Coronavirus creates challenges for ESOP companies

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The coronavirus and the attendant economic disruption is creating challenges for companies that sponsor retirement plans. We have discussed some of those challenges in a separate multipart series of articles, available here – Part I, Part II, and Part III. In addition to those issues, companies that sponsor Employee Stock Ownership Plans (ESOPs) have additional unique challenges.

The purpose of this article is to highlight those challenges and to suggest some administrative and operational steps ESOP companies may wish to consider.

Valuation

Under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (Code) an ESOP is required to have the value of the employer securities it holds valued by an independent valuation firm at least once a year. Normally that valuation happens as of the last day of the ESOP's plan year. For many, if not most ESOPs, that date is December 31. Of course, that process takes some time as the books need to be closed and company financial statements prepared. As a practical matter, the valuation report is not ready until sometime in the middle of the following year.

Valuations for the 2019 plan year are going to be interesting for trustees and companies. Valuing the company as of December 31, 2019, is likely to produce a value which is probably not realistic given what has happened in the past few months. The coronavirus has caused major economic disruptions. Nonessential businesses have been ordered closed. Others, while still open, are laying off employees due to decreased business demand. Employees are working from home. The stock market has suffered major declines in value.

All of that translates into a valuation that may create problems for companies. While the value for December 31, 2019 may be exactly correct as of that date. It is not correct today.

Interim valuations

The requirement as discussed above is that the ESOP be valued once a year. Because of the time and expense of the valuation process ESOPs are not normally valued other than once a year. That said, most ESOPs while requiring a valuation on the last day of the plan year will typically have language that permits valuations on other days. This language permitting interim valuations is usually invoked if there are transactions or extraordinary events. The current situation is certainly something that could be considered such an extraordinary event.

It is important to remember that the 2019 value will be the value used by the ESOP for ongoing administration, including diversifications and distributions during 2020. Given the current economic situation, it would very likely that a current valuation of an ESOP company would result in a valuation that is lower than the value as of the end of 2019. Using the higher 2019 value could cause the company and or the ESOP to be paying a higher price for shares.

One should review their ESOP document to see who has authority to request an interim valuation. It may be the trustee. But, sometimes it may be an ESOP administrative committee. If the ESOP does not have a provision for an interim valuation, it would be a good idea to amend the ESOP to do so.

The 2019 valuation should still go on as planned. An additional valuation while an added expense is probably worth the cost. It might be possible for the valuation firm to pursue both valuations simultaneously and thereby generate some efficiencies that might create some cost saving.

Having a current “more accurate” valuation for 2020 based on current economic realities will be important for the ESOP, the company and the participants as discussed below.

Distributions

Having a more current valuation will assist in permitting the ESOP to pay accurate benefits without unduly strapping the company and potentially impacting the other participants negatively. In the normal course of operations, the ESOP probably has any number of terminated participants who are entitled to a distribution. In addition, companies may be laying off or actually terminating employees who may wish to receive distributions. Using a current valuation will lessen the cash demands by the ESOP on the company or if the ESOP is using cash inside the ESOP to fund distributions, it will lessen the decline of the other participants’ accounts.

Some ESOP companies have designed their ESOP to contain the statutorily permitted distribution timeframe of starting payment in the year following death, disability or normal retirement or starting payment after five years after termination for anything other reason Payments would be then over five years. While including those provisions, some companies have created distribution policies which accelerate the time frames and accelerate the payments maybe even permitting lump sum payments. Given the cash demands, it may be appropriate to revisit those policies and if possible revert to the longer statutorily permitted distribution timelines to protect cash flow.

Diversification

ESOPs are required to permit participants who have attained age 55 and 10 years of participation to diversify a portion of the employer stock held in their account over a 6-year period. The source of cash to permit that diversification comes like the funds for distributions from the company and/or the cash held in the accounts of the other participants. Having a current valuation helps with the cash needs.

Ironically, while ESOP stock values will probably decline, an ESOP company may see less people diversifying. ESOP companies have proven to do better and to hold their value better than the market. Given the decline in the value participants may be seeing in their 401(k) accounts, they may opt to stay in employer stock.

Nevertheless, they still need to be given the option and the funds need to be found to satisfy the diversification needs.

Reshuffling

Some ESOPs are designed to include what is called a "reshuffling" provision. Typically, this provision takes the employer stock held in the accounts of terminated participants and replaces it with cash from the remaining participant's accounts. The terminated participants get converted to all cash and the theory is that doing so helps reduce an ESOP's repurchase liability long term and prevents terminated participants who are no longer helping to grow the value of the company from reaping the benefits of the increased value.

Sometimes the reshuffling language is mandatory; more typically it is designed so that reshuffling happens only if there is sufficient cash to enable the reshuffling to occur. If there is not, sometimes the reshuffling is then done pro rata or sometimes it is drafted to reshuffle the participants who have been gone from the company the longest. Given the probable decrease in employer stock value a company may wish to review what the impact will be on its cash needs and the accounts of the participants who remain with the plan before permitting reshuffling to occur. It may be necessary to amend the ESOP to either stop or use a different reshuffling technique.

Contributions

Normally, companies will have an obligation to contribute to their ESOPs in two situations. The first has been described above where the company needs to contribute to permit distributions or diversifications. The second is where the ESOP is leveraged. When the ESOP borrowed the funds from the company to buy the employer securities or it purchased the shares from the selling shareholder or shareholders by issuing a note, the company obligated itself to contribute sufficient funds either by contributions, dividends or distribution of S-Corporation earnings to handle the ESOP's debt service.

Although the company may find itself short on cash this is an obligation the company needs to address. If the ESOP note is with the company, the company that finds itself cash strapped might forgive this year's payment—or take what cash it has and make multiple little payments and effectively recycle the cash to pay down the note. The cash would go into the ESOP and right back out to the company so the company has its cash back when it is all over.

If the ESOP note is with a former shareholder, the problem might not be that easily resolved. The former shareholder may be counting on those payments. Any contributions that the company makes will leave the ESOP and go to the former shareholder.

Some ESOP companies may be tempted to restructure the notes to lengthen the term so as to reduce current payments. The Department of Labor has been adamant in warning ESOP trustees about restructuring notes. Trustees have effectively been told that if they restructure a note the ESOP needs to get something in return. Companies have been creative in what to give ESOPs. Sometimes it has been faster vesting, sometimes a greater match in the 401(k) and sometimes faster ESOP payouts.

ESOP companies may wish to explore having the shareholders replace the note from the ESOP with a note from the company. The company then becomes the note holder with respect to the ESOP. The company may have more flexibility then in dealing with the shareholder and the shareholder's note.

Families First Coronavirus Response Act (FFCRA) Payments

As a method of easing the financial strains on employees who are required to take time off from work due to having contracted COVID-19 personally or to assist a family member who has been affected, FFRCA is requiring some employers to provide paid time off when they might never have done so before. Such payments will be effectively W-2 income. As such, the payments will typically be considered compensation for retirement plan purposes. This means that such compensation will be included in calculating any ESOP contributions.

If the company does not want such payments to be included in the contribution calculation it may be necessary to amend the ESOP to specifically exclude such payments from being considered ESOP compensation.

Partial terminations

Some ESOP companies may try to manage the current economic conditions by laying off or even terminating employees. ESOP companies are typically reluctant to take steps like that, but it may be necessary for their survival in the short run. One of the issues created for retirement plans, generally including ESOPs, when companies reduce staff is the potential for a "partial termination of the plan." There is no precise definition of a partial termination of a plan under ERISA, but the Internal Revenue Service (IRS) has indicated that when 20% or more of a company's workforce is terminated involuntarily there is the possibility that a partial termination of the plan has occurred. If there is a partial termination of the plan, then ERISA requires the affected participants to become 100% vested. The participants who have not terminated do not need to be vested.

The partial termination concept is designed to address situations where the employee is unable to work and progress along the plan's vesting schedule due to actions the employer has taken. Of course, employers may always let people go. The concept only becomes applicable when larger numbers are affected. The action does not have to be a single event. The IRS has indicated that the 20% threshold may be reached in a series of events. For example, a single layoff event may not reach 20% but when all the layoffs are considered over a period of time the threshold might be met. It is also not clear how long that period might be. The IRS has on occasion considered terminations occurring over multiple plan years as being one partial termination event because they all resulted from the same set of facts.

The partial termination concept affects employers of all sizes. In a large employer, the number of people who need to be terminated before it is an issue could be large. But in a small employer, a layoff of two or three people could trigger a partial termination of the plan as it relates to those laid off employees. Those laid off employees must be vested.

A related question of course is whether an "a laid off" employee is terminated for these purposes. The answer is probably a facts and circumstances matter. If the employee is laid off but recalled in a relatively short period of time, the employee was probably not terminated. The longer he or she remain "laid off" the more likely they could be considered terminated.

Companies are best advised to be aware that actions to cut back on their workforces may have an unexpected and unanticipated consequence. With ESOP companies, such layoffs or terminations may solve one problem but dramatically increase or even accelerate the ESOP's repurchase obligations.

Employee morale

ESOP companies should be, and no doubt are, very conscious of the impact of all these challenging economic times have on employee morale. Many ESOP companies have never really seen a decline in employer stock value. That can be traumatic. That fact coupled with layoffs, remote working or even outright shutting of the companies doors even if only on a temporary basis can be devastating for employees.

Typically ESOP companies, especially the ones that have truly implemented a culture of employee ownership, have a history of good communication. Now is the time to ramp up your ESOP communication committee and get the information about the company, its strengths and its plans for weathering the crisis.

Conclusion

ESOP companies have an extremely good track record for handling economic stress and coming out stronger than before. The COVID-19 crisis while maybe unprecedented in it combination of health and economic challenges is something ESOP companies may be in a better position to address than non-ESOP companies. While there are administrative and fiduciary issues to be dealt with, by engaging in a bit of planning and addressing all the possible administrative pitfalls related to the ESOP itself, ESOP companies should do well in these challenging time.

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