Don't put your employee stock ownership plan on autopilot

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Companies, as plan sponsors, make many plan design decisions (e.g., distribution policies) when implementing an ESOP and then often automatically follow those procedures despite changes in the business, in employee demographics and in the environment. Company leaders may not realize that plan provisions can be changed, within some limits, or may not fully understand how changes may benefit the company or employees. The result? Plans that are on autopilot may fail to adapt to the changing needs of the company. A few key areas that often need to be readdressed at some point during the life of an ESOP are benefit levels, share allocations, distribution rules and repurchase obligations, as outlined in the following table.

Key operational issues for ESOPs	
Employee benefit levels	In ESOPs, the employee benefit level is heavily dependent upon the share price, which can be hard to predict. In leveraged ESOPs, benefit levels are also affected by the loan amortization schedule that governs the number of shares released to employee accounts. If desired, companies have the ability to target specific benefit levels; however, this will require thorough planning.
Share allocations	The form of distributions (shares or cash) and loan amortization for leveraged ESOPs dictates how and when shares are allocated. These policies may result in an undesirable allocation within the plan, which may lead to issues with business sustainability. It is important to monitor allocations so that policies can be amended proactively should potential repurchase obligation issues begin to form.
Distribution rules	Distribution provisions dictate what happens to accounts of terminated participants. If participants are not segregated or cashed out, terminated participants may retain a significant claim on the company's equity. This often also leads to greater repurchase obligation risk.
Repurchase obligations	The method, timing and financing decisions with respect to repurchasing shares from terminated participants will all affect who ends up with shares in the ESOP and how well the company can manage its commitments to buy back those shares.

A number of issues can make what seemed like sensible procedures in these areas at first seem less favorable now. These can include:

- Share price changes
- Size and demographics of the workforce
- Company culture
- Company cash flow levels
- Acquisitions of other companies
- International employee groups
- Operating capital needs
- Non-ESOP repurchase obligations
- Diversification

For instance, if your share price is increasing rapidly, and your distribution policy says that distributions will not begin until the latest possible starting date, the repurchase obligation will be larger than if you started distributions sooner. Conversely, operating capital needs might dictate that an early distribution policy might not be sustainable. Or consider another scenario: If your workforce increases significantly, there may not be a lot of new shares available for allocation to these workers unless you make some changes to how your plan operates.

The good news is that plan rules are not immutable. A written distribution policy, for instance, can live outside the plan document and allow for discretion within certain parameters. A company might, for example, have a policy to pay people out more quickly than legally required provided that it has the cash flow to do so without threatening the stability of the firm. Companies can add provisions like account rebalancing and segregation to get shares to newer employees more quickly. By reviewing your plan periodically with your advisors, you can identify optimal strategies for the current situation, and modify your plan without violating applicable laws and regulations.

As your ESOP matures, you may find that the benefit level it is providing is more or less than intended. This may be a result of adding more employees more quickly than planned, or the share price changing more or less than planned. For instance, if your payroll goes up quickly but you are making the same total contribution to the ESOP every year, the benefit level may shrink, and new employees may not get many shares (of course, this is also a function of how much the share price is increasing, so no one factor can be viewed in isolation). You may address this by having the company make additional cash contributions to the plan, or you may consider account segregation to get shares to newer employees.

Tax deduction planning is also frequently considered in initial ESOP plan design, but tax situations change over time as well. You may also find that formerly valuable tax deductions no longer matter if you have converted to S corporation status and the ESOP owns 100%. Some of your plan contribution, repurchase and distribution policies may have been based on an assumption of deductibility that no longer applies.

Another major area is repurchase planning. Unless you are regularly reassessing where you are and how you will pay for it, you are on autopilot. Careful studies allow a company to estimate the number of shares that will need to be repurchased in future years. Your distribution policy, as well as participant demographic profiles and turnover patterns, will dictate a large portion of that repurchase timing. Model multiple scenarios to "stress test" what you can manage. With this information in hand, you can better decide whether to change when people get distributions and in what form they receive them.

You also need to know how your repurchase strategy drives share value. Incorporate scenarios of future share value change. Rising stock values mean added nonproductive costs that normally will drive the stock price lower than if simply ignored (as still too often happens). Debt repayment, benefit expenses, the number of shares outstanding, funding methodology and cash flows related to operating expenses all need to be considered. The result is an iterative, dynamic planning process.

These are just some key examples. The takeaway is that ESOPs are not immutable. A best practice for ESOP plan sponsors is to reevaluate plan design occasionally. As your business circumstances change, your plan may need to change with them to best meet the business's needs and desires. It is important to remember that while ESOPs are often implemented as ownership transition vehicles, once in place an ESOP is a retirement plan that benefits employees. Employers would be prudent to use that benefit as part of an overall compensation package that works to meet the company's goals. Absent occasional reevaluation, the ESOP may seem to work against you rather than for you.

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