Employee Stock Ownership Plans:
Do the Benefits Outweigh the Risks?

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Employee Ownership. Excellent Exit Strategy. Tax Advantageous. Company Growth. Increased Shareholder Value. Increased Employee Motivation. These are just a few things that many think of when considering an Employee Stock Ownership Plan (ESOP). Employees and employers alike can reap significant benefits from an ESOP; however, upon closer inspection, ESOPs may not be the right fit for every company. There are many positive arguments that can be made for ESOPs, yet little attention has been paid to the risks that ESOPs can present.

ESOPs are a qualified defined contribution employee benefit plan designed to invest primarily in the stock of the sponsoring employer. By definition, ESOPs break one of the cardinal rules of investing: diversify. ESOPs inherently increase the concentration of assets in a single security—company stock, and critics believe that this makes ESOPs too risky. Diversification is meant to reduce the exposure to one particular asset or investment and reduce risk and volatility. In fact, there are federal laws governing employer sponsored retirement plans which require assets within the plan to be diversified; however, ESOPs are exempt from these laws. The risks faced by privately held companies can be different than those faced by publicly held companies, and companies considering an ESOP need to be aware of these differences when considering risks associated with an ESOP.

The lack of diversification is an understandable concern. Employees have an added risk when they depend on the same, single company, for both their paycheck and their retirement account. What happens when an ESOP company begins to struggle financially? Generally, the stock price drops, causing participants’ retirement accounts to suffer. Often time, layoffs occur, compounding the problem. Now, you may have employees out of work, declining retirement accounts and no financial security to fall back on when employees may need it the most.

On second look, is the lack of diversification as concerning as many think? The diversification argument assumes that companies are substituting the ESOP for a diversified retirement plan. While this might be true in some cases, ESOP companies typically have a secondary retirement plan. That secondary retirement plan is often a 401(k) plan and is usually, at least, partially funded by the employee. The 401(k) plan (or any other qualified retirement plan sponsored by the employer) would be subject to the federal diversification laws and would not be directly linked to the financial well-being of the company. In essence, this is a way of diversifying the ESOP plan and is recommended by most benefit experts. In addition, employers could combat the problem of diversification by allowing, and encouraging, participants to diversify out of the employer stock at a rate sooner than legally required, allowing distributions immediately after termination, or allowing in-service distributions. Nonetheless, diversification should be considered when considering an ESOP.

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Corporations with ESOPs invested in privately held company stock that is not readily tradeable on an established market face a unique cash flow risk that can quickly escalate. This risk arises from the requirement that a participant in an ESOP holding privately traded stock must be given a “put” option, forcing the company to repurchase this stock at its fair market value. The common events that lead to an ESOP repurchase obligation are:

- Preretirement termination of employment
- Retirement
- Diversification
- Disability
- Death

Preparation is the best way to minimize the effects of the repurchase obligation. The best form of preparation is to perform a feasibility study when establishing the ESOP and in-depth repurchase liability studies throughout the life of the ESOP. An ESOP repurchase study is used to forecast the future repurchase commitments. This study will project the amount of cash flow needed to meet the above mentioned repurchase obligations. These studies can alert employers to future distribution obligations, so that they can be prepared with sufficient cash available to fulfill distributions.

Although employers can delay ESOP distributions for years after a participant terminates (up to five years or until the leveraged loan is paid), many employers do not want to see terminated participants share in the growth of the company; therefore, they want to allow distributions from the ESOP in a timely manner after termination. This view may change, however, if the employer isn’t prepared for the cash obligation this may cause.

Some ways that employers can plan for the cash needed to fulfill the repurchase obligation are:

- Require that some cash be held in the plan as a reserve for cash payouts
- Hold segregated cash in a separate company account, intended to only be used for future ESOP distributions
- Consider additional ESOP loans

### Leveraging

An ESOP is the only tax-qualified plan that can be leveraged. Leveraging can be a useful tool to battle the repurchase obligation, but can also be a source of abuse if the employer does not adhere to its intended purposes. In general, retirement plan assets are to be used primarily for the benefit of the participant and cannot be used to finance employer operations. Leveraging also should not be abused as a means of delaying ESOP distributions. For example, delaying distributions until the ESOP loan is repaid is acceptable; refinancing near the end of the loan term in order to extend the distribution timing in not acceptable. Delaying distribution payment until the leveraged loan is repaid also heightens the problem of diversification previously discussed.

A leveraged ESOP may also risk creating a “Have and Have-Not” issue. Leveraged ESOPs generally release shares annually as the loan is repaid; at which point all shares have been released into the hands of participants. The participants with shares are considered the “Haves” and new participants entering the plan are considered “Have-Nots.” How can employers address this problem? Again, future preparation is the best defense, but a few common remedies to consider if this issue is imminent are:

- Redeem shares throughout the life of the ESOP loan and place those shares in treasury. These shares can be releveraged or recontributed to participants at any point. This method may dilute the price of the stock so should be analyzed carefully.
- Issue new shares that can also be leveraged or contributed to participants. This option also bears the same stock price risk.
- Recycle shares each year. As participants sell shares to take a distribution, these shares are repurchased by active participants. This is a way of getting shares into the accounts of all active participants, including new participants, but may not get shares into their account at a rate fast enough to relieve the Have and Have-Not issue.
- Rebalance the ESOP each year. Each year the accounts are balanced so that each participant has the same percentage invested in employer stock and cash. This is a way of taking shares from the Haves for the benefit of the Have-Nots.
Many things may affect the employer’s decision on which direction to take when dealing with the Have and Have-Not issue, including employee culture, morale and the financial situation of the company.

**Administration**

The set-up, administration, and annual work required to keep an ESOP flowing can be quite complex and typically carry more expense than other qualified retirement plans, which can also affect the cash flow of the ESOP. Record-keeping for ESOPs is complex, as are the rules governing ESOPs. There are many areas of ESOP design and administration that can be risky. An improperly designed loan can become a prohibited transaction rather than an exempt loan; failure of the §409(p) anti-abuse test can disqualify an ESOP; §1042 transactions can disqualify an ESOP if assets aren’t handled properly during the transaction period. These are only a few examples, as there are a number of errors that could affect the tax-qualified status of the plan. It is crucial that the employer choose an expert support team when designing and administering an ESOP. Among other things, ESOP recordkeepers should have strong knowledge and expertise in the area of loan tracking, special tax rules for deductions, and §1042 transactions and restrictions.

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While there are many successful ESOPs throughout the country, the media loves to focus on the failures of some of the big dogs, drawing attention to the risks associated with these unique plans. Is this negative attention? Maybe, however, the media attention and focus on risk may not be a horrible thing; it may make companies more aware and force them to analyze the situation before jumping into an ESOP. Despite the risks, the fact is that when considering options for succession, many business owners see ESOPs as a more attractive option than selling to a competitor or attempting a company buyout. Despite the fall of Enron, RadioShack, and United Airlines the number of ESOPs continues to increase because of the great benefits, mainly tax savings.

So the question remains—do the benefits of ESOPs outweigh the risks? The more important question may be: Is your company an ideal candidate for an ESOP? Plan sponsors hold significant responsibility in the retirement security of their employees and ESOPs should only be considered by secure, financially sound companies.

**In perspective**

Some questions employers may want to ask when contemplating an ESOP: Does my company have a strong cash flow and history of increasing profits? Does my company have a strong management team that can sustain that profit in the foreseeable future? Does my company have a strong workforce that will embrace the meaning of the ESOP and work toward the growth of the company? If these criteria are met and a knowledgeable group of advisors are recruited to guide the company through the legal, accounting, and administrative arena, an ESOP might be a great fit. While risk is certain and success is not guaranteed, the potential is great. The liability of maintaining an ESOP can be tremendous, but the benefits and rewards can be enormous.

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