

THE IMPORTANCE OF A REPURCHASE OBLIGATION STUDY

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With the myriad of procedures required to establish an employee stock ownership plan (ESOP), a sponsor company forming an ESOP may overlook the repurchase obligation associated with ESOP-owned employer stock. A repurchase obligation is the liability that results when ESOP participants put their employer corporation shares back to the sponsor company. Typically, this liability will be relatively small in the years immediately after the initial ESOP formation. And, typically, this liability will increase substantially as the ESOP participants are granted a legal right to sell the employer corporation stock acquired through the ESOP back to the sponsor company. A repurchase obligation study will help ESOP employer corporations to better manage this liability. Having a periodic repurchase obligation study performed for an ESOP is more than a good idea. It may also save the ESOP sponsor company considerable time, effort, and money.

INTRODUCTION

The CFO of a closely held employer corporation that sells 100 percent of its stock to a newly established employee stock ownership plan (ESOP) is faced with numerous issues.

The CFO must engineer a loan from the bank to the sponsor company and a second loan from the sponsor company to the ESOP. The CFO must hire a knowledgeable ESOP attorney to draft the ESOP plan document and to determine that all loan documents comply with Internal Revenue Code requirements for an exempt ESOP loan.

The CFO must also plan to contribute enough cash to the ESOP over the following ten years (i.e., the typical ESOP stock acquisition loan term) to meet the debt service requirements of the ESOP loan. Finally, the CFO should have made sure the required contribution is within the Code Section 404 deduction limits.

Even after considering all the issues described above, there remains one obligation that may dwarf the ESOP loan liability. This liability will unfold 10 or more years in the future but can, with sound actuarial modeling, be estimated at the time the ESOP is formed.

This obligation is referred to as repurchase liability. The failure to plan for this liability could be catastrophic for a sponsor company with a newly established ESOP.

The repurchase obligation originates with Internal Revenue Code—specifically, Code Section 409 (h)(1)(B), which states in part:

[If] the employer securities are not readily tradable on an established market, [the participant] has a right to require that the employer repurchase employer securities under a fair valuation formula.

This is known as the “put option requirement.” And, this requirement places an obligation squarely on the shoulders of a closely held sponsor company (with stock that is “not readily tradable on an established market”) to buy back the shares of stock distributed by an ESOP to departing employees.

This requirement reveals three important facts:

1. The repurchase obligation does not apply to publicly traded sponsor companies (if your ESOP sponsor company is publicly traded, you can stop reading now).
2. The obligation is greatly affected by the distribution provisions of the subject ESOP documents.
3. The ESOP trustee may repurchase employer corporation shares, but the ESOP trustee cannot be forced to do so (i.e., the ultimate obligation lies with the employer corporation).

ESOPs are generally required to distribute benefits by:

1. the close of the fifth plan year following the plan year of the termination of employment, or

2. the close of the plan year following the plan year of termination due to death, disability, or normal retirement.

Code Section 409(o)(1)(B), however, allows the ESOP to defer distribution of shares purchased with an ESOP stock acquisition loan until the loan is fully repaid.

Another source of the repurchase obligation is the diversification requirement of Code Section 401(a)(28). Once a participant has reached age 55 and completed 10 years of participation in the ESOP, the participant must be given an opportunity to liquidate 25 percent of his or her employer stock holdings in the ESOP. An additional 25 percent can be diversified six years later.¹

HOW DO SPONSOR COMPANIES COPE WITH REPURCHASE LIABILITY?

There are a variety of options for funding the repurchase obligation and a sponsor company rarely relies on just one method. Here are some of the typical options:

- Pay from the employer corporation's current corporate cash flow. This method is frequently used when (1) the ESOP owns a fairly small percentage of the employer corporation and (2) the subject corporate profits are strong.
- Establish a cash reserve within the ESOP. The employer corporation contributes more cash to the plan than is required to meet the current ESOP debt service payment.
- Establish a sinking fund outside of the ESOP. The employer corporation accumulates a reserve fund within its corporate assets for the purpose of repurchasing shares of employer stock.
- Purchase corporate-owned life insurance. This may be appropriate if a large part of the ESOP stock holding is concentrated in the accounts of a few key individuals.
- Releverage the ESOP. A large repurchase obligation in a year may be best accommodated by a new exempt ESOP loan.
- Borrow funds outside of the ESOP. The sponsor company could borrow money outside of the ESOP to satisfy the repurchase obligation.
- Sell stock to internal buyers. Corporate managers could buy the employer corporation shares to be repurchased.
- Sell to external buyers. If the repurchase cannot be met by any other means, the sponsor company will have to be put on the block and an outside buyer found.

When planning for stock repurchases, it is important to distinguish whether shares will stay in the ESOP (referred to as recycling) or leave the ESOP for an extended time period (called redeeming). Stock is recycled by having the ESOP repurchase the shares directly. However, shares are also recycled if the ESOP is releveraged to buy back the shares or if the employer corporation repurchases the shares and contributes those shares back to the ESOP.

Redeeming versus recycling will determine the ESOP's ownership percentage of the sponsor company. Generally, redeeming shares outside of the ESOP will lower the plan's ownership unless the shares are actually retired from circulation. If the shares are retired, there may be an unanticipated effect on the share value, which will affect the cost of future employer stock repurchases.

Recycling shares will result in a greater repurchase liability over time. This is because the same shares are constantly being subject to repurchase. Redeeming shares but keeping the employer stock active (for example, selling the securities to key management) will result in lower repurchase obligation in the long term. Redeeming and retiring shares will fall somewhere between the two extremes.

One major reason why an ESOP sponsor company will elect to recycle stock through the ESOP rather than to redeem shares is that recycled shares are purchased on a pretax basis. This is because contributions to the ESOP are tax-deductible. Redeemed employer shares are acquired with after-tax dollars.

In addition, sponsor companies typically have a particular ESOP ownership level they want to maintain. For an S corporation, the desire may well be for the ESOP to own 100 percent of the sponsor company in order to maximize the tax benefit. For a C corporation the threshold may be linked to (1) the availability of a Section 1042 tax-deferred rollover for selling shareholders, or (2) a desire for the ESOP to have majority ownership in order to eliminate a discount for lack of ownership control on the ESOP stock.

Lastly, redeeming employer shares may result in an ESOP with little or no value to the new plan participants—no employer stock will be available for new employees if employer stock is not recycled through the ESOP.

Let's consider the case where a closely held employer corporation (SponsorCo) establishes an ESOP to acquire \$10 million of the employer corporation stock. Perhaps this acquisition is 100 percent of the sponsor company stock or perhaps it is something less than 100 percent of the sponsor company stock.

Let's assume that the ESOP borrows the money required for the initial employer stock purchase using a 10-year note at a reasonable interest rate. The ESOP is designed to defer distributions other than for death, disability, and normal retirement, until the ESOP employer stock acquisition loan is repaid.

In this example, let's assume the SponsorCo CEO has been intimately involved in all aspects of establishing the ESOP. Let's assume that the CEO was the seller of the \$10 million of employer corporation stock that was acquired by the ESOP.

After completing the ESOP formation stock purchase transaction, the CEO is now ready to return to doing the things that made the sponsor company successful. However, it may be appropriate at this point for SponsorCo management to begin planning for the future repurchase obligation. This is true even though that repurchase obligation may not be due for 10 years.

A repurchase obligation analysis may be performed to assist SponsorCo management with planning for the future repurchase obligation. This analysis is an actuarial projection of future events. As such, the analysis involves a great many assumptions and requires reliable underlying data. The consultant that prepares the repurchase obligation study should be extremely knowledgeable about ESOP requirements, as well as about the specifics of the subject sponsor company ESOP plan documents and loan agreement.

A repurchase obligation study will typically incorporate assumptions related to the following contingencies:

- Stock appreciation. How will the employer corporation share price evolve over the projection period (taking into account the impact of the ESOP loan on share value

and the effect of loan principal payments over the next 10 years)?

- Demographic decrements. What is the probability of death, disability, retirement (at the plan's normal retirement age), and employee turnover for other causes (e.g., quit, fired, early or late retirement)?
- Diversification utilization. To what degree will employees eligible to diversify their stock accounts take advantage of this right?
- Salary increases. At what rate will salaries increase over the projection period. And, are there groups that will have distinguishable differences in salary increase rates?
- Workforce growth. At what rate will the sponsor company's workforce (and therefore ESOP participation) grow?
- New employee demographics. What will be the age and compensation level of new hires over the period?
- Rate of return on other investments. What will ESOP assets other than the sponsor company stock return over the period?
- Future exempt ESOP loans. Will there be other ESOP loans initiated over the period?
- Company stock dividends. Will the sponsor company pay any cash or stock dividends during the projection period?

Figure 1
Illustrative Example of
Repurchase Liability Assumption Projections

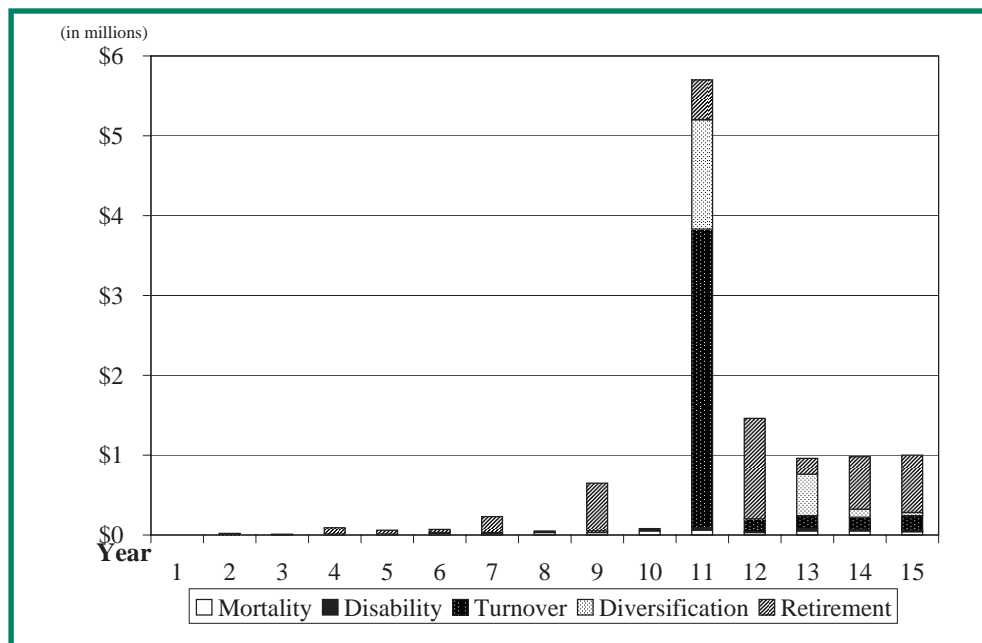


Figure 2
Difference in the Repurchase Obligation
When Employer Corporation Shares are Recycled versus Redeemed

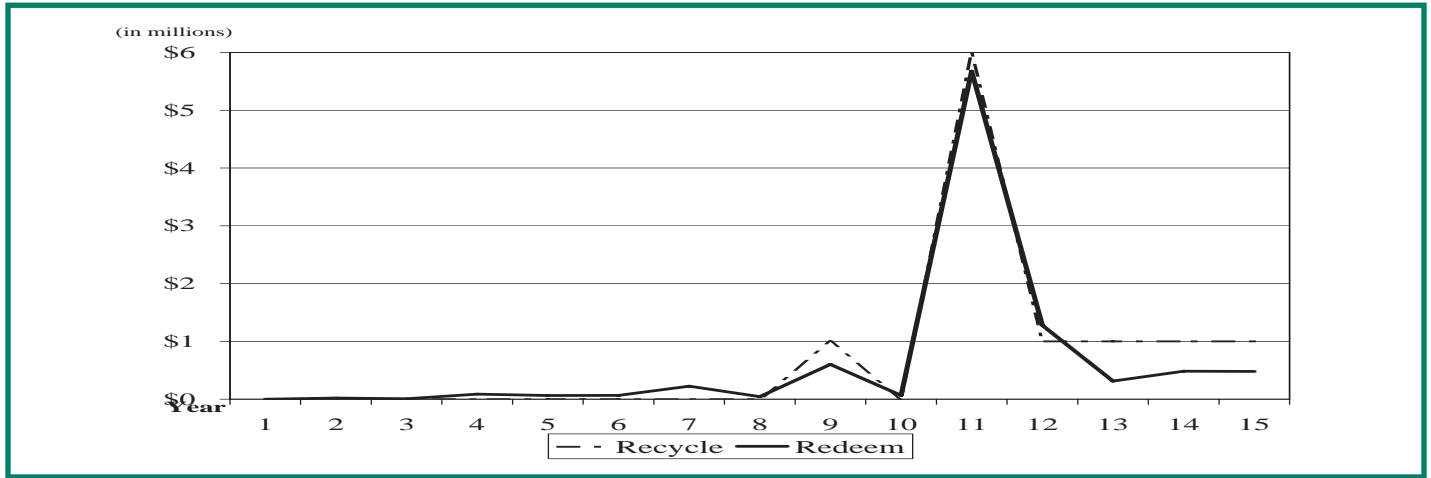


Figure 3
Illustrative Repurchase Obligation Analysis
SponsorCo Projected Cash Outlay

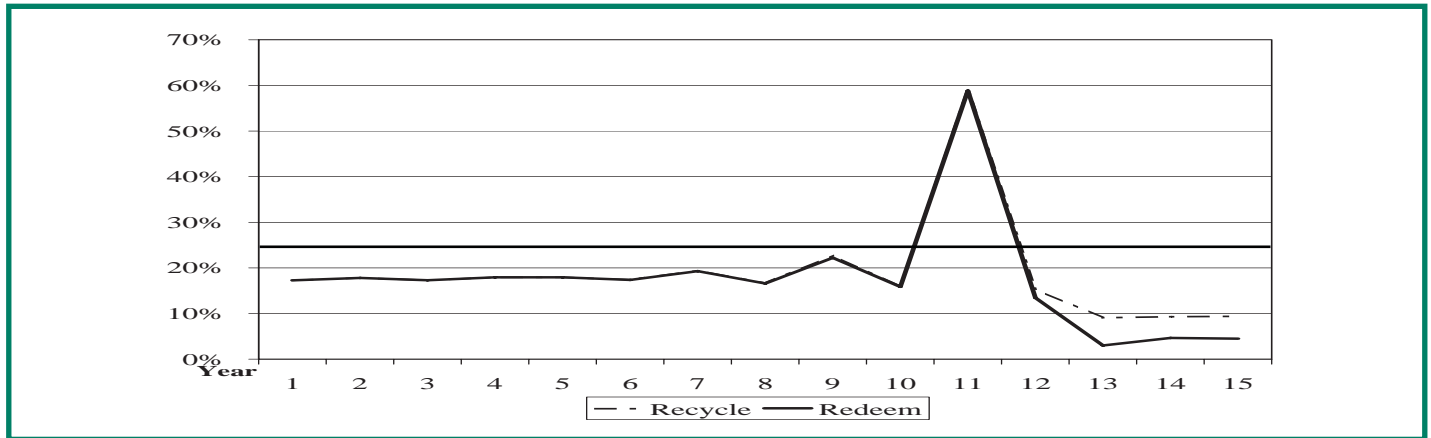
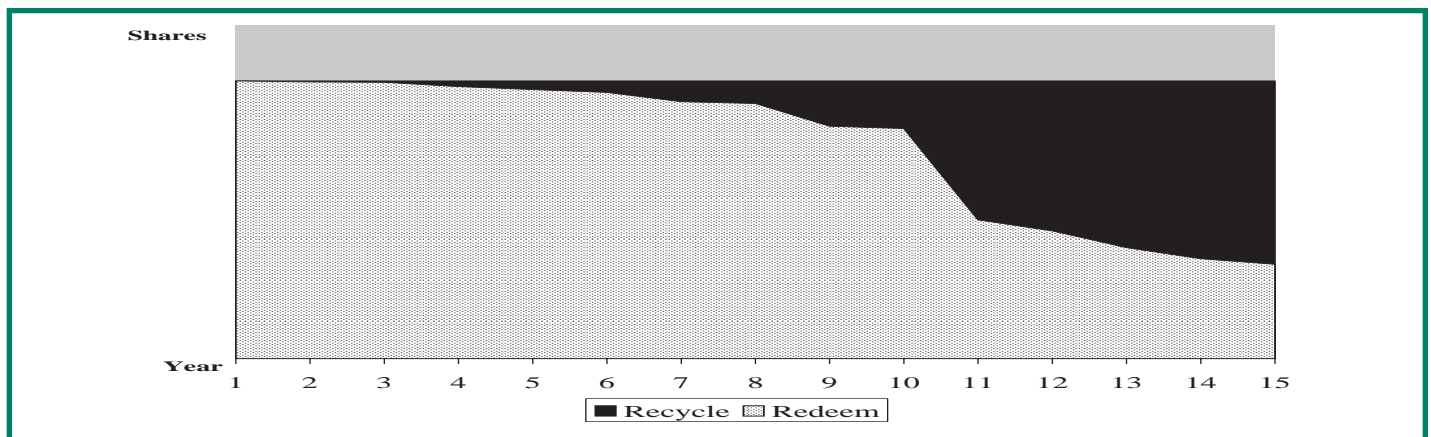


Figure 4
Projected Number of Employer Corporation Shares
Included in the SponsorCo ESOP



The analysis performed by the consultant may consider the estimated repurchase liability anticipated over the projection period (say 15 years). Figure 1 presents the projected obligation by year, broken down by the cause of the ESOP distribution.

As presented in Figure 1, the liability is minimal during the ESOP loan repayment period. After the tenth year, however, the repurchase liability increases significantly. The repurchase liability increases due to the following:

1. Terminated participants will be eligible to receive their ESOP distribution (in this example, the plan was designed to restrict payouts until the ESOP stock acquisition loan was repaid).
2. Participants first eligible when the ESOP started will have ten years of plan participation and will be eligible for diversification of their stock account if they have attained age 55.

In the example presented in Figure 1, the result is nearly \$6 million of repurchase liability in year 11 of the plan.

Figure 2 presents the difference in repurchase obligation if (1) the employer corporation shares are recycled back through the ESOP or (2) the employer corporation shares are redeemed (but not retired) outside of the ESOP. As expected, there is little difference between the two options until after the 11th year, when recycling starts to show an increased repurchase liability.

Figure 3 provides the SponsorCo total cash outlay, including (1) contributions to the plan and (2) amounts needed to meet the repurchase obligation. It is prudent to look at this analysis as a percentage of payroll. This is because there may be deduction limits (generally 25 percent of accrued payroll) that could restrict the company's ability to handle the repurchase through additional cash contributions to the ESOP on an as needed basis.

Lastly, Figure 4 presents what happens to the number of employer corporation shares in the ESOP depending on whether the sponsor company recycles or redeems the employer corporation shares. The impact of redemption is clearly significant to the ESOP.

SUMMARY AND CONCLUSION

Going through the process of conducting a repurchase obligation analysis early in the life of the ESOP makes available all of the options for repurchase listed earlier in this discus-

sion. With 10 years to plan, SponsorCo management could begin to make additional cash contributions to the ESOP as a resource for repurchase liability. It should be noted, however, that there will be a certain amount of leakage with this reserve as departing ESOP participants will have acquired some part of these additional contributions.

SponsorCo management may also start preparing for a new ESOP loan in the 11th year. SponsorCo management could use the new loan proceeds (1) to repurchase shares and (2) to stretch out the period over which these repurchased shares will be allocated to participants' accounts. By knowing the repurchase liability facing SponsorCo (or at least a reasonable estimate), SponsorCo management can plan for the cost of the obligation—even as circumstances change.

On the other hand, if a repurchase obligation analysis is not conducted until the eighth or ninth year of the ESOP, the business may be in a down cycle where credit is tight. Options to meet the repurchase obligation may be more limited in future years. And, SponsorCo management may be forced into the sale of the employer corporation.

It is important to conduct a repurchase liability analysis early in the life of the ESOP. It is also prudent to review the repurchase obligation study every year. Further, the initial analysis may be updated (1) if actual experience has deviated from that assumed or (2) if it appears that future experience will be discernibly different from the assumption.

A new analysis should be performed every three to five years in order for the analysis to reflect even small variances. Finally, undertaking a repurchase obligation study such as the one outlined in this discussion may protect the ESOP sponsor company from potential fiduciary liability.²

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Notes:

1. The Pension Protection Act of 2006 added additional diversification requirements for certain defined contribution plans.
2. See *Armstrong v. Amsted Industries, Inc.*, No. 01 C 2963 U.S. Dist. Ct. (N.D. Ill. July 30, 2004) which indicated that a repurchase obligation analysis, even a faulty one, protected an employer corporation from a fiduciary breach claim.

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