SOLVING THE SUSTAINABILITY PUZZLE

Managing ESOP Costs & Benefits

Mac Mid Atlantic ESOP CHAPTER

carolinas ESOP CHAPTER of the ESOP Association

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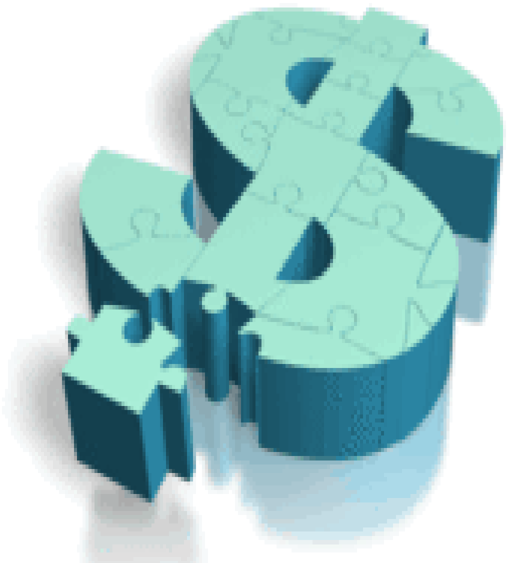
The Operating Premise for All ESOPs is That They are Going (Sustainable) Concerns



The Puzzle Won't Assemble Itself

How Should Maturing ESOP Companies Strategically Coordinate the Pieces of the Puzzle?

Valuation, Administration, Repurchase Obligations?

Agenda for Our Conversation

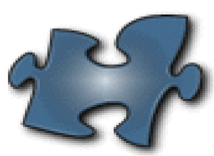
A. Companies operating maturing ESOPs should already know the basics. While there is a real need for understanding the array of operating rules, equally important is knowing how to coordinate their application.

B. The occasionally overlooked issue is the sometime surprising way the many factors affecting repurchase obligations interact with each other.

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

Some Key Factors Driving the Magnitude of Repurchase Obligations

1. **Share price fluctuations & the valuation methodology.**
2. **Actuarial statistics of the plan population**
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 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. Then, after 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 growth.

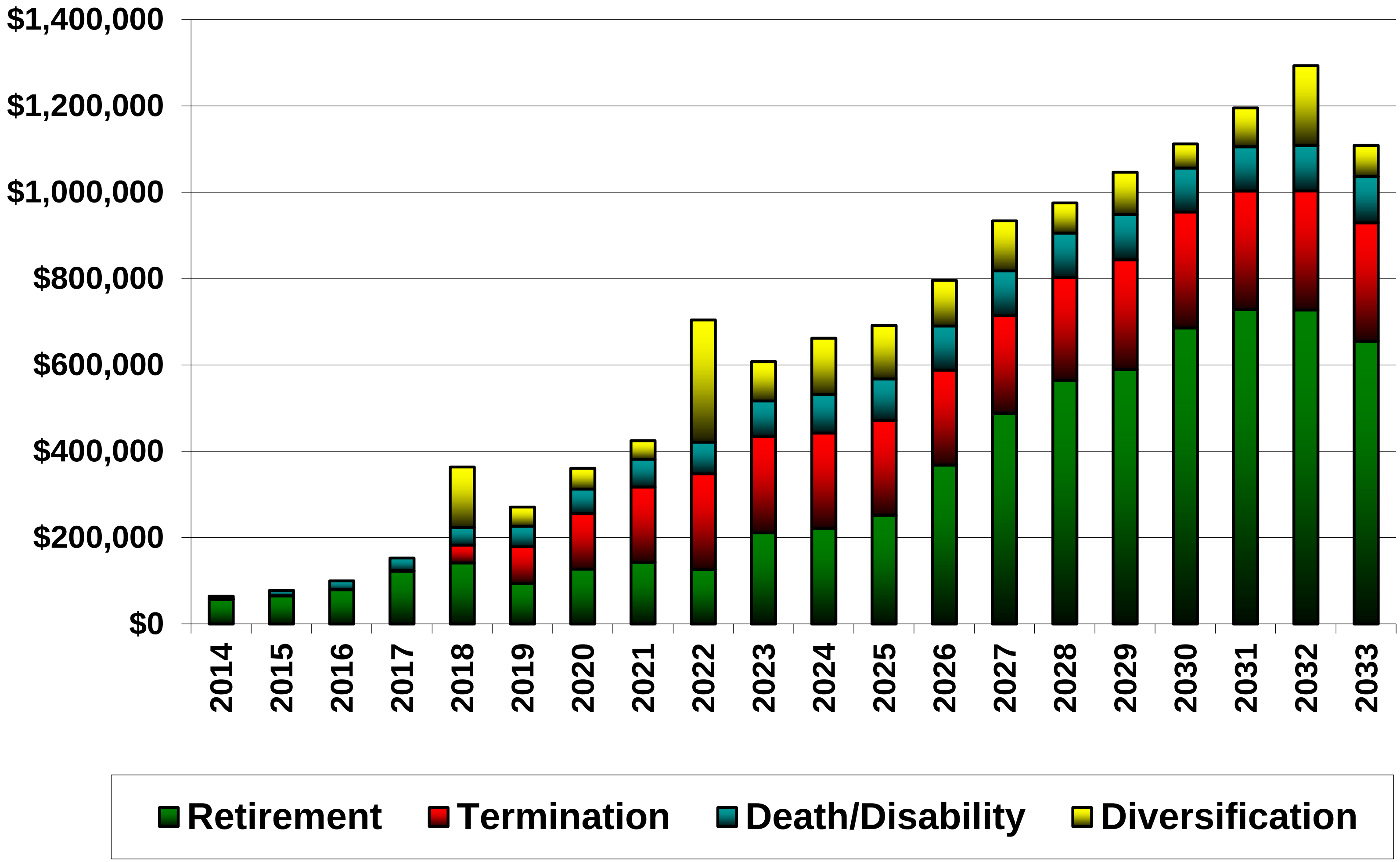
Sustainable?

To Understand When Recycling, Redeeming or Re-Leveraging May Be Appropriate, the Following Two Charts Are Important

1. **The following 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.**
4. **It is instructive to hear what a valuation expert says about the impact of these differing results on value.**

Cumulative Stock Repurchase Obligations for Current Plan with No Releveraging or New Share Issues to ESOP: **3%**

Through 2023 = $3.13 M; through 2028 = $7.19 M.

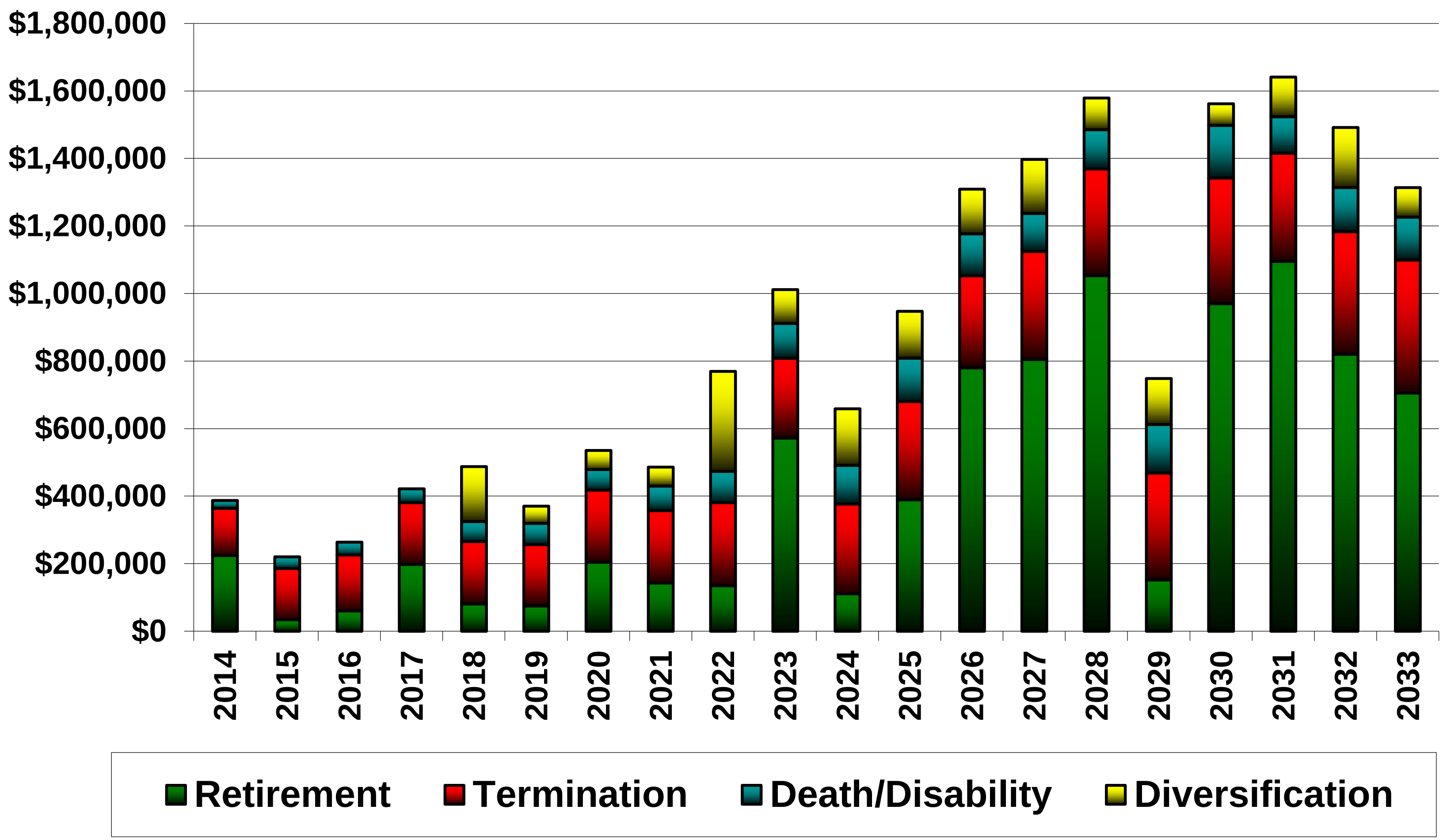


Restrictive Payout Rules: Accounts Held in Shares Vested Balances Paid in Installments

Cumulative Stock Repurchase Obligations for Current Plan with No Releveraging or New Share Issues to ESOP:

Through 2023 = $4.95 M; through 2028 = $10.85 M.

3%



Liberal Distribution Rules: All Accounts Are Immediately Paid in Cash, Whether Inside or Outside the Plan

What Is Happening Here? Why the Big Differences?

Cumulative Payouts Through Years==>	2023	2028
I. Restrictive Rules 3% Growth Baseline	$3.13 M	$7.19 M
II. Liberal Payouts 3% Growth Baseline	$4.95 M	$10.85 M

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?
4. And what is your stock appraiser going to say about the effect of your policies on value?

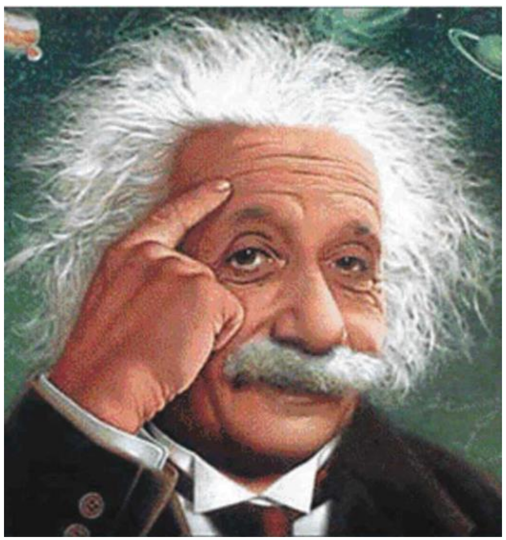
Definition and Effects of the Recycling Shown in the Graphs

Share Recycling in the Plan:

1. An exchange of other investments for employer securities so that participants receiving a distribution can be paid in the form of cash.
2. This assumes sufficient cash in the plan to do this.
3. The question is always one of the “recycle rate.”
4. The faster the rate, the higher the repurchase costs.
5. A slow recycle rate, means accounts will continue to hold stock for a longer period.
6. Financial applicability depends primarily on stock appreciation rate, plan distribution rules and percentage of stock in terminee accounts.

But Do You Really Just Want to Recycle Shares in the Plan?

What if your appraiser just told the Trustees that the value was up considerably….and you were planning to recycle a large block of shares from former participants?



Wait!

- There is a better idea in some cases.
- You don't have to buy shares directly into the ESOP and have them immediately allocated to current participants.
- That can create "haves" and "have nots" inside the plan…among other issues.

You will need to get your appraiser and the Trustees involved, but you can….RELEVERAGE.

How Do You Deal with Clusters of Large Payouts?

- The following diagram illustrates the technique of a corporate redemption of stock followed by a resale of some or all of the redeemed shares to the ESOP for a note.
- Questions in this case include:

1. What are the requirements for a ‘clean’ redemption.
2. What are the effects on stock value of the stock redemption and re-issue? Dilution? Counter-dilution?
3. What are the requirements for the purchase of the re-issued shares by the ESOP?
4. What are appropriate loan terms?

Dealing with Large Distributions – Avoiding Immediate Allocations

Technique for Releveraging Shares into the ESOP

Smoothing the Buybacks & 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.

Sponsoring Corporation

Redeemed Shares Resold to Plan

Note from ESOP to Company with payments from annual contributions

Shares from Repurchased Accounts

Employee Stock Ownership Trust

Tax-Exempt Single Shareholder

Pro-Rata Share of S "Dividends"

Deductible ESOP Contributions

Pro-Rata Share of S "Dividends"

Active Participant Accounts

Terminee Accounts?

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

Effects of Releveraging

1. The shares redeemed by the corporation require the use of after-tax retained earnings (may not matter with a large S ESOP).
2. The shares redeemed from former participants can then be re-sold to the ESOP (with Trustee approval) at a value discounted from the usual FMV.
   a) This allows the participants to receive statements showing lower costs for share purchases/allocations
3. The ESOP loan running between the plan and the corporation can extend over many years and allocate shares slowly to future participants.
4. This typically reduces the annual buyback costs.
5. And if it is done in several successive tranches, the ESOP costs are smoothed out over time by carefully matching transaction amounts to valuation effects (coordinate carefully with your appraiser).
6. This requires an actual stock transaction with the ESOP with appropriate valuation and legal documentation. Thus there is an economy of scale arguing in favor of re-sales over $250,000.

Releveraging Key Points

1. **The new ESOP Loan can be structured to be repaid over a long period, i.e. 20+ years, and the shares repurchased will be re-suspended in the ESOP and will result in a slower allocation rate to active ESOP participants.**

2. **The process can be repeated each year as needed with the long-term ESOP Notes under each internal ESOP Loan folded into a growing refinance loan each year *<u>as long as</u>* the 20 year schedule of share release is met with respect to each year's repurchased shares.**

3. **Ideally, a separate recordkeeping of the cumulative repurchases should be constructed to track the associated share release requirements and separate stock certificates should be maintained which would represent each tranche of shares repurchased and their annual release.**

What About the Valuation Impact?

1. The strategies we are discussing here should typically be implemented to enhance long-term value…but it can happen that a transaction (of any kind) may be very good for the company, but could temporarily depress value.

2. This means having the Trustees keep your appraiser involved in whatever process is underway that could affect value.

3. If a value decrease is unavoidable, the Board can consider setting a 'floor price' for corporate redemptions to protect certain participants who might have been negatively affected.

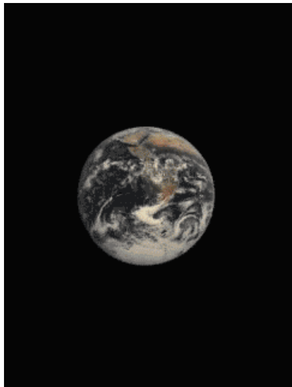
   - Design of floor price arrangements must be carefully crafted to avoid overcommitting the corporation dollars.

Participant Expectations

1. ESOPs work best when managed for a 'slow burn' with as few sudden way up or way down swings in value as possible.

2. Many of the issues related to swings in value, disparities in the stock accounts of "haves" vs. "have-nots" and resulting participant disappointment can be mitigated by:
    - Understanding and implementing the appropriate techniques noted in this presentation, and
    - Timely, accurate and engaging communications with plan participants (especially if there is bad news).

In short, care in strategy development and implementation will keep you from blowing up Planet ESOP.



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

Issues to Consider When Drafting a Distribution Policy

- Consider whether changing a distribution policy is a settlor act or a fiduciary act
  - establishment of a distribution policy pursuant to the terms of a plan could be a fiduciary function
  - Specifically defining distribution policy in plan document could be settlor function
  - Flexibility vs minimizing fiduciary risks
- What are the participant expectations for payment and how does that work for a policy?
- Have you measured the costs/benefits of holding terminee accounts in stock?

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
- Besides releveraging, 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 and increased administrative costs

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**

Questions?

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Thank You!