The Hidden Risk in ESOP Companies: Repurchase Liabilities
By
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My experience with ESOPs began some years ago when I was working with a client of mine who was looking for a solution to a business transition and succession issue. He had a closely held business which was quite successful and neither of his children had any real interest in running the business and he had a management team that had been instrumental in growing the business over time. I had been introduced to an ESOP consultant who had worked with some other clients of mine and between the two of us we came to the conclusion that an ESOP would be the preferable solution for this client. Thus, started my experience with ESOPs.

From that time until now, we have been involved in and worked on a number of ESOPs, particularly as a tool to provide a business transition device for the owners of these businesses. But, several years ago, we began to focus on one aspect of ESOPs that is sometimes neglected - **funding the repurchase liability of the ESOP**.

In an article published by Stout, Risius and Ross, Inc., a leading valuation firm, the author cites that one of the most common reasons for the termination of an ESOP is an **overwhelming repurchase obligation** that has not been addressed. Since the statutory put option creates a market for the ESOP company stock, and **the company is obligated to purchase that stock**, it could have a detrimental effect on the company's ability to sustain its ESOP. **In other words, the liability proves to be beyond their capability to fund.**

And, how does it get that way?

Here is how an ESOP company typically operates. Once an ESOP transaction closes, management will typically shifts its focus to managing the company's operations. For the first few years, stock repurchases are usually limited, given the lack of allocated and vested shares and, in cases of leveraged transactions, the high levels of debt and low share price. It is a classic case of out of sight - out of mind.

As time passes, shares are allocated and debt is repaid, **the repurchase liability can build quickly** and **command an increasing share of the company's cash flow.**

Usually unless being prodded, the management team allows this to rock along until they come to a point where they have a **significant cash flow obligation in one year**, and they begin to look at the liability in a closer fashion. If management has not planned adequately, the company may have to resort to using cash that otherwise would have been used to contribute to the firm's growth to satisfy the repurchase liability. As a result, inadequate planning could limit the company's growth trajectory, causing its stock price to drop and its future to be dimmed.

As the ESOP matures, so does the repurchase liability, causing the company to have to come up with ways of funding the repurchase liability over time. And, the company could wind up having to borrow large amounts of money just to pay off the repurchase liabilities as they are coming due - moving an off the books liability to one that is on the books. But in addition, **the company will have an obligation to the bank in addition to the repurchase liability to the participants.**

Start with a Repurchase Liability Study

In order to find out what the problem is, you first must start with a repurchase liability study. This is a detailed study which makes some assumptions but is based upon your current financial situation with the ESOP, your census of employees and the trajectory of your stock price over time. All of those factors will impact just how large the repurchase liability will be and when it will come due.

Of course, understand that the liability study will have assumptions and that it will not be 100% accurate over a long period of time, but it will surely give you accuracy over a the short term. The short term is what you must be ready for now. The long term is what you need to begin to get prepared to handle.

Why It Matters

Every ESOP company carries a repurchase liability: the obligation to buy back shares from employees as they retire, change jobs, or diversify. For many companies, this is the **largest unfunded obligation on the balance sheet**—yet often it's ignored until it becomes a crisis.

- **Cash Flow Shock**: Repurchases don't arrive in steady amounts—they spike with retirements, economic downturns, or valuation increases.
- **Growth Constraints**: Unexpected cash drains limit investment in expansion, R&D, and acquisitions.
- **Control Risk**: Companies without a funding plan often resort to forced borrowing or sales, reducing independence.

What Smart Companies Are Doing

Forward-looking ESOP companies are moving from *reaction* to *preparation*. CFOs review strategic alternatives to their funding needs. Strategies include:

- **Side Funds**: Building reserves with bonds, equities, or short-term investments.
- **Releveraging**: Using low-cost financing while maintaining control.
- **Corporate-Owned Life Insurance (COLI)**: Tax-advantaged funding to meet long-term liabilities efficiently.

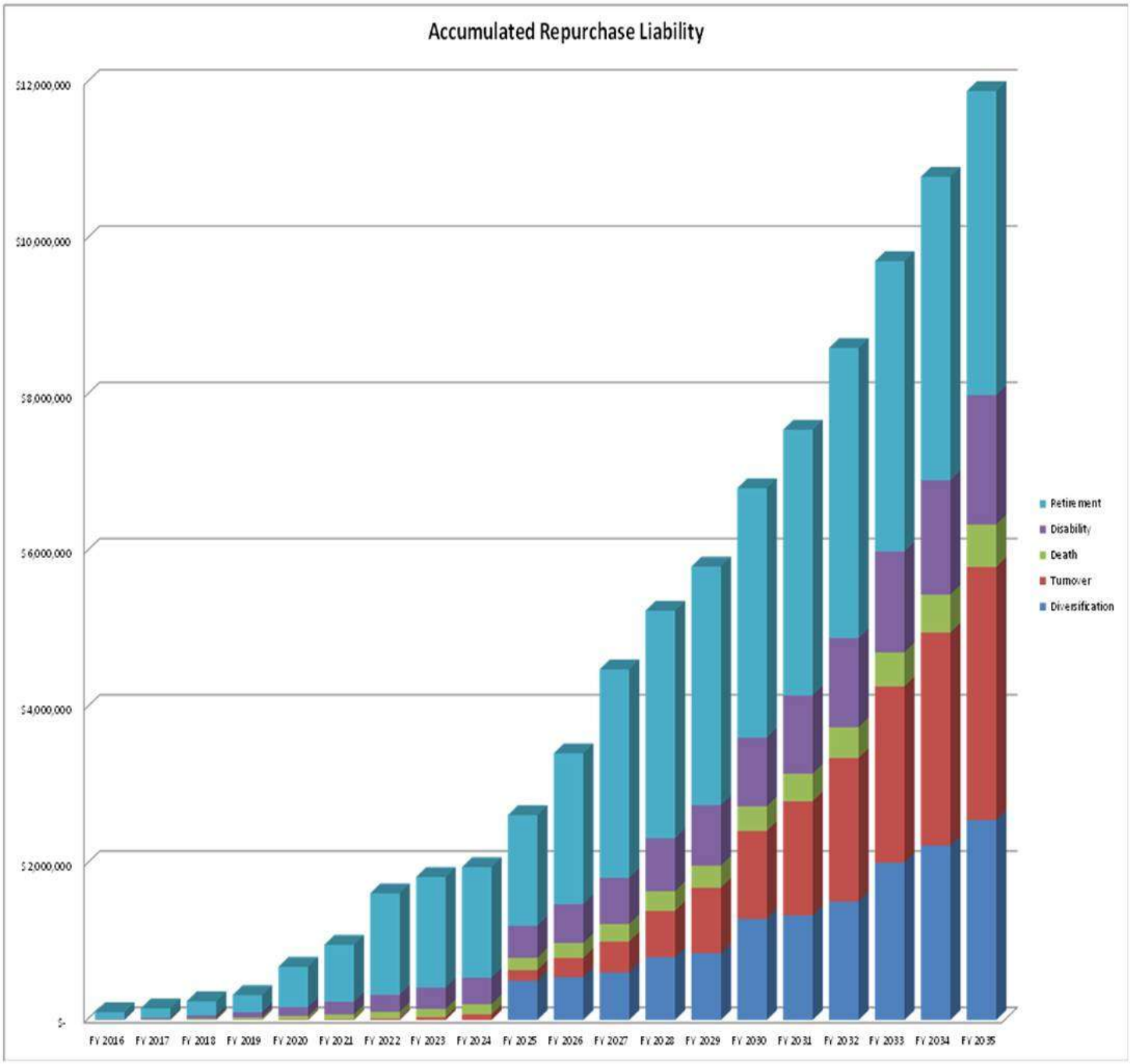
Benefits of Funding Early

- **Stability for employees**: Protects retirement benefits and trust in the ESOP.
- **Stronger valuation**: Lenders and buyers reward companies with a plan.
- **Peace of mind for management & board**: Turns an unfunded problem into a managed strategy.

Question for your team: Has your company stress-tested its repurchase liability against a wave of retirements?

Follow the Curve

The projected repurchase liability will follow a curve that is best represented by a new ESOP and how it increases over time. The **key is providing funding which is integrated that follows this curve**. As the liability grows over time, the funding should follow the same curve as the liability.



In its most fundamental aspect, **the funding of the repurchase liability should match up with the liability itself**. As the liability grows, then the funding, no matter what source, should follow the liability curve.

Focus on Mature ESOPs

Over the past couple of years, we have been increasingly focused on **mature ESOPs** which have not addressed their repurchase liability issues. One of them had to **borrow tens of millions of dollars in order to satisfy its obligations in one year!** That solved their current cash flow problem, but it only kicked the can down the road until a later time. And, in

the meantime, **the debt has the effect of depressing the stock's value, thus affecting the account balances of the participants**. In short, not having a plan to fund the repurchase liability adequately not only impacts the company but also impacts the participants of the ESOP. And, ultimately, it could cause the ESOP to fail.

What is the answer to the funding problem? An integrated approach to the funding of repurchase liabilities is the answer. Integrated means using a cohesive group of funding methods in an organized fashion to meet the funding needs. Just as companies plan out their capital expenditures over time, so should the CFO plan for the funding of the repurchase liability over time. And he or she should use a combination of funding methods to do so.

So, what are the options to funding the repurchase liability?

Funding options

Companies that perform integractive repurchase obligation studies have the advantage of foresight when it comes to the timing and magnitude of future repurchase obligations. Management can use this knowledge to prepare accordingly, including deciding whether to maintain or modify how repurchases are funded. Funding options available to a company typically include:

1. using existing cash from the balance sheet,
2. forming a sinking fund within the ESOP and funding it with a mix of debt and equity investments,
3. raising outside debt and engaging in a leveraged transaction, and
4. purchasing corporate-owned life insurance to offset some of the obligation.

When determining how to fund a repurchase obligation, a company should consider the impact each funding option will have on its day-to-day operations, as well as its cash availability and valuation. And, **with an existing and mature ESOP**, you should use an **integrated approach** to the funding of the repurchase liability.

Using existing cash from the balance sheet

Under this method, the company uses cash from its balance sheet to fund repurchase obligation liabilities as they arise. The advantage of this option is that it provides operational flexibility, which **could make sense for a company with stable cash flow and manageable repurchase obligations**. If the company is redeeming stock, then the stock will be retired as Treasury stock and the participant's accounts will go up as they gain a greater share of the outstanding stock. If the company is recycling stock, the overall equity of the company remains the same while the liability on the stock goes down. Participant shares do not grow as quickly as under redemption but performs nicely.

The disadvantage is that utilizing cash from the balance sheet could lull the company into a false state of preparedness. In the event the company underperforms and cash flow decreases, or in the case of a mature ESOP that requires large repurchases, cash might not be available to fund repurchases. Remember the example from above where a company had to borrow tens of millions of dollars in one year to fund the liability? How do you think that CFO felt once they were presented with the bill? **Talk about sticker shock!**

Forming a sinking fund within the ESOP

For taxable corporations, this proactive method of repurchase obligation funding creates a tax deduction, and it can be implemented **only if the company intends to recycle shares within the ESOP**. Although transferring cash from the company’s balance sheet to the ESOP’s sinking fund typically results in a lower stock price, the value of participant accounts is unchanged due to the increase in cash within the ESOP. Once the cash is in the ESOP, however, **it can no longer be used for general corporate purposes**, which could limit the company’s operational flexibility. Additionally, the value of the cash then will add some value to the overall stock value which would **lead to a higher repurchase liability**.

This sinking fund can be either debt instruments or equity based. With debt instruments, the rate of return on the funds would be somewhat less than equities, but typically would not suffer the ups and downs of the market in value. With equities, the rate of return long term would be higher, but the value of the fund at any point in time could be significantly lower if the market is down - which could create a problem if funds have to be withdrawn for the liability at that time.

The main thing would be that funds are being set aside and they are earning interest in the meantime which would lower the overall cost of the liability.

Forming a sinking fund within the Company

For companies who are redeeming shares, setting aside funds that remain on the balance sheet of the company can provide an alternative and cost effective approach to the funding of the repurchase liability. Whether the funds are invested in debt instruments or equity funds, the interest earned on these funds can be a cost effective way to offset the repurchase liability costs.

The same principles apply to this form of a sinking fund as they do to the other. **But, in this case, the sinking fund can be used to redeem or recycle stock.**

And, when the liability comes due, from an accounting perspective, simply move an asset on the books and redeem the stock and retire it as treasury stock. It should have little effect on the financials of the company.

The only other issue would be the taxability of the earnings since it is on the balance sheet of the company and would be fully taxable unless the company was a 100% ESOP. So, determining the effective tax rate and the taxability of the sinking fund is very important.

Raising outside debt and engage in a leveraged transaction

Although limited to companies with sufficient borrowing capacity, this method of repurchase obligation funding is especially useful in the case of unusually large repurchase obligations and, depending on the company's cost of capital, could be less expensive than other options. In a leveraged transaction, a company borrows funds from a third-party lender in order to repurchase shares from eligible participants. In this manner, **a company can convert a large one-time repurchase obligation to a debt obligation that is paid over time, maintain corporate cash to fund operations and growth initiatives, and take advantage of low interest rates** and the interest expense tax deduction.

But, in reality, borrowing the funds to pay the current repurchase liability only shifts the cash flow from current to over time. **The liability still must be paid.** And, with interest rates going up, the cost of funding the liability in this manner could be onerous.

In addition, the releveraging of the repurchase liability has the effect of **moving a liability which is not on the balance sheet to one that is on the balance sheet having the effect of depressing the stock price somewhat**. Although in practice, it should not make a difference, recognizing the liability on your balance sheet has the impact of reducing the value of the company.

Purchasing corporate-owned life insurance to offset some of the obligation

Corporately owned life insurance can provide a means of accumulating funds in **a tax-favored manner** (much like the sinking fund above) but have the added benefit of **creating a death benefit** that can provide added funds with which to fund the repurchase liability.

Life insurance then provides a **non-correlated asset** which will provide the means of accumulating considerable funds on a tax-favored basis which will be competitive with other forms of side funds.

Additionally, **the death benefit will provide an enhance to the overall rate of return on the COLI**. The overall cost of the death benefit is surprisingly small over time due to the nature of the design of the coverage. And, the death benefit along with the actuarial certainty of a certain amount of deaths prior to normal life expectancy of a large group, enhances the rate of return on the overall funding.

In addition, COLI is an asset that is easily financed, and the company uses the right mix of indexed COLI, a significant amount of **arbitrage** can be gained by the use of the leverage. Typically rates of return on indexed COLI will be in the 8-10% range whereas debt financing on this type of funding averages 4-6%, leaving a an average spread of 4% over time.

The risk of unanticipated significant repurchases is greater for mature ESOPs with large participant account balances. As a result, many companies **purchase life insurance policies on these high-balance participants** to complement other funding methods. Although insurance incurs an additional cost, it provides companies protection against the cash demands of an unanticipated significant repurchase due to a participant's death.

Type of Life Insurance - Corporately Owned Life Insurance - Design of the Product

In discussing this funding alternative with administrators who have been around for some time, ten to fifteen years ago, the product mix for COLI was not performing up to the needs of the companies sponsoring ESOPs and therefore fell out of favor. Today, there is a robust COLI product available to answer the funding needs of just about any company.

- **Guaranteed issue** - the coverage will be issued by the carrier on a guaranteed issue basis
- **Design of contracts** - the contracts will be designed to have the maximum amount of funding up to the Modified Endowment Contract limit. This will cause the rate of return on the cash value of the contract to be enhanced and the expense loading of the contract to be minimal.
- **Types of COLI -** as with any other type of permanent insurance, there are whole life/bond portfolio products or there is an indexed universal life contract that offers superior rates of return and more transparent pricing.
- **Use of premium financing** - this allows for additional design on the part of the cash flow required to fund the COLI but also allows for a greater rate of return on the coverage due to the leveraging aspects. In this manner, you can design and tailor the accrual of cash reserves and the creation of death benefits to fit your liability curve.
- **Death benefits** - interestingly enough, COLI provides enhanced rates of return through the death benefits which are part of the COLI product. Given standard mortality, this feature enhances the rate of return on the product and will consistently produce rates of return in the 10-12% range when coupled with the leverage of premium financing.

And, based upon our work in this area, the combination of guaranteed issue indexed universal life coupled with premium financing provides the most flexible and suitable funding mechanism for most companies in conjunction with an **integrated approach** mentioned above.

And for the mature ESOP, an integrated funding approach will prove to be the best manner to fund the liability over time.

In Summary

ESOPs offer significant benefits to both owners of businesses and the employees who work for them. But, these benefits do not come without some responsibility on the part of management to make sure that the ongoing repurchase liability is being funded properly in order to guarantee the ongoing success of the business enterprise. Truly, the business is the goose that is laying the golden egg that everyone desires. If we don't take care of the goose, then the golden eggs will cease to come. If the goose founders, there are no more golden eggs.