

## THE ESOP TRUSTEE'S ROLE IN ESOP STOCK VALUATION AND REPURCHASE OBLIGATION

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*This article addresses some common questions relating to the ESOP trustee's role in ESOP stock valuation and repurchase obligation.*

### **Who is the legal owner of the stock held by the ESOP?**

- ESOP participants are not the legal or record owner of the company stock allocated to their accounts in an ESOP.
- The trustee of the ESOP is the legal and record owner of company stock.
- Participants are the beneficial owners of company stock.
- The trustee is appointed by the board of directors of the company and may be removed by the board of directors at any time with proper notice.

### **Has the Department of Labor provided guidelines on repurchase obligation issues?**

- The DOL has proposed but not finalized regulations regarding issues related to the valuation of stock in transactions between parties in interest.
- Roles and responsibilities relating to repurchase obligations are addressed by these proposed regulations and ERISA:
  1. Determination of the fair market value of the company stock must be made at the time it is either given or purchased by the ESOP and annually thereafter.
  2. Determination must be made that any loan agreement entered into by the ESOP contains interest rates and terms that are reasonable.
  3. Determination must be made that the company has adequate resources to meet its repurchase obligation when ESOP shares are put back to the company.

### **What are the trustee's duties to guide the company in designing the ESOP plan document including distributions options that affect repurchase obligations?**

- The trustee should assist the sponsor of the ESOP to consider options that minimize repurchase obligation pressure on the company in the stage in which it is highly leveraged.
- While the final decision on plan design is made by the sponsoring company, the trustee has an obligation to ensure that the company has sufficient cash flow to meet its debt obligations.
- Options that generally minimize the repurchase obligation pressure on the company in the early years of leverage include:
  1. Adopting the statutory delay period that permits the ESOP to defer making distributions to non-retiree terminated participants until after the ESOP debt is paid in full. \* Experienced lenders may also require this provision to ensure that cash flow of the company will be available to service debt.



2. Distribute ESOP accounts to non-retiree terminated participants beginning five years after termination of employment with the company.
3. Distribute ESOP accounts in a lump sum in stock and pay put option over five years using a note paid with interest.
4. Distribute ESOP accounts over five years in installments.
5. Convert the account of a terminated employee to cash immediately after termination and hold until distribution is required.

### **Should the trustee insist on a repurchase liability study?**

- The trustee can promote the determination of adequate resources by influencing the company to perform a formal repurchase obligation study or to make an internal estimate of the future obligations due.
- The trustee will then, independent of the company, determine if the company will be able to repurchase the stock that will be put back to it.
- Should the trustee determine that the company could not meet its obligation, the trustee, through its independent financial advisor, could renegotiate with the sellers. For example, the purchase price might be reduced or the percentage of stock purchased might be reduced, thereby lowering the repurchase obligation.

### **What obligations does the trustee have with respect to diversification, distributions and dissemination of material to participants?**

- The trustee should make sure that diversification is offered to all eligible participants and that distribution rules are followed.
- The trustee should ensure that summary plan descriptions are distributed to all plan participants.
- The trustee should ensure that annual statements are provided to all ESOP participants.

### **What is the role of the IRS and DOL in overseeing ESOPs?**

- Both the IRS and DOL are involved in overseeing ESOPs.
- Sometimes the two federal agencies do not agree on the solution of the issues brought before them.
- This leaves the trustee without clear direction.
- It is the legal obligation of each ESOP trustee to be knowledgeable regarding the standards set out in ERISA.
- The ESOP trustee must conduct and act exclusively in the best interests of the ESOP participants and beneficiaries.
- Companies with ESOPs where the trustee are members of company management or are shareholders should be extremely wary of the fiduciary liability created by repurchase obligations.



### **What are the obligations of the trustee to monitor the repurchase obligations of the company?**

- At the present time, there is no specific requirement that would obligate either the sponsoring company or the ESOP trustee to perform periodic repurchase liability studies.
- The trustee would be guided by general obligations under ERISA to examine repurchase liability.
- Factors to be considered by an ESOP fiduciary might include:
  1. Size of the ESOP as a percentage of the company owned
  2. Age of the ESOP
  3. Relative ages of the ESOP participant group
  4. Cash flow of the company
  5. Size of participant account balances
  6. Vesting of account balances
  7. Number of employees who are close to retirement
  8. Turnover experience of the company
  9. Distribution methodology under the ESOP plan document
  10. Cash build-up in the ESOP trust
  11. Existence of a corporate sinking fund
  12. Trends in the fair market value of company stock

### **How would the company benefit from doing an annual repurchase obligation study?**

- It would be desirable from a fiduciary viewpoint for the company to make a repurchase obligation study part of the company's annual budget process.
- The major benefits for the company performing such a study would be:
  1. Measurement of the amount of cash needed to repurchase stock distributed from the ESOP
  2. Determination of the timing of this cash flow need
  3. Quantification and understanding of the components that impact the obligation so the company can better manage its finances
  4. Creation of a basis to form a long-term repurchase obligation funding strategy
  5. Determination of an accurate debt service analysis

### **What alternative strategies are available to companies to fund repurchase obligations?**

- Funding out of Current Cash Flow. The company does not set aside funds for the required repurchase of shares, choosing instead to fund from the cash flow of current operations. The current cash flow method provides little security if the company's fortunes turn downward or the plan experiences a large distribution within a single year. This alternative is one of the most commonly used among ESOP companies, most likely because it requires no planning.



- Pre-funding through Additional Cash Contributions. The company makes contributions to the ESOP to fund future projected repurchase obligations. This method can be especially effective when the level of contributions is within the “market level” of benefits for the employer. Pre-funding should maintain the current level of ownership percentage. The tax benefits are available to the company in the year the contribution is made. This is the funding alternative of choice for companies that re-circulate ESOP shares.
- Debt. The company or the ESOP may be able to borrow money to satisfy its repurchase obligation shares from ESOP participants receiving distributions. This funding alternative’s use often reflects improper planning or occurs when a significant event has occurred causing a large, unexpected repurchase expense. The use of debt can cause an immediate drop in the value of the company and might not be available when needed.
- Corporate Sinking Fund. Use of a sinking fund involves the systematic setting aside of corporate assets for the specific purpose of repurchasing ESOP shares put to the company. A sinking fund can be the most effective method of pre-funding the repurchase obligation because the company does not face any limitation to its pre-funding effort. It also provides some security for participants demonstrating there will be cash available for future repurchases. Contributions to corporate sinking funds are not tax deductible.
- Corporate Owned Life Insurance (COLI). This funding alternative is a mechanism for establishing a corporate sinking fund that uses an investment product that has limited tax benefits (e.g., life insurance). Use of COLI requires a long-term time horizon for the tax advantages of the investment to take effect. The costs associated with COLI include premium taxes, sales and administrative expenses and mortality charges. Companies should not consider COLI unless their written ownership policy commits the ESOP to be maintained longer than the lives of the current employees. The investment returns should provide an after-tax return that is greater than market levels. COLIs should only be used with the redemption of ESOP shares.
- Sale to a Third Party. Sales to a third party can involve the entire company or merely the sale of partial interest. This is as much an ownership policy issue as a funding alternative. Generally, the sale of a company is not planned for but rather turned to as the last best option to relieve the company of its ESOP repurchase obligation.
- Sale of Stock. Raising capital by the sale of stock (usually newly created) can also be considered. Most often considered to fund growth, this type of sale might “dilute” the ESOPs proportion of stock ownership, which might reduce the future repurchase obligation.
- Initial Public Offering (IPO). The question as to whether or not to become a public company is an ownership policy issue. However, there are many financial and economic issues that must be considered before an IPO is created. Many ESOP companies discover that the costs of an IPO outweigh the benefits derived. Going public does not automatically solve the company’s ESOP repurchase obligation as the IPO’s stock might be thinly traded. Thinly traded stock does not meet the “readily tradable on an established market” definition for employer securities. Therefore, the ESOP trustee would still need to determine fair market value independently.



Additionally, the company would need to carefully evaluate the impact on the market value of the stock when a large block of ESOP stock enters the public market.

- Employee Investment in Company Stock through a 401(k) Plan or Employee Stock Purchase Plan. This funding alternative is becoming increasingly popular with ESOP companies. A widely held myth is that ESOP companies who are privately held cannot allow participants the option of choosing to invest their 401(k) deferrals, or other voluntary contributions in employer stock. It is assumed that this type of employee investment requires registration with the Securities and Exchange Commission (SEC) and/or other state “blue sky” law requirements. Most ESOP companies are usually exempt from one or more requirements of these registration requirements. However, even if an ESOP is exempt from SEC registration, additional financial disclosure and reporting rules will be required by ERISA. Legal complexity and concern for concentration of investments in company stock by the employee has historically limited its appeal to larger, privately held ESOP companies.
- Direct Ownership by Employees Outside of Qualified Retirement Plans. Some companies can establish “internal markets,” which allows their employees to invest in the company. Programs such as stock grants, stock option plans, direct awards, phantom stock, deferred compensation arrangements and employee stock purchase plans can create demand for company stock. This demand can be used to absorb shares distributed from the ESOP. These programs can reduce the number of shares the company is required to buy. However, the demand from these programs will be erratic and unpredictable. In the end, the company is still responsible for the repurchase of all ESOP shares not absorbed by direct employee ownership arrangement outside of a qualified retirement plan.
- S Corporation Status ESOP. Effective January 1, 1998, companies that sponsor ESOPs will be eligible to make the “S election” for federal income tax purposes. An S corporation is not subject to federal income tax. Instead, the S corporation’s income is passed through to the shareholders, whether it is distributed to them as dividends or retained in the corporation. An important tax advantage of this treatment is that only one tax is imposed on the earnings of an S corporation. Regular or “C corporations” are subject to a “double tax” – once at the corporate level and again at the shareholder level when the after-tax corporate earnings are distributed to the shareholders.

Substantial tax savings might be available for ESOP companies that make the S election. This is because ESOP trusts are tax exempt and, therefore, the share of an S corporation’s income that is passed through to an ESOP will not be subject to income tax. An ESOP company that makes the S election may apply part or all of the tax savings to fund the ESOP repurchase liability, either by contributing to the ESOP cash equal to part or all of the tax savings or by applying the tax savings toward funding of corporate redemptions.

