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Sustaining Employee Ownership for the Long Term: The Challenge of the Mature ESOP Company

By Martin Staubus

The first ESOPs were established even before Congress enacted the formal authorizing law as part of ERISA in 1974. Following the passage of that legislation, the number of ESOP companies grew steadily. Today the count is approaching 12,000. While many of these ESOPs have been established only in the past few years, others have been in existence for 10, 20, even 30 years. These veteran ESOP companies have much to teach us about what it takes to sustain ESOP ownership over the long term.

Haves and Have-Nots

The most widespread challenges that mature ESOP companies encounter is the problem of the "haves and have-nots." This is the term that is now used to describe a situation in which some employees (usually those who have been with the company for many years) have accumulated substantial ESOP accounts, while other employees (the relative newcomers and/or those with low compensation rates) have much smaller account values. This typically occurs as a result of a large-leveraged ESOP stock purchase that occurred a number of years in the past. This led to large allocations of shares during the years that the acquisition loan was being paid off, but much smaller share allocations once the loan was paid off and the stock suspense account was depleted. Employees hired after the loan was paid off may receive nothing but the handful of shares that result from terminating employee forfeitures of unvested stock.

The effect of this pattern is that it creates two classes of employee shareholders: those with large account balances, who will be highly motivated to protect and enhance the value of their accounts; and those with meager account balances, who will be unlikely to see employee ownership as something that is truly significant. For these employees, the company's efforts to promote employee ownership culture and spirit may be greeted with disinterest and cynicism, even a sense of alienation from the "inner circle" of long-tenured employees who are seen as enjoying higher ranking positions, influence and fat ESOP accounts. Moreover, aside from these problems of culture and morale, this situation produces a pragmatic problem of which even the most steely eyed CFO will take notice. That is, the concentration of ESOP stock in the accounts of the more senior employees has the effect of accelerating the company's repurchase obligations. Shares concentrated in the accounts of employees in their fifties will no doubt have to be bought back in the next ten years. If more of those shares were in the accounts of employees in their thirties, the repurchase obligation would be deferred.

So okay, already, you say. You get it. A "have and have nots" situation creates problems of culture, morale and finance. The question is - what can be done about it?

There are in fact a variety of techniques that can be applied to moderate the situation. You can think of this collection as a kind of tool box. The bad news is that none of these tools is likely to be a magic bullet that instantly wipes out the problem. Rather, each tool, on its own, may only be able to nibble at the problem. The good news is that it may be possible to apply two, or three or four of the tools concurrently. And the combined effect can produce significant improvement. Let's take a look at what's in the tool box.

1. Longer ESOP loan terms (an ounce of prevention...). A basic provision of ESOP finance is that when an ESOP borrows money to buy stock, the shares that are purchased with that money are initially held by the ESOP trustee in a "suspense account," and only allocated to employees over the succeeding years at the same rate as the borrowed money is repaid. But who is the lender? Bank financing for ESOP transactions is typically structured as a "mirror loan" arrangement. That is, in order to supply the ESOP with the cash to buy stock, the bank will loan money to the company (the outside loan), and once the company has the cash it will then make its own loan of that money to the ESOP (the inside loan). Banks like to be repaid fairly promptly by smaller, private companies, and will typically insist on a repayment schedule for the outer loan that gets the money back to them within five years. But the company and the ESOP are free to agree to a longer repayment schedule for the inner loan – perhaps 10 or even 15 years. Importantly, the release of shares from the ESOP suspense account is based on the repayment of the inner loan. By stretching the term of that loan, a company can defer the day that the suspense account runs out of shares to release. And, by the time it does run out, there will be a larger number of veteran ESOP participants who are leaving the company, so their shares can be bought back from them and made available for allocation to the other employees. Which leads us to the next tool...

2. Recycling shares. When the time comes for a terminated employee to cash in his/her ESOP shares, there are three options for how to proceed: a) the company itself can buy the shares from the former employee and then simply retire the shares; b) the company can buy the shares and then (rather than retiring them) contribute them to the ESOP; or c) the ESOP can buy the shares (if it doesn't have necessary cash, the company can supply it). Options b and c effectively "recycle" the shares that are bought from departing participants. That is, the shares they cash in are returned to the ESOP where they will once again be allocated to all eligible participants according to the ESOP's standard allocation formula. There may be reasons why an ESOP company might want to chose option "a" and retire the shares of terminating employees. But they should be mindful of the negative effect of that practice with regard to the haves and have-nots problem. In fact, this "recycling" process is likely to be the largest single source of shares for allocation to the have-not participants. Unless, of course, the ESOP has an opportunity to...

3. Buy an additional block of shares. Where an ESOP does not already own 100 percent of the company's outstanding stock, it is possible that a non-ESOP shareholder may be prepared to sell stock to the ESOP. The ESOP's acquisition of another significant block of stock will likely fix the haves/have-nots problem for a number of years to come; so it's a great step if you can get it. Otherwise, the only source of new shares for the ESOP may be...

4. Company contribution of new shares. In some years, the departure of some of the "haves" employees may produce an abundance of shares to allocate to newer employees, so that "recycling" becomes quite effective. But what if, in a given year, that isn't the case? What if there are no participant departures, and consequently no shares to recycle? An option is that the company can print up some new shares and contribute them to the ESOP. This will create a supply of shares that the ESOP can allocate to the participants, and may also generate a tax deduction for the company, resulting in a cash flow increase. On the downside, however, it will result in share price dilution. For this reason, this is a tool that a company will use judiciously. If the prospect of share price dilution is a show-stopper, there is always...

5. Rebalancing of accounts. If, in a given year, the ESOP does not have an adequate supply of shares to allocate to participants, a company may still be able to put stock in have-not employee accounts through "cash and rebalancing." This process begins with a company contribution of cash to the ESOP. As with all contributions, that cash will then be allocated among all eligible participants according to the plan's allocation formula. At this point, new participants will have cash in their ESOP accounts, but no stock. In fact, the plan as a whole may now hold, say, 95 percent of its assets in the form of company stock, with the remaining 5 percent in cash. While this is the overall ratio of the plan, individual employee accounts will vary significantly. The new participant just described, for example, will have an account that consists 100 percent of cash; while a veteran participant who had already accumulated many shares in years past may have an account consisting of 99 percent stock and 1 percent cash. The magic comes with the second step in this process: the ESOP trustee exercises its fiduciary authority to "rebalance" the investment asset mix of the plan participants. This process involves adjusting each participant's mix of stock and cash so that each ends up with the same ratio of (in this example) 95 percent stock and 5 percent cash without changing the dollar value of any account. So the veteran employee with a $100,000 account ($99,000 in stock and $1,000 cash) will end up with an account that is still worth $100,000 but now consists of $95,000 in stock and $5,000 cash. Conversely, the new employee whose account balance had consisted solely of $1,000 in cash will end up with an account consisting of $950 in stock and $50 in cash. Presto! The new participant now has stock in his ESOP account. And the ESOP as a whole has cash that can be used to fund future redemptions of stock from departing participants. Which raises another consideration: what do you do if the retirement of a group of senior ESOP participants results in an unusually large number of shares becoming available for repurchase? There may in fact be far more shares than is really needed for the year at hand. If only there were a way to preserve some of those shares for succeeding years...

6. Redeeming shares with a new inner loan. For the most part, most companies simply pay their repurchase obligations out of cash flow. If x number of dollars is needed to redeem shares from departed participants, then the company contributes that amount to the ESOP so it can repurchase and recycle the shares. But there is another option: if the ESOP needs x number of dollars to repurchase shares, the company can loan that sum to the ESOP, rather than giving the money outright as a contribution. As with all loan-financed ESOP stock purchases, the shares will initially be held by the trust in a suspense account. The length of the loan can be set based on how long the repurchase forecast suggests would make sense. For example, if the value of the shares to be redeemed equals, say, 30 percent of company payroll, then a three-year loan term (to be repaid in equal installments) would result in annual releases of stock from the suspense account of roughly 10 percent of payroll. In short, this is a technique for smoothing the peaks and valleys that may occur from year to year in the number of shares being tendered by departed participants. But what if you don't have a large number of shares coming into the plan? Maybe you can manufacture an extra supply if you...

7. Offer early diversification. The law's requirement is that ESOP companies offer certain diversification opportunities to participants who meet both of the following criteria: they have at least 10 years of participation in the ESOP; and they are at least 55 years of age. Participants meeting those criteria must be offered the opportunity to cash in and reinvest up to 25 percent of the stock in their account. There is nothing in the law, however, that prohibits an ESOP company from offering diversification opportunities to participants who do not meet the above criteria. For example, the company could offer diversification to participants who reach age 50, or to those with only five years of participation, or they could increase the amount that can be diversified to 50 percent. By expanding diversification eligibility, the company may get more of the "haves" to take up that opportunity, which will generate more shares that can be recycled. Of course, the lion's share of this stock may still end up going to the other "haves" in the company, unless the company were to...

8. Adopt a creative allocation formula. The great majority of ESOPs provide that any shares it comes by are to be divvied up among the participants in proportion to the W-2 reported pay of those participants. Is that because the law requires it? Nay nay. The law only requires that the allocation formula not discriminate unduly against non-highly compensated employees. And a system of allocation based on pay is the simplest, surest way to guarantee that an ESOP will be in compliance. But in fact, there is room to get creative in your allocation formula so long as it doesn't shortchange the non-highly compensated employees relative to what they would receive if the allocation were done simply on relative pay. Since the "have-nots" are typically not highly compensated, this creates real opportunity to make a sizeable dent in the haves and have-nots problem. For example, you could adopt an allocation formula that gives participants extra credit during their first five years of service. A new hire with no service tenure could get five extra allocation points; the following year it would drop to four points, etc. until phasing out after five years. This would give a boost to the ESOP accounts of new hires. Still, some new employees will feel only that the pace of growth in their account has moved from snail pace to turtle pace, a problem that might be remedied if the company were to...

9. Award equity outside the ESOP. Especially when it comes to attracting a key hire for a critical role, it may not be enough to promise that they will become a participant in the ESOP at some point and that they will eventually start to accumulate stock in their account – if they are patient and put in enough years. A solution to this may be a "second channel of equity." This could be a plan that enables new hires to buy shares directly and personally, without the involvement of the ESOP. Various other forms of "equity compensation" also could serve for this purpose, such as awards of stock options, "restricted" stock, phantom stock or something else. Programs of this kind operate independently of the ESOP and are not subject to the rules and restrictions that apply to ESOPs, giving the company great flexibility.

10. Declare victory and sell the company. So your company has done very well since it started its ESOP and the "haves" have accumulated prodigious ESOP accounts. In fact, those accounts are so valuable that you're not really sure how the company will be able to finance the redemption of all that valuable stock, and the task of getting the stock from the haves to the "have-nots" seems like too big a mountain. What to do? You can adopt the viewpoint that the purpose of the ESOP was to generate wealth through stock ownership for participating employees, and the ESOP has done exactly that. So you can hang out the "mission accomplished" banners and put the company up for sale.

It's a Matter of Values and Priorities

An ESOP provides both unique opportunities and unique challenges. In terms of opportunities, it can provide a foundation for a profoundly different relationship between a company and the people employed by it. What has come to be known as an "ownership culture" can generate the employee commitment and motivation that helps the company outperform its competitors. In turn, this high-performing arrangement changes employees' lives – not only by generating personal wealth but by changing their work life experience and by enhancing their sense of self-respect and personal dignity as business owners.

Yet these profound benefits do come at a certain cost. As ESOP company leaders deal with the burden of managing the ongoing ESOP repurchase obligation, of ongoing regulatory compliance, and of dealing with the array of specialized service providers that ESOPs require, they may wax nostalgic about the days when these tasks weren't on their plates.

Is it all worth it? Do the benefits of employee ownership outweigh the administrative burdens that come with an ESOP? Ultimately, that question will be answered by a values-based analysis, not a financial one. Do the company and its leadership see substantial value in the benefits that employee ownership can bring? That is for each company to decide.

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