Standing at the Crossroads: An Integrated Approach to the ESOP Repurchase Obligation

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This discussion outlines some of the fundamental principles of an employee stock ownership plan (ESOP) and presents a framework for analyzing the employer corporation stock repurchase obligation. The ESOP repurchase obligation has several important interrelated variables that require a comprehensive plan encompassing five important factors: Strategy of the corporation, The valuation, Actuarial variables, Repurchase funding sources and mechanics, and Sustainability considerations. This "STARS" framework is designed to promote dialogue and coordination between the sponsor company management, the ESOP trustee, the ESOP legal counsel, and the valuation analyst. This discussion describes these repurchase obligation factors and explores how these factors affect each other.

Introduction

The employee stock ownership plan (ESOP) is unique in the sense that this hybrid type of corporate ownership structure requires a source of liquidity in order for a sponsor company to continually repurchase its own equity. Internal Revenue Code Section 409(h) states that if employer securities held within an ESOP are not readily tradable on an established market, then the departing plan participant has the right to require that the sponsor company repurchase the employer securities.

This "put option" provides the beneficiary of the employer security with an enhanced source of liquidity for the shares, compared to shares of most closely held corporations. The purpose of this option is to increase the benefit to plan participants. This call on the company's cash flow, however, creates a liability that requires an appropriate level of corporate planning.

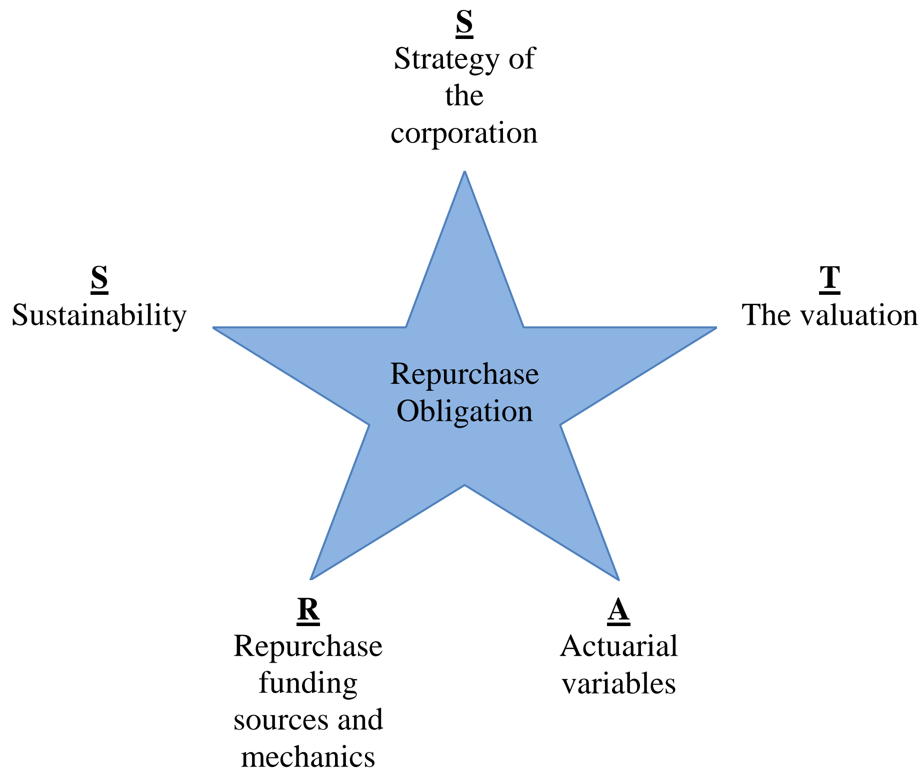
This corporate planning is necessary in order to accommodate the required ESOP distributions to plan participants and to their beneficiaries. These distributions are related to the participants' death, disability, retirement, or termination of service.

This contingent liability should be taken into account in the valuation of the stock of the sponsor company for ESOP plan administration purposes. By circular logic then, any resulting adjustment in the sponsor company stock price due to the repurchase obligation analysis may in return affect the repurchase obligation until each iteration finally results in a sufficient level of precision.

The integrated relationship between a sponsor company's repurchase obligation and the valuation of the employer securities in the ESOP creates some complex corporate financial planning issues. These corporate financial planning issues include the following:

1. corporate strategy (investing for corporate growth versus for retirement plan obligations)
2. actuarial variables and plan maturity (employee census, and the difference between new ESOPs and mature ESOPs)
3. funding alternatives (source of liquidity for departing plan participants)
4. mechanics (redeeming vs. recycling and plan payout provisions)

Figure 1
Sponsor Company Repurchase Obligation
STARS Framework



5. sustainability (both the ability of the ESOP to remain a viable option for the employer corporation and the corporate management decision on whether or not being ESOP-owned should be the sponsor company's primary objective).

The proposed "STARS" framework for the ESOP repurchase obligation consideration is displayed in Figure 1.

The figure is designed to provide an integrated model for all relevant parties to approach corporate strategic planning, valuation, plan design, funding, and maintenance with regard to the sponsor company's ESOP and its repurchase obligation.

Strategic Considerations of the Employer Corporation

The ESOP Installation

When a decision is first made to establish an ESOP for an employer corporation, it generally is done to meet one or a combination of three important but different strategic objectives. First, an ESOP may provide an attractive liquidity option for the owners of the closely held corporation. Second, an ESOP may also provide an attractive employee benefit that allows a sponsor company to attract and retain top employees. Third, an ESOP may also present special income tax advantages in certain circumstances that may be advantageous to sponsor companies as well as to selling shareholders.

Whether an ESOP is installed to meet one or more of these objectives, employer corporation management, ESOP trustees, legal counsel, and valuation analysts should coordinate from the very beginning to ensure that the optimum structure is implemented to marry (1) the near-term installation objectives, (2) the corporation's long-term growth objectives, and (3) the ESOP repurchase obligation.

The Established ESOP

As the ESOP matures, the objectives of the sponsor company may change from those that motivated the initial implementation. A minority ESOP-owned

company may become a 100 percent ESOP-owned company. The sponsor company may change from a C corporation to an S corporation.

The size and value of vested plan assets may require a change in the way a sponsor company plans to fund its repurchase obligation. The sponsor company management may have to choose between funding a large repurchase obligation and other investment opportunities—such as acquisitions, investments in new plant and equipment, and hiring new employees.

These decisions all have opportunity costs, and those costs could have positive or negative effects on the sponsor company projected cash flow. The magnitude of these effects should be reflected in the employer corporation stock valuation.

The Valuation Effects of Repurchase Obligation

The valuation of the employer corporation stock should include consideration of the ESOP repurchase obligation. The specific mechanics by which the valuation analyst may address the repurchase obligation is an often debated topic in the ESOP community. This is a topic of frequent discussion at ESOP conferences and in ESOP-related publications.

In general, the consensus is that the repurchase obligation should be explicitly estimated and identified within the valuation.

In certain circumstances, it may be appropriate to capture the ESOP repurchase obligation in a specific line item within a sponsor company's historical and projected cash flow. The conclusion that the repurchase obligation is of de minimis value may also be appropriate in certain situations. In other circumstances, the ability of the sponsor company to meet its repurchase obligation may be addressed within the application of a valuation adjustment, such as the discount for lack of marketability.

The valuation analyst should consider several factors that are not likely to be explicitly captured in a specific line item in a valuation model. Rather, these factors should inform all aspects of the analysis of the present value of expected future cash flows to shareholders.

Growth rates, discount rates, projected capital investments, working capital changes, and the selected pricing multiples in a market approach valuation are all examples of valuation factors that may be affected by the analysis of the repurchase obligation.

The mechanics of share repurchases may also affect total equity value and value per share, as stock redemptions have different effects than the recycling of shares.

However it is captured, the valuation impact of the repurchase obligation is affected by a sponsor company's strategic goals with regard to (1) the desired ownership composition, (2) the desired level of employee benefits, (3) the selected repurchase mechanisms, and (4) other corporate financial and strategic objectives.

Therefore, it should be part of the valuation analysis to determine the most appropriate valuation methodology, given the specific facts and circumstances of a subject sponsor company as of the particular valuation date.

Actuarial Variables

Repurchase Obligation Studies

Currently, there are several options available to sponsor companies to model and quantify the sponsor company's expected repurchase obligation. The sponsor company management may choose to have a repurchase obligation study performed for planning purposes in order to predict the repurchase obligation that the company will incur over a period—often from 15 to 25 years in the future.

These repurchase obligation actuarial studies can be performed by outside consultants or by internal sponsor company staff. Like any pension or other retirement benefit plan, these studies typically include a detailed analysis of the plan participant census data. This analysis examines (1) the age, gender, length of service, vesting, and account

balances of the current and expected future plan participants, (2) employee turnover rates by job category, and (3) foreseeable plan participant retirement patterns.

These studies will also make growth rate assumptions and adjust for anticipated payout mechanics—such as lump sum distributions or extended payment plans. Often, a study will include a range of values based on different input assumptions in order to give management a broader perspective of possible future outcomes, based on different scenarios.

In general, it is recommended that mature ESOPs perform these studies once every three years or so. However, a sponsor company may need to have these studies performed more or less frequently, depending on its situation and outlook.

Another option that provides management with a greater deal of flexibility and control is for management to use an off-the-shelf software program designed to help prepare internal actuarial analyses. These software programs allow management to control the inputs and assumptions used in the study and adjust as situations change.

For some, this greater flexibility and control is desirable. However, the inputs are typically highly sensitive to the input assumptions and due care should be exercised to ensure that the results are meaningful and statistically relevant. For example, a change of one percent in the growth rate assumption may return a repurchase obligation value that is orders of magnitude larger than a similar study with a slightly lower growth rate assumption.

In either method, the inputs and results should be reviewed for reasonableness and appropriateness. Common mistakes in these studies include estimation errors and “irrational exuberance” with regard to sponsor company growth rates and share value (overly conservative estimates can be equally inappropriate).

The user of a repurchase obligation study should consider the results of the analysis in the context of the overall framework and adjust as necessary. This extra step of reviewing and revising is recommended, especially in the case of internal management analysis. This is because it is easy to lose the big picture and get lost in the details (for example, concluding a repurchase obligation estimate in significant excess of current equity value).

Repurchase Obligation Studies and Plan Maturity

Typically, the magnitude of the repurchase obligation is different (and often should be considered differently) in newly formed ESOPs compared to

mature ESOPs. Mature ESOPs typically require the greatest level of corporate planning to accommodate as participant account balances can become relatively large.

In newly formed ESOPs, the repurchase obligation can be orders of magnitude smaller than for most mature ESOPs. As such, repurchase obligation studies should be approached differently depending on the life cycle stage of a sponsor company’s ESOP.

For example, in newly formed ESOPs, it may be appropriate to use a more limited scope repurchase obligation study that uses more global input assumptions than a full study based on a detailed employee census and actuarial study. This limited scope option is often significantly less expensive and time consuming. And, it can yield results that are just as meaningful to the intended study users.

In this scenario, an analyst may make assumptions about the future equity value, yearly share allocations, and general participant population dynamics. The analyst then models for different payout scenarios and plan particulars.

Varying plan particulars may include scenarios such as the following: a newly formed ESOP, for example, may not allow for any retirement distributions during a period after a transaction when a seller note is still being repaid.

In contrast, it is possible for a plan to allocate a significant portion of equity in the very early stages of an ESOP, provide for immediate vesting, and require lump sum distributions for departing participants. In this particular scenario, a sponsor company may have a harder time funding the near-term repurchase obligation.

Different plans should consider the strategy and the intended benefit that it is being designed to provide and determine the optimal plan design and funding mechanism—with consideration of its future repurchase obligation.

Repurchase Funding and Mechanisms

There are several options available to sponsor companies to fund their ESOP and repurchase obligation. These options are listed below, including a look at (1) some of the situations in which each option may be appropriate and (2) some of the advantages and disadvantages of each option:

I. Cash on the balance sheet.
   - A. Appropriate when:
     1. repurchase obligations are manageable as a percentage of cash flow,
     2. repurchase obligations are evenly distributed,
     3. combined with other funding methods,
     4. future earnings are likely to be stable, or
     5. employer contributions and dividends to fund the repurchase obligations are a normal level of benefit for the sponsor company's given industry.
   - B. Advantages:
     1. doesn't tie up assets in a sinking fund,
     2. retains flexibility to recirculate or redeem shares, and
     3. contributions are deductible up to qualified plan limits.
   - C. Disadvantage: timing of repurchases can affect the availability of necessary cash.

II. ESOP sinking fund.
   - A. Builds cash in the ESOP to accumulate funds for future purposes and is best suited for use when the sponsor company is generating significant cash in excess of corporate operations/needs.
   - B. Advantages:
     1. investment yields may be tax-free,
     2. dedicated fund for paying repurchase obligations, and
     3. ties the sponsor company to future "recycling" of ESOP shares because this cash will be "recirculated" inside the ESOP.
   - C. Disadvantages:
     1. lacks flexibility (can only recirculate funds) and
     2. removes assets from corporate balance sheet—cannot get cash back once in the ESOP.

III. Corporate sinking fund.
   - A. Is effective in pre-funding because there are no limitations to the prefunding effort.
   - B. Appropriate when a sponsor company wants flexibility in how they repurchase shares (redeeming/recycling).
   - C. Advantages:
     1. keeps assets on corporate balance sheet and
     2. contribution is tax deductible.
   - D. Disadvantages:
     1. contributions to sinking fund are not deductible,
     2. removes assets from working capital, and
     3. may increase the employer stock value.

IV. External debt.
   - A. Appropriate when:
     1. repurchase obligations are very high for one or a few years,
     2. not enough time to accumulate a sinking fund, and
     3. the sponsor company cannot meet its expected repurchase obligations from cash flow or other internal assets.
   - B. Advantages:
     1. may be less expensive than pre-funding or funding with current cash flow, depending on cost of capital, and
     2. sponsor company may be able to deduct interest expenses.
   - C. Disadvantages:
     1. financing may not be readily available, and
     2. lender fees and interest expense may add additional costs.

V. Corporate-owned life insurance (COLI).
   - A. Can be used to provide death benefits, or cost recovery funding.
   - B. Appropriate when the sponsor company has not (or cannot) put aside sufficient funds to repurchase the shares of large ESOP account holders in the event of premature death.
   - C. Advantage is the policy's cash value may provide a reasonable rate of return.
   - D. Tax advantages:

1. increases in the policies' cash value may not be subject to income tax,
2. death benefits paid to the employer corporation may not be subject to income tax if certain rules are met,
3. sponsor company can obtain tax-free access to cash values through loans and withdrawals not in excess of premiums paid, and
4. interest on policy loans may be deductible in certain cases.

These five items represent some of the most popular methods of funding an ESOP and its repurchase obligation. The optimum funding choice(s) not only depend on the other factors listed in this article, but also on the actual plan payout provisions and repurchase methods used.

Plan payout provisions may stipulate that certain account balances should be paid in lump sum distributions while other balances may be paid over five annual installments. Whatever the specific provisions, they should be considered in the repurchase obligation analysis with respect to the funding choice and overall strategy of the sponsor company.

Another important factor to consider is the repurchase methods used. The sponsor company management may elect to redeem its shares from departing participants or to recycle them. These different repurchase obligation mechanisms are summarized below:

1. *Redemption*. In the redeeming option, the employer corporation purchases the shares and subsequently cancels them (the shares are retired into the sponsor company treasury). The number of shares outstanding changes, but the value of the ESOP-owned employer corporation shares, on a shareholder level, does not change in a redemption.
2. *Recycling*. In the recycling option, the plan participant's employer shares are repurchased by the employer corporation, and the repurchased shares are subsequently contributed to the ESOP as an employee compensation expense. The total number of shares outstanding does not change, but the cost of recycling the shares affects the expense structure of the sponsor company and may, therefore, be dilutive to total equity value if the funds come from the sponsor company.
3. *ESOP Investing*. In the ESOP investing option, the ESOP trust may purchase shares directly from departing participants using the plan's own funds. The funds are typically accumulated from sponsor company distributions and these repurchases are not dilutive to equity. This is because the transaction is between the ESOP and the plan participant and does not involve the sponsor company. Repurchased shares using this method are reallocated to existing plan participants based on ownership instead of compensation and this method is also generally not tax deductible.

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Exhibit 1 summarizes the employer stock repurchase alternatives and their respective impacts on the sponsor company.

Sustainability

The issue of ESOP sustainability has become another discussion topic in the ESOP community that is interrelated to all of the factors described above. The term itself has two different connotations in the current ESOP lexicon.

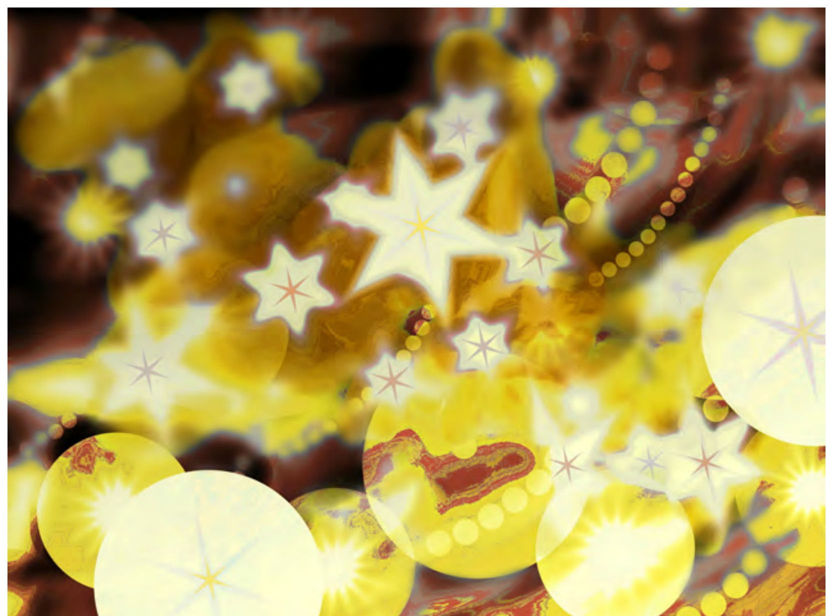

Exhibit 1
Employer Stock Repurchase Alternatives
Impact on the Sponsor Company

Expected impact on the sponsor company	Redeeming of Shares	Recycling of Shares	ESOP Investing in Shares
Change in total shares outstanding	Yes	No	No
Change in relative ownership percentage	Yes	No	No
Direct impact to the income statement	No	Yes	No
Shares are cancelled	Yes	No	No
Income tax deductible	No	Yes	No
Dilutive to the per share equity value	No	Yes	No
Reallocates shares to plan participants	No	Yes	Yes
Reallocation is based on	N/A	Compensation	Ownership
Type of transaction	Capital	Expense	Capital

In general, ESOP sustainability is simply the recognition of the fact that an ESOP is statutorily required to repurchase a departing participant's shares upon death, disability, retirement or termination. And, the ESOP and its repurchase obligation should be managed in such a way as to ensure that the statutory requirements are met.

The more fervent connotation of ESOP sustainability by some practitioners and sponsor company managers implies that an ESOP owned company should be managed in such a way that it will forever be an ESOP owned company. While this corporate ownership structure may be eternally appropriate for some companies, for others, an ESOP may simply be a means to a different end.

Regardless of one's views on the subject, the point is that the ability of the ESOP to remain viable requires some degree of active management and open dialogue between all of the relevant parties to the ESOP to appropriately account for and manage the repurchase obligation.

This integrated relationship of repurchase obligation to ESOP sustainability is best displayed through the valuation.

A valuation that does not consider repurchase obligation will likely lead to overvalued employer stock. This, in turn, creates a greater repurchase liability that, in extreme scenarios, can result in forcing the sponsor company to seek some form of outside liquidity to meet its repurchase obligation. Similarly, a sponsor company may maintain excess assets to fund its repurchase obligation.

If a valuation analyst does not adjust for the repurchase obligation, this could result in a similarly overstated stock price, and therefore an increase in the repurchase obligation. In the opposite scenario, a company may manipulate a repurchase obligation study to increase the contingent liability and drive down share prices, thereby reducing its repurchase obligation in order to fund other pet projects or goals.

Summary and Conclusion

The complexity of sponsor company ESOP repurchase obligation and its interrelatedness to other corporate financial and strategic objectives requires that ESOP-owned companies and ESOP service providers participate in an ongoing, open and coordinated dialogue. This process should ensure that an ESOP is accomplishing the goals and objectives that it is intended to accomplish. This process should also appropriately account for, and plan for, the repurchase obligation.

The proposed STARS framework is meant to provide a starting point to promote dialogue and coordination between sponsor company management, ESOP trustees, legal counsel and valuation analysts as they analyze the issue of a sponsor company's ESOP repurchase obligation.

These five, discrete, interrelated variables (Strategy of the corporation, The valuation, Actuarial variables, Repurchase funding sources and mechanics, and Sustainability considerations) should be considered, monitored, and updated within each stage of an ESOP sponsor company's life cycle.

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