ESOP Administration Insights

The National Center for Employee Ownership Research Project on ESOP Terminations

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This discussion summarizes the results of the first phase of a research project sponsored by the National Center for Employee Ownership. This discussion describes the results of this research project regarding the reasons why sponsor companies terminate their employee stock ownership plans.

Introduction

In April 2007, the National Center for Employee Ownership (NCEO) released a report on the reasons why sponsor companies terminate employee stock ownership plans. The NCEO routinely gathers data with regard to plan terminations of an employer-sponsored ESOP.

According to the NCEO, approximately 3 to 4 percent of all ESOPs are terminated each year. ESOPs are terminated for a variety of reasons. And, prior to this study, the causes of terminations have not been studied.

This first phase of the project is limited to a small number of interviews, and it is not meant to provide the statistical reasons why sponsor companies terminate their ESOPs. The interviews are subject to two important limitations.

First, the study results are not necessarily representative of typical ESOP sponsor companies. This is because the majority of the sponsor companies interviewed are, or were, active members of the ESOP community.

Second, the data reported by the executives of these sponsor companies may be biased and the interpretations are not the only possible ones.

This first phase of the project, will, however, suggest potential causes of ESOP terminations and whether those causes warrant further study. Although the second phase of the research project is not underway, it should be known that the parts go hand in hand.

The first phase of the study, although somewhat limited, suggests two overall trends: (1) the most common reason for an ESOP termination is that the sponsor company was acquired by another corporation and (2) the next most common reason for an ESOP termination is that the sponsor company was unable to manage the ESOP repurchase obligation.

Summary

Out of the 51 sponsor companies the NCEO attempted to contact, the NCEO representatives were able to complete 30 sponsor company interviews. The sponsor companies fell into three groups: (1) acquired companies, (2) terminations, and (3) continuing ESOPs.

According to the NCEO, while the majority of former ESOP sponsor companies in the NCEO research project were acquired, it does not necessarily mean that the majority of former ESOP sponsor companies in the overall economy are acquired. Often sponsor companies that terminate their ESOPs may be less willing to participate in such surveys. And, representatives from sponsor companies that went out of business at the same time that their ESOP terminated can be difficult to contact.

The NCEO used data from sponsor companies listed in two of its databases: (1) the majority employee ownership list and (2) the minority employee ownership list.

Factors

There were several factors that affected the different sponsor companies included in the NCEO study. Some factors were extremely important to the sponsor companies, while other factors were essentially irrelevant. The following is a list of the factors that were most important to the sponsor companies that participated in the NCEO study:

- ESOP repurchase obligation
- acquisition offer
- S corporation status
- company size

- percentage ESOP-owned
- corporate performance
- other factors

ESOP Repurchase Obligation

Out of the 19 sponsor companies that fell into the acquired group, eight of the sponsor companies said the ESOP repurchase obligation was a major driver in the decision to sell the company. Two other sponsor companies said that the ESOP repurchase obligation played somewhat of a role in their decision to sell the company. And, the other eight sponsor companies said the ESOP repurchase liability had no impact on their decision to sell the company.

Out of the seven sponsor companies that fell into the terminations group, four of those companies said that the ESOP repurchase obligation was an important factor.

Acquisition Offer

Out of the acquired sponsor companies, twelve stated what features of the acquisition offer led them to accept the offer. Eight of those twelve sponsor companies said price was the most important feature of the offer and why they accepted the offer.

Table 1 presents the other characteristics and terms of why the sponsor companies accepted the acquisition offer.

Table 1
Reasons Why the Acquired Sponsor Companies Accepted the Acquisition Offer

Acquisition Offer Acceptance Reason	Number of Acquired Sponsor Companies
Size of the purchase price premium	8 of 12 (67%)
Strategic objectives	5 of 12 (42%)
Increased investment into company	5 of 12 (42%)
All cash offer	4 of 12 (33%)
Promise of no job cuts	3 of 12 (25%)
Quality of the acquiring company	3 of 12 (25%)

Note: The percentages do not add to 100%, as the sponsor companies could indicate more than one reason for their acceptance.

The average price premium over the appraised employer stock value for the sponsor companies in the acquired company group was 57 percent, while the median price premium was 45 percent. The price premiums ranged from a low of 0 percent to a high of 180 percent.

Table 2 presents the distribution of the purchase price premiums for the acquired sponsor companies that were willing to share that information.

Table 2
Size of the Purchase Price Premium over the Employer Stock Appraised Value

Purchase Price Premium	Number of Acquired Sponsor Companies
0 to 10%	3 of 15 (20%)
11 to 40%	5 of 15 (33%)
41 to 80%	3 of 15 (20%)
81 to 180%	4 of 15 (27%)

S Corporation Status

Many of the sponsor companies felt strongly that the S corporation ESOP income tax benefit was an extremely important contributor to the ability of the ESOP to survive. Several interviewees from the acquired sponsor companies acknowledged that S corporation benefits allowed the companies to remain ESOP-owned for longer than would have been possible otherwise.

Table 3 illustrates the number of sponsor companies interviewed that are S corporations.

Table 3
Number of Sponsor Companies That Are S Corporations

NCEO Study Group	Percent of Companies That Are S Corporations
Acquired sponsor companies	11 of 17 (65%)
ESOP terminations	4 of 6 (67%)
Continuing ESOPs	4 of 5 (80%)

Sponsor Company Size

According to the NCEO study, ESOP termination companies are significantly smaller than the typical continuing ESOP sponsor companies in terms of both (1) revenue and (2) size of workforce. There are two factors that may make smaller sponsor companies more likely to terminate their ESOPs. First, smaller companies are likely to have an extremely variable ESOP repurchase obligation. Second, the plan administration costs of an ESOP are also more substantial for smaller sponsor companies.

In larger companies, the size of the workforce ensures a more gradual and predictable change in the ESOP repurchase obligation. When individuals leave or retire from a smaller sponsor company, the cost of the ESOP repurchase is more significant.

Table 4
Percentage of Sponsor Company Shares Owned by the ESOP

ESOP Ownership	Acquired Sponsor Companies	ESOP Terminations	Continuing ESOP Sponsor Companies (interviewed)	Continuing ESOP Sponsor Companies (database)
Median	93%	58%	100%	65%
Average	83%	62%	92%	63%
Range	44% to 100%	15% to 100%	64% to 100%	5% to 100%

Percentage ESOP-Owned

Out of the interviewed sponsor companies, most were majority owned by their ESOPs. Among the sponsor companies included in the NCEO study, acquired sponsor companies generally have a higher percentage of shares in the ESOP. This percentage is higher than the ESOP termination sponsor companies and the continuing ESOP sponsor companies in the NCEO database.

These data are presented in Table 4.

Corporate Performance

Sponsor companies that are extremely profitable may be more likely to terminate their ESOPs for two reasons:

1. Profits translate into rapid increases in employer share value, making the ESOP repurchase obligation increase.
2. The sponsor company management may wish to invest in the growth of the sponsor company, instead of diverting cash to the ESOP.

Other Factors

Other issues related to the termination of the ESOP were extremely important for some of the sponsor companies. However, these issues were not considered to be key issues as previously discussed. These issues are as follows:

- Leadership issues were a key factor in terminating the ESOP for three of the nineteen acquired sponsor companies and two of the seven ESOP termination sponsor companies. The main issues were the sponsor companies' ability to find a replacement manager who (1) would share the vision(s) of the original leader and (2) would be able to provide a greater equity stake to incoming managers without making the ESOP less important.
- Seven of the twenty-six acquired and terminated sponsor companies mentioned that diversification of employee retirement benefits seemed to be a substantial concern since the Enron bankruptcy.
- According to four of the acquired sponsor companies, the ESOP fiduciary obligation played a significant part in their acceptance of the acquisition offers. One of the four ESOP sponsor termination companies indicated the fear of accidentally violating ERISA rules and provisions which could result in being sued was their primary reason for terminating the ESOP.
- The need for strategic alliance and/or increased investment in the sponsor company motivated a small number of the acquired sponsor companies.

Summary and Conclusion

This discussion provided a summary of the first phase of the NCEO study on ESOP terminations.[1]

The first phase of the NCEO study suggests two overall trends: (1) the most common reason for the ESOP termination is that the sponsor company was acquired by another corporation, and (2) the next most common reason for the ESOP termination is that the sponsor company was unable to handle the ESOP repurchase obligation.

The next phase of the NCEO study will consist of more quantitative analysis with a larger number of sponsor companies.

Note:

1. The NCEO is a private, nonprofit membership and research organization that serves as the leading source of accurate, unbiased information on employee stock ownership plans, equity compensation plans (such as stock options), and employee ownership culture. A copy of the study can be found on the NCEO Website at http://www.nceo.org/files/ESOP_termination.pdf.

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