benefits is recommended.

Benefit level too high?

- Create an unsustainable expectation
- In early leveraged years communicate the high levels are for only for a period of time

Benefit level too low?

- Incentive for optimum individual performance lost
- Employees retire unhappy or worse yet, exit early for other opportunities

Benefit Levels

Who is receiving the benefits in the ESOP?

- In mature ESOPs, Dividends and S-distributions benefit those who have shares allocated to them already, avoiding accidental skewing of benefits.
- The IRS requires contributions be made to the ESOP (profit sharing) portion of the plan regularly, but is not required annually. Funding the ESOP with Dividends or S-distributions of earnings alone is not compliant.

Employee Communication

Required Communications:

- Summary Plan Description (SPD)
- Annual benefit statement
- Summary Annual Report (SAR)

Are these required documents enough to effectively communicate employee ownership and serve as an incentive for enhanced performance?

At times, employees have a tight grasp on employee ownership and how stock value correlates to individual and combined employee efforts and performance.

At other times, some employees do not fully understand employee ownership and its benefits.

Employee Communication

Talk to your people honestly, openly, and timely.

Employee ownership cultures are developed – it is a process not an event.

Are the goals of the program really being achieved if some employees still don't get it?

Consider hiring an outside consultant to assist with employee meetings and Q&A or explore how other ESOP companies have successfully developed their culture.

Go to the national conferences to get ideas.

Features of an Effective ESOP Culture

The Beyster Institute describes this well:

1

Free-flowing information: “All know what they need to know to make a difference.”

2

Individual autonomy: “Each owns the right and responsibility to have an effect on the success of the enterprise.”

3

Opportunity for all: “The future belongs to all and the responsibility for it is owned by all.”

Features of an Effective ESOP Culture

4

An atmosphere of trust and respect:

“Contributions to success are acknowledged and valued and the truth is shared by all.”

5

All share a stake in the outcome: “The end product, both good and bad, is shared fairly.”

There is imperial evidence gathered by the NCEO that shows that team building as an employee owned company magnifies success.

Competition for Capital

- Funding for ESOP debt service
- Funding the repurchase liability to pay terminatee account balances
- Other outside shareholder returns/dividends
- Normal operations
- Expansion
- Retaining key management
- Effect of spending on value

Balancing the cash needs of the plan sponsor and an ESOP requires careful analysis and will depend on the life cycle of the ESOP. Strategic oversight of these cash requirements is essential for sustainability and success of the Company and ESOP.

Mature ESOPs

Companies sponsoring aging ESOPs must revisit their strategy/cash requirements to remain sustainable

- ESOP's at 10 years must offer diversification payouts.
- Potential second/third tranche transactions to continue succession plan.
- Distributions to terminees begin to grow as the ESOP ages.
 - Mortality and morbidity payouts add up
 - Shares have been released
 - Terminees have been gone long enough to begin installment payouts.

Mature ESOPs: Case Study

Facts on the ground:

- S-Corporation leveraged ESOP with 65% of shares in the plan
- ESOP loan will be paid off in 2019
- EBITDA is \$3M
- Funds flows to the ESOP are \$900,000 between \$100,000 tax deductible contributions and \$800,000 distributions of S-earnings or 17% of pay. Heavily skewed to long time employees who have the bulk of the allocated shares.
- Eligible payroll is \$5.2 M with maximum allowable contributions of \$1.3M
- Plan segregates terminee balances into cash which is in effect like having a provisions for lump sum payouts for all causes regardless of the reason for payout from the ESOP.
- ESOP has \$1.6M of segregated cash in terminee accounts
- All shares are re-cycled in the plan during the distributions process
- The board has 5 defined contribution, discretionary deferred compensation agreements in place with key executives.
- No current repurchase problems but future years appear to be problematic

Repurchase Obligation Observations

In the year 2020, ESOP distributions of stock balances are projected to total \$1.3M and will use more than the funds flows into the ESOP of \$900,000.

In the year 2024, the ESOP buy back is over \$3M, certainly more than they want to award the employees in that year if they simply continue to put funds in the ESOP and re-cycle shares.

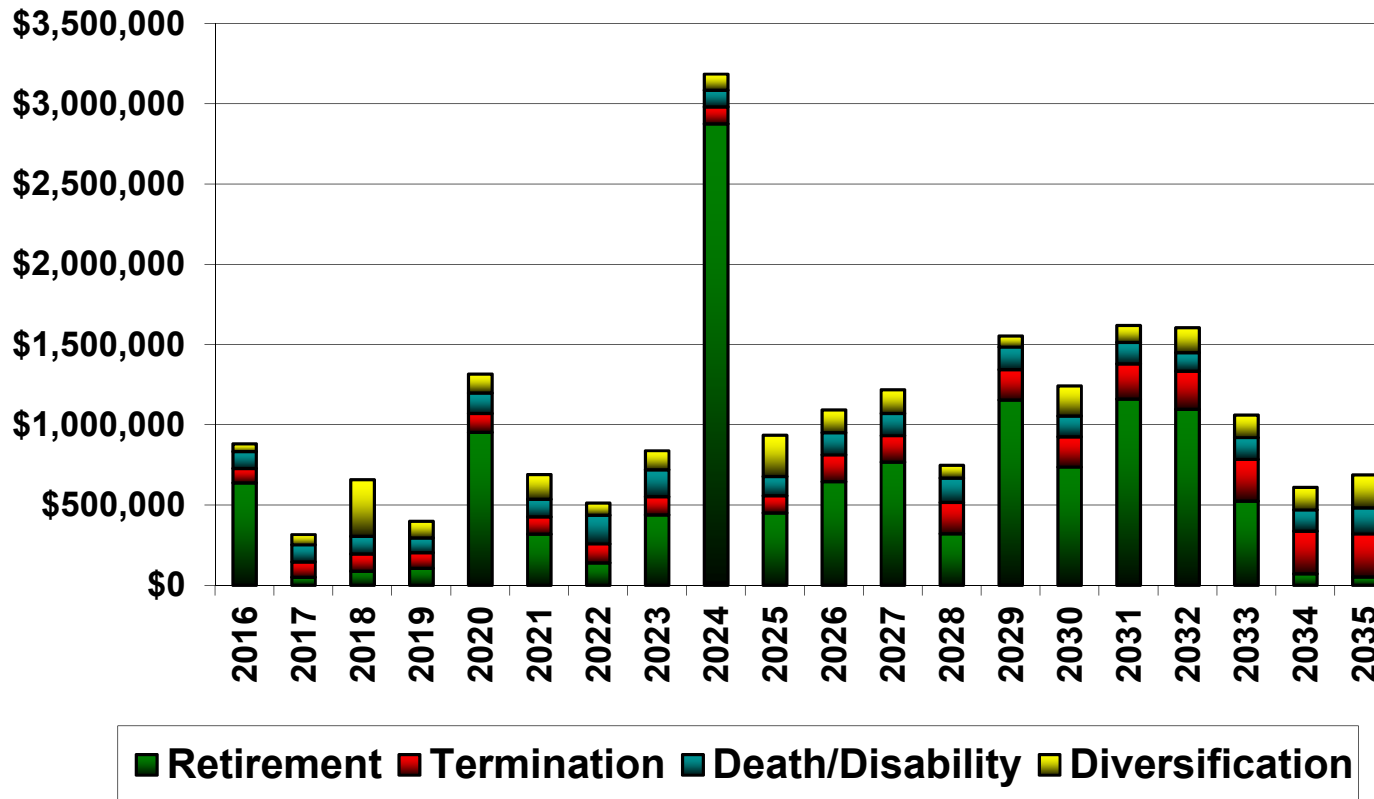
Consider a change in the distribution rules to smooth the repurchase obligation.

Mature ESOP Strategy

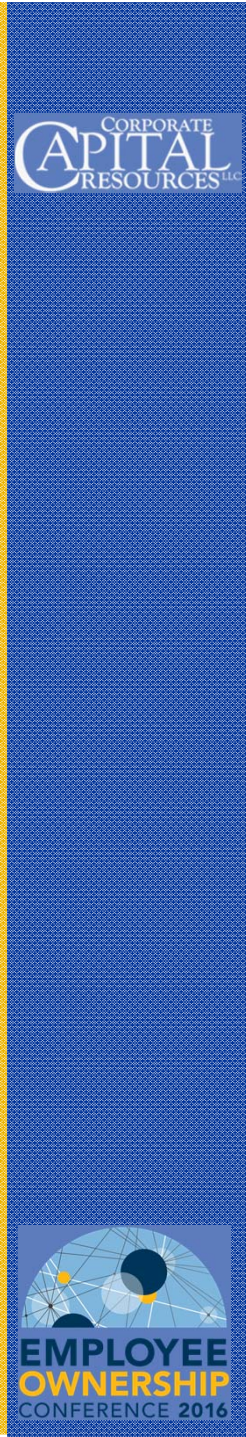
- Prospective restriction of distribution rules to include a delay on starting terminnee distributions and pay in installments if the plan allows for an outside policy and the flexibility to make a prospective change.
- The contrast between immediate cash payments (even if only to the plan in a segregated fund) and maximum delays can be easily be demonstrated.
- A good repurchase liability study with mortality and morbidity assumptions included in the forecasting model is essential to evaluation of the distribution rules.
- IRS rules and the plan document dictate the most restrictive rules allowable based on the reason for termination:
 - Death / Disability / Retirement / Normal Termination

Current practice of immediate liquidity to effect segregation regardless of reason for payout of all accounts, with no new stock issues or loan anticipation; 3% average annual share price appreciation.

Cumulative Stock Repurchase Obligations for Current Plan Through 2025 = \$9.73 M; Through 2030 = \$15.6 M.



Consistent share price appreciation of 3% annually; no new stock issues; average retirement @ age 65 (early retirements assumed to be negligible); mortality per CSO 2000 tables; 6 year 100% vesting schedule; total salaries and number of employees grow at 2% annually; moderate turnover model (Sarason Table T5); all shares recycled in plan.

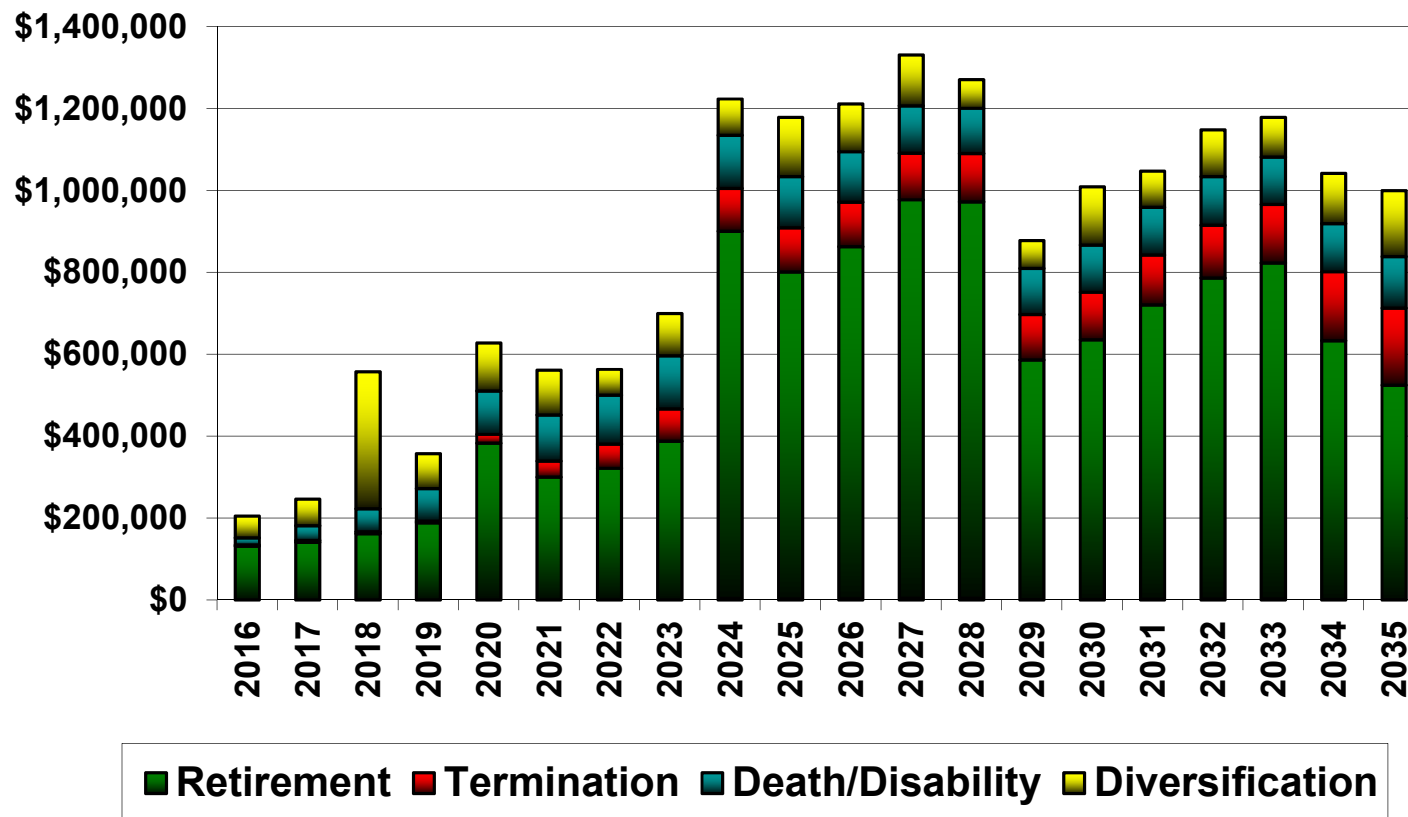


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- Consider a change in the distribution rules to smooth the repurchase obligation.

Assume no new stock issues or loan anticipation plus maximum restrictive distribution rules for delayed payouts from vested account balances *held in stock*; 3% average annual share price appreciation.

**Cumulative Stock Repurchase Obligations for Current Plan Through 2025 = \$6.22 M;
Through 2030 = \$11.9 M.**



Consistent share price appreciation of 3% annually; no new stock issues; average retirement @ age 65 (early retirements are assumed negligible); mortality per CSO 2000 tables; 6 year graded vesting schedule; total salaries and number of employees grow at 2% annually; moderate turnover model (Sarason Table T5); all shares recycled in plan.

Observations

- By simply maintaining a 3% increase in share value by flowing any excess growth into deferred compensation plans for key employees, a smooth appreciation trajectory is possible (watch 409(p)!) Remember a large S-dividend is also being paid in as well as a contribution each year. Average account balance increase is 19% per year with a 3% stock appreciation rate.
- By changing the distribution rules and removing segregation, the process of churning shares by buying them over and over is ended or reduced. The cumulative savings in the next decade is projected to be over \$3.5M. Over the next 15 years the savings is over \$3.7M.
- Segregation is being eliminated and terminees hold shares. Even with terminees receiving appreciation and getting dividends, the overall obligations are reduced significantly.

Key Takeaways

Plan sponsors and fiduciaries have an obligation to continually monitor ESOP operations to make sure the plan is being operated for the exclusive benefit of the plan participants and meeting all regulations and current corporate strategic objectives.

Particular areas of responsibility include:

- Legal Compliance
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