

SSG FINANCIAL GROUP

The Repurchase Obligation Cliff

How ESOP Companies Can Fund Their Promise Without Starving the Business

A White Paper by SSG Financial Group

www.ssgfingrp.com

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Executive Summary

An ESOP makes a promise to every participant: when you leave the company, your shares will be repurchased at fair market value. This promise—the repurchase obligation—is the defining financial commitment of any ESOP-owned company, and it is the one most likely to be underestimated, underfunded, and ultimately destructive if left unmanaged.

For young ESOPs, the repurchase obligation is a distant concern. Participants are years away from retirement, share values are modest, and the annual repurchase cash requirement is manageable. But as the ESOP matures—as share values increase through years of profitable operations and as long-tenured participants approach retirement—the obligation compounds. What was once a manageable annual outflow becomes a multimillion-dollar cash demand that competes directly with the company’s ability to reinvest, grow, and sustain itself.

This white paper examines how repurchase liability develops over time, why common funding strategies fall short, and how insurance-based funding approaches create a dedicated, tax-advantaged repurchase pool that fulfills the company’s obligation to participants without compromising its operational health.

Key Takeaway: The repurchase obligation is not optional—it is a legal and fiduciary requirement. The only question is whether the company will fund it deliberately through a planned strategy or reactively through cash flow diversion, debt, or — in the worst case — the sale of the company itself.

Understanding the Repurchase Obligation

Under ERISA and the Internal Revenue Code, an ESOP is required to repurchase shares from participants who leave the company—whether through retirement, termination, disability, or death—if there is no established public market for the stock. Since the vast majority of ESOPs hold stock in privately held companies, this repurchase requirement applies to nearly every ESOP in existence.

How the Obligation Grows

The repurchase obligation is a function of three variables: the number of participants approaching distribution events, the per-share value of the stock, and the distribution schedule (lump sum vs. installment). Each of these variables trends upward over time:

- **Participant concentration:** In a maturing ESOP, the longest-tenured employees—often the highest-compensated—hold the largest account balances. As these participants approach retirement age, the repurchase demand concentrates in a narrow window. A

company that must repurchase \$500,000 in shares this year may face \$3–5 million in annual repurchase obligations within a decade.

- **Share value appreciation:** A successful ESOP company's stock price rises over time—which is exactly what the ESOP is designed to do. But every dollar of appreciation increases the per-share repurchase cost. The paradox of a well-run ESOP is that its success accelerates the very obligation that threatens its sustainability.
- **Distribution timing:** Federal law requires that distributions begin no later than one year after the plan year in which a participant separates from service (with extended timelines for retirement-age distributions). The company cannot simply defer payments indefinitely. The clock starts when the participant leaves, and the cash must follow.

The Compounding Effect

The interaction of these three variables creates a compounding effect that catches many ESOP companies off guard. Consider a company where the ESOP has been in place for 15 years. The stock price has tripled. The founding generation of participants—who have the largest account balances—is beginning to retire. The annual repurchase obligation may jump from \$1 million to \$4 million within three to five years, and continue climbing as additional participants reach distribution age.

This is not a theoretical risk. It is a mathematically predictable event that can be modeled with precision—yet many ESOP companies do not perform this analysis until the cash flow impact is already being felt.

Why Common Funding Strategies Fall Short

ESOP companies typically consider three approaches to funding the repurchase obligation. Each has significant limitations.

1. Corporate Cash Flow

The most common approach—and the most dangerous—is to fund repurchases from operating cash flow. This works when the obligation is small, but as it grows, the repurchase demand competes directly with capital expenditures, working capital needs, debt service, and reinvestment in the business. A company that diverts \$3–4 million annually from operations to fund repurchases is a company that is slowly cannibalizing itself. Growth slows, maintenance is deferred, and competitive position erodes—all while the per-share value (and therefore the repurchase cost) continues to rise.

2. Sinking Funds

Some companies establish a dedicated repurchase reserve—a sinking fund—that accumulates cash over time for future repurchase obligations. This is a better approach than relying on

operating cash flow, but it has two critical weaknesses. First, the sinking fund must be large enough to meet the obligation when it peaks, which requires accurate long-term projections and the discipline to fund the reserve consistently over many years. Second, sinking fund contributions are made with after-tax dollars and generate taxable investment income, creating a tax-inefficient accumulation that grows more slowly than the obligation it is meant to cover.

3. Recycling Shares

Recycling involves the ESOP repurchasing shares from departing participants and reallocating them to active participants. This can reduce the net cash outflow in the short term, but it does not eliminate the obligation—it defers it. The recycled shares must eventually be repurchased again when the next generation of participants departs. In effect, recycling trades a current obligation for a larger future one, since the shares will likely be worth more at the time of the second repurchase.

The Insurance-Based Funding Solution

At SSG Financial Group, we design repurchase liability funding strategies built on life insurance because it addresses the specific structural challenges that other approaches cannot.

How It Works

The company purchases permanent life insurance policies on the lives of key participants—typically the owners, senior executives, and highest-balance ESOP participants whose departures will generate the largest repurchase demands. The policies serve dual purposes:

1. **Cash value accumulation:** Permanent life insurance policies build tax-deferred cash value over time. The company can access this cash value through policy loans or withdrawals to fund repurchase obligations as participants retire or separate. Unlike a taxable sinking fund, the cash value grows without annual tax drag, making it a more efficient accumulation vehicle.
2. **Death benefit protection:** If a key participant or insured executive dies, the death benefit provides an immediate, income-tax-free lump sum that can be used to fund the repurchase of that participant's shares and bolster the repurchase reserve for future obligations. This is particularly critical for the largest account balances, where the death of a single participant could create a multimillion-dollar repurchase demand.

Tax Advantages

Corporate-owned life insurance (COLI) provides several tax advantages when used for repurchase liability funding:

- Cash value grows tax-deferred—no annual tax on the internal buildup

- Policy loans can provide tax-free access to cash value (when structured properly)
- Death benefits are received income-tax-free by the company under IRC Section 101
- For S corporation ESOPs (which pay no federal income tax on the ESOP's share of earnings), the tax-deferred growth of COLI complements the company's already tax-advantaged structure

Note: COLI is subject to IRC Section 101(j), which requires employer notice and consent procedures for policies on employees. Proper compliance with these requirements is essential and should be coordinated with the company's legal counsel.

Matching Assets to Liabilities

The most important advantage of insurance-based funding is that it creates an asset whose behavior matches the liability it is designed to cover. The repurchase obligation is tied to participant lives and departures. Insurance policies are also tied to participant lives. When a participant dies, the obligation and the funding event occur simultaneously. When a participant retires, the cash value that has accumulated over their working years is available to fund their repurchase. This alignment between asset and liability is something that neither corporate cash flow nor a generic sinking fund can replicate.

Fiduciary Considerations

ESOP trustees and corporate directors have fiduciary obligations that extend to the management of the repurchase liability. ERISA requires that the plan operate for the exclusive benefit of participants and beneficiaries. A failure to adequately plan for repurchase obligations can constitute a breach of fiduciary duty.

Specifically, fiduciaries should be asking:

- Has the company performed a repurchase liability study that projects the obligation over a 10–20 year horizon?
- Is there a funded strategy in place to meet the projected obligation, or is the company relying on future cash flow?
- Could the repurchase obligation, if unfunded, impair the company's ability to operate or force the sale of the business?
- Are the funding assets appropriately matched to the timing and magnitude of the projected repurchase demands?

Trustees who cannot answer these questions affirmatively are exposed to fiduciary risk. The repurchase obligation is not a problem that can be deferred—it is a liability that the trustee must address as part of their duty of prudence.

Hypothetical Scenario: Precision Mechanical, Inc.

The following scenario is hypothetical and provided for illustrative purposes only. It does not represent any actual client of SSG Financial Group. Individual results will vary based on specific circumstances, policy terms, and applicable law.

Background

Precision Mechanical, Inc. is a 100% ESOP-owned S corporation with 140 employees, \$35 million in annual revenue, and a current stock valuation of \$28 million. The ESOP was established 18 years ago when the founder sold his interest. The company has been profitable every year since the ESOP was created, and the per-share value has increased approximately 8% annually.

The ESOP has 12 participants with account balances exceeding \$500,000, including three senior managers with balances above \$1.2 million each. The oldest of these senior managers will reach retirement age within three years. Over the next ten years, 22 participants are projected to reach retirement eligibility.

The Problem

The company's annual repurchase obligation has averaged approximately \$800,000 over the past five years—manageable within normal cash flow. However, the company's ESOP advisor has completed a repurchase liability study projecting the following:

Time Period	Projected Annual Repurchase Obligation
Current (Year 18)	\$800,000
Years 19–21	\$1.8–\$2.4 million
Years 22–25	\$3.2–\$4.5 million
Years 26–30	\$4.0–\$5.8 million
Cumulative 10-Year Obligation	\$28–\$35 million

The cumulative repurchase obligation over the next decade is projected to exceed the company's current total stock valuation. Without a funding strategy, Precision Mechanical would need to divert \$3–5 million annually from operations—approximately 10–15% of revenue—to meet repurchase demands. This would severely impair the company's ability to invest in equipment, hire, and compete.

The Solution

Working with SSG Financial Group, Precision Mechanical's board and ESOP trustee implemented a multi-layered funding strategy:

3. **Corporate-owned life insurance on 12 key participants.** Permanent life insurance policies were purchased on the 12 participants with the largest account balances. Combined death benefits total \$8.5 million, providing immediate liquidity if any of these participants die before or during retirement. The policies' cash values are projected to accumulate approximately \$4.2 million over ten years, available via policy loans to fund scheduled repurchases.
4. **Supplemental sinking fund with structured contributions.** To complement the insurance, the company established a dedicated repurchase reserve funded by annual contributions of \$600,000, indexed to 2% annual increases. This reserve addresses the portion of the obligation not covered by insurance cash values and provides a buffer for unexpected departures.
5. **Share recycling strategy for smaller balances.** For participants with smaller account balances (under \$200,000), the ESOP will recycle repurchased shares into the accounts of active participants, reducing the net cash outflow for these distributions while concentrating the insurance and sinking fund resources on the larger balances that pose the greatest cash flow risk.
6. **Annual repurchase liability study and funding review.** The company committed to updating its repurchase liability projections annually and reviewing the insurance portfolio and sinking fund adequacy against the updated projections. This ensures the funding strategy keeps pace with changes in share value, participant demographics, and company performance.

The Outcome

Before Planning	After Planning
No repurchase liability study beyond basic estimates	Annual projections updated with current share value and demographics
Repurchases funded entirely from operating cash flow	Three-layer strategy: COLI cash value + sinking fund + share recycling
No death benefit protection for largest balances	\$8.5M in COLI death benefits covering 12 highest-balance participants
Projected \$3–5M annual cash flow diversion within 5 years	Cash flow impact smoothed and distributed across insurance, reserve, and recycling
Fiduciary exposure for trustee and board	Documented funding strategy demonstrating prudent management of obligation
Risk of forced company sale to meet obligations	Self-sustaining funding structure preserves company independence

Precision Mechanical's plan doesn't eliminate the repurchase obligation—nothing can. But it transforms the obligation from an unpredictable cash flow crisis into a managed, funded, and fiduciarily defensible commitment. The company can continue to invest in growth, compete in its market, and deliver on the promise it made to every participant when the ESOP was established.

The Role of the Advisory Team

ESOP repurchase liability funding sits at the intersection of ESOP administration, corporate finance, insurance design, and fiduciary governance. It requires coordination among the ESOP trustee, the company's ESOP advisor or TPA, the corporate attorney, the CPA, and the insurance specialist.

SSG Financial Group serves as the insurance and financial planning specialist within this advisory ecosystem. We work alongside the ESOP trustee and administrator to design funding strategies that are calibrated to the company's specific repurchase projections, tax structure, and cash flow capacity. We do not replace any member of the advisory team—we provide the insurance expertise and financial modeling that completes the repurchase funding plan.

For ESOP advisors, trustees, and TPAs working with maturing ESOP companies, we are available as a technical resource to model insurance-based funding scenarios, evaluate the adequacy of existing funding strategies, and ensure that the insurance portfolio is aligned with the projected obligation.

Conclusion: Fund the Promise

The ESOP repurchase obligation is not a problem to be solved later. It is a financial commitment that exists today, grows every year, and will eventually demand the company's full attention whether or not the company has prepared for it.

Companies that fund the obligation deliberately—with a combination of insurance, reserves, and strategic share management—preserve their ability to grow, compete, and deliver on the ESOP's promise. Companies that defer the obligation discover, too late, that the cost of inaction is measured in lost investment, lost competitiveness, and in the worst cases, the loss of the company itself.

The time to begin is now. The obligation is already growing. The question is whether your company will manage it—or be managed by it.

SSG Financial Group helps ESOP companies design and implement repurchase liability funding strategies that protect cash flow, fulfill the company's obligation to participants, and preserve the long-term viability of the ESOP structure.

Schedule a complimentary 20-minute consultation: [Book Your Consultation](#)
Learn more at www.ssgfingrp.com

Disclaimer

This white paper is intended for informational and educational purposes only and does not constitute legal, tax, financial, or fiduciary advice. The information presented reflects general principles as of the date of publication and should not be relied upon as specific guidance for any individual situation. ESOP repurchase obligations, funding strategies, and tax implications vary based on specific plan terms, company circumstances, and applicable law. Readers should consult with qualified ESOP advisors, legal counsel, tax professionals, and fiduciary experts before making decisions regarding repurchase liability management or insurance. SSG Financial Group does not provide legal, tax, or fiduciary advice. Insurance products are subject to underwriting approval, and policy terms, conditions, and availability may vary. Corporate-owned life insurance is subject to IRC Section 101(j) notice and consent requirements. The hypothetical scenario presented is for illustrative purposes only and does not guarantee similar results.