ARE YOU READY FOR THE PUT?

Chief financial officers are responsible for optimizing capital efficiency and protecting the integrity of the balance sheet. Unfortunately, some overlook the risks that their employee stock ownership plans (ESOPs) pose to those goals or miss financial opportunities by failing to plan for their repurchase liabilities (RPLs).

ESOPs provide private company owners and stockholders real advantages when transitioning their company to successor owners. Forming an ESOP creates a market for the stock by selling a portion or all of the company to the plan. This also provides significant tax and liquidity advantages for the shareholders. In addition, the ESOP creates incentives for employees who participate. Corporate ownership through the ESOP trust gives employees a keen interest in the overall performance of the company and increases the company's share value. Increased share value translates to larger retirement account balances, improved morale and better retention.

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ESOP sponsorship comes with its own unique responsibilities. In order to assure employees of the ESOP's financial viability, the corporate finance team must develop a plan to fund the plan's RPL. Most private companies begin this process by conducting a comprehensive actuarial repurchase obligation study, examining the employee population and forecasting the company's obligation. The study considers four factors: retirement, death or disability, termination, and diversification.

When vested participants retire, die, become disabled or are terminated from employment, or when certain participants reach age 55, the ESOP's repurchase obligation is triggered. Internal Revenue Code (IRC) section §409(h) provides that a vested participant who is eligible for a distribution must be given a "put option" enabling them to sell shares back to the company. This put option can be triggered with as little as 60 days' notice. In other words, the company must make a market for the company stock held in the participant's account. Since the RPL is off the balance sheet, the company has a real obligation to purchase the shares; however, they are not required to account for this liability on their financial statements

THE COST OF PROCRASTINATION

Many challenges may arise for companies without an established financial plan to address the RPL, including:

- Devaluation of company stock
- Poor employee morale as a result of the value of company stock
- Limited ability to secure corporate credit
- Personal liability for ESOP fiduciaries
- Company insolvency created by repurchase cash flow demands

Companies with newer ESOPs tend to ignore the obligation because, in the early years, RPLs are small and manageable. As individual ESOP accounts grow and ESOP share value increases, the obligation can also grow significantly. It is easy for ESOP sponsors to develop a false sense of security when current corporate cash flows can easily sustain the liability. But these ESOP sponsors may be surprised by the future growth of the obligation. Employee retirements are predictable; however, deaths, disabilities and terminations are random and difficult, if not impossible, to accurately anticipate.

Failing to plan and fund the repurchase obligation may force a plan termination or corporate liquidation, or result in an initial public offering (IPO) or merger. Lack of a plan may also create inadvertent credit challenges and cash flow problems. With this issue in mind, credit facilities today often require current actuarial studies from their business customers with significant ESOP stock ownership.

THE SOLUTION

The ESOP RPL should be taken seriously. Plan fiduciaries have a legal duty to manage the obligation responsibly, and companies should create very specific strategies. Many engage ESOP valuation consultants to prepare repurchase studies based on relevant actuarial assumptions. A repurchase study creates a road map for corporate finance and investment teams to anticipate the negative cash flow events associated with the repurchase of ESOP shares. Depending on the plan's design, the ESOP trust may make the repurchase from employees or beneficiaries, but it is ultimately the sponsoring company's obligation if the trust has insufficient assets. With a repurchase plan in place and routine monitoring, the RPL can be very manageable.

FOUR EVENTS TRIGGER THE REPURCHASE OBLIGATION

- **Retirement**
  Distributions must begin within a year after the end of the plan year in which the participant retires. They can generally be spread over a maximum of five years (six installments).
- **Death or Disability**
  Distribution requirements are the same as above.
- **Termination (Voluntary or Involuntary)**
  Distributions can be deferred up to six years or until an existing ESOP loan is repaid. They can be spread over a five-year period.
- **Diversification**
  At age 55, an ESOP participant with at least 10 years of participation in the plan must be given the option to diversify up to 25% of the value their ESOP account. "Diversifying" means converting the beneficial interest in the employer's stock to another investment option within the plan. This option continues until age 60, at which time the employee has a one-time option to diversify up to 50% of their account. This requirement applies to ESOP shares allocated to employees' accounts after December 31,1986.

BUILDING A STRATEGY

Once the repurchase study is complete, then it's time to build the financial plan. The plan should incorporate four components:

1. The repurchase study, outlined above
2. An investment strategy
3. Execution
4. Monitoring

The strategy aligns corporate objectives, potential tax ramifications and investments. (The investment strategy should consider market volatility, interest rates and glide path.) During the planning process, an in-depth analysis should compare the utilization of corporate cash, mutual funds, corporate-owned life insurance (COLI) or a combination of the three. The fully developed strategy will match cash flows predicted in the repurchase study with the financial plan, creating a sinking fund to assure asset availability when the repurchase obligations mature and come due.

The types of investments in the financial plan should encompass all classes and styles. Additionally, COLI should not be overlooked. As mentioned, the RPL is excluded from the balance sheet — as are life insurance death benefits. Using COLI as part of your strategy will not only provide a cash accumulation tool, but also create death benefits payable to the company that offset the

ESOP repurchase cost and protect the company from losses associated with the untimely death of key personnel.

Choosing the right mix of financial tools will depend on the sponsoring company's unique circumstances. The approach must consider not only the plan itself, but also other stock plans, qualified plans and nonqualified plans to provide an integrated approach to total retirement and wealth creation strategies. Utilizing a single advisor who understands the complexities of all these benefit programs will provide more holistic advice, more cost-effective plans and better employee outcomes. Through our network of partners, NFP is uniquely qualified to simplify this planning process while minimizing cost, reducing human resource time, improving the employee experience and protecting the integrity of the balance sheet.

Dan Barry is a senior vice president with NFP and serves as the Southeast region practice leader for Executive Benefits. Dan has more than 30 years of experience in the executive benefits business. He has specific expertise in the design, implementation and administration of benefit restoration plans, 409A (nonqualified deferred compensation) plans, and alternative benefit strategies to assist companies in their efforts to recruit, reward, retain and retire executive talent. Daniel also has significant experience in developing and implementing strategies to help closely held businesses with succession and transition planning.

About NFP

NFP is a leading insurance broker and consultant that provides employee benefits, specialized property and casualty, retirement, and individual private client solutions through our licensed subsidiaries and affiliates. Our expertise is matched by our commitment to each client's goals and is enhanced by our investments in innovative technologies in the insurance brokerage and consulting space.

NFP has more than 5,700 employees and global capabilities. Our expansive reach gives us access to highly rated insurers, vendors, and financial institutions in the industry, while our locally based employees tailor each solution to meet our clients' needs. We've become one of the largest insurance brokerage, consulting, and wealth management firms by building enduring relationships with our clients and helping them realize their goals.

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