ESOP Distribution Policy: Choices, Consequences, & Compromises

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The employee stock ownership plan ("ESOP") distribution policy—the policy which dictates the timing, method, and form in which participants receive their ESOP account balance upon termination — is a key element of plan design. Accordingly, a company should thoughtfully approach the development of its policy, as well as changes that may be necessary after plan inception.

What works well early in the life of the ESOP may not work as well years later. With careful consideration and attention, distribution policy is a tool ESOP companies can use to manage repurchase obligations ("RO") and participant benefit levels throughout the ESOP lifecycle.

It is important that a company understand the benefits and consequences of various choices when designing or amending its distribution policy. Once a company has a complete understanding of the many elements of distribution policy, it can reflect on the company's values and its financial situation and identify a policy that aligns well with the goals for the ESOP and the corporation. Each company may benefit from a different set of distribution rules. Therefore, it is important to do a thorough, company-specific analysis before establishing or amending your policy.

Statutory Guidelines

Before we dig into the consequences of policy design decisions, let's cover the basics – the statutory guidelines that each ESOP company must follow.

Most ESOP plan documents are initially drafted in accordance with the statutory guidelines regarding distributions. The guidelines stipulate the maximum payout terms allowed by the Internal Revenue Code ("IRC"). IRC Section 409(o)(1)(A) requires that distributions of ESOP account balances must commence no later than one year after the close of the plan year following:

- The plan year in which a participant terminates due to death, disability, or retirement
- The fifth plan year following the plan year in which a participant terminates employment for any other reason

The statutory rules do allow for exceptions. For instance, "small accounts" (i.e., accounts valued less than a certain threshold), can be paid immediately, regardless of termination reason. Certain "large accounts" (i.e., accounts valued greater than $1,130,000 in 2019, as indexed) can be paid over an extended installment period, with one additional installment for each $225,000 (as indexed) by which the account value exceeds the threshold, up to a maximum of ten years. Finally, distributions of shares acquired with an ESOP acquisition loan can be delayed until the loan is fully repaid.

Often, the distribution policy described in the ESOP plan document is broad, containing flexible language such as "no later than" when referring to the fifth plan year following termination for reasons other than death, disability, or retirement, or that installments will be paid over a period of "no more than" five years.

In recent years, companies have increasingly adopted separate distribution policy documents which more narrowly define how distributions will be paid following termination of employment. This allows a company to maintain flexible language in the ESOP plan document and amend its distribution policy from time to time. A separate distribution policy document can also serve as a helpful supplement to the Summary Plan Description ("SPD") to clearly communicate the timing, manner, and form in which participants can expect to be paid following their termination of employment.

Unintended Consequences of Accelerating Distributions

Many ESOP companies prefer to pay out participants who have terminated (i.e., inactive participants) as quickly as possible, based on the philosophy that the ESOP should benefit current employees who are actively contributing to the company's growth. In addition, a common belief is that RO will be less expensive if distributions are paid sooner, since year-over-year share value is typically rising.

Comparison of Immediate / Lump Sum Distributions vs. Delays / Installments

Immediate / Lump Sum		Delayed / Installments	
Advantages	**Disadvantages**	**Advantages**	**Disadvantages**
Locks in value at termination	Potential variable cash requirements	More level cash requirements	Inactive EEs may benefit from increases in value
Inactive participants do not receive dividends	Less time for repurchase planning	Additional time for repurchase planning	Inactive EEs will receive dividends
Shares held primarily by active EEs	Accelerated future obligations	Slows down future obligations	Larger % of shares in inactive accounts
Makes shares available for new EEs	Potential uneven benefit level	More even benefit levels	Fewer shares available to new EEs

However, there are consequences to paying distributions quickly. Let's take a look.

Immediate and Lump Sum Distributions

Immediate and complete ("lump sum") distributions generally work well in the early stages of an ESOP, when ESOP RO is low, not all shares are allocated, a company may be de-leveraging, and value per share is rising rapidly. Some of the perceived benefits associated with these practices include:

- Former employees no longer participate in growth (or declines) in value per share
- Former employees no longer receive dividends paid to the ESOP
- Repurchased shares become available to allocate to new employees sooner
- Administratively easier – does not require tracking former employees' accounts, resulting in reduced administrative costs and fewer lost participants

On the other hand, the following are unintended consequences of such practices:

- Accelerated cash requirements associated with the distribution of former employees' accounts
- Lower distributions to individuals, but likely more expensive on the aggregate
    - o If recycling or recontributing shares, there is a faster turnover of shares in the ESOP. In other words, the same shares will be repurchased more times over the same period
    - o In periods of high ESOP RO, reallocating or recontributing shares right away can exacerbate a have vs. have-not issue (i.e., participants employed in that year receive a potentially large windfall of shares)
- Less predictability of ESOP RO
    - o There will be less time to plan for unexpected large distributions
- Greater variability in ESOP RO
    - o Particularly in small populations, lump sum distributions can result in annual ESOP RO which is highly variable and, in turn, can translate to variable cash requirements and potentially, uneven benefit levels

Delay Periods and Installments

Distribution policies which allow for delay periods and installment payments provide a company with a greater planning horizon to fund large unexpected distributions as well as the ability to spread the associated cash requirements over a period of years, potentially resulting in smoother benefit levels. While former employees still

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holding stock will benefit from any increases in share value and/or dividends, maintaining a certain percentage of the ESOP's shares in inactive accounts slows down the turnover of shares which, in turn, slows down future ESOP RO. Delay periods and installment payments also provide a pool of shares to be reallocated to future participants. That said, having a significant percentage of the ESOP's shares in inactive accounts can be a concern, especially if participants are not electing to take distributions on time, or in situations where certain shares are delayed until Normal Retirement Age (shares acquired prior to 1987) or until an ESOP loan is repaid.

Companies concerned about cash flow, those facing challenges funding their ESOP within the IRC § 404(a) maximum contribution limit, or those concerned about uneven or higher-than-desired benefit levels or a "run-on-the-bank" situation, may find immediate payouts and/or lump sum distributions undesirable. In contrast, a company that can fund its ESOP RO comfortably within contribution limits and has determined it will have ample cash to fund distributions while meeting its other business needs, may find that paying inactive participants as quickly as possible is a completely suitable policy.

Account Segregation

Segregation is the conversion of former employees' accounts from employer stock to other investments (e.g., cash). This is typically done immediately following termination. Companies that segregate accounts often do so to prevent former employees from participating in future growth in share value and/or dividends and to make shares available for active participants.

Because segregation requires a company to have the cash needed to convert the entire account at the time of segregation, this practice is similar in many ways to paying immediate, lump sum distributions, with like consequences. For instance, a company that segregates accounts may face unpredictable and highly variable cash requirements while future ESOP RO is accelerated.

One key difference between segregation and simply paying lump sum distributions is the ability for a company to convert a former employee's account out of employer stock while maintaining its distribution policy which may provide for delays and installment payments. If cash flow is not an issue but there is concern about participants terminating just to access their ESOP account or to use their large ESOP distribution to open a competing business, segregation may be an appropriate solution. Segregating can also be useful in situations when participants are not electing to take on-time distributions and it prevents a large percentage of the ESOP's shares from being held by ex-employees. All of this said, best practices suggest that a participant's entire account must be segregated, not just the vested portion. This accelerates ESOP RO even more than lump sum payouts and is another key difference.

Some distribution policies provide a company with the discretion to segregate in installments, or up to the amount of available cash in the ESOP. This allows a company to control how large a portion of participants' accounts to segregate. Companies should note that when the company has more cash, participants are likely to get segregated at higher share values and when less cash is available to segregate, participants may remain invested in company stock during a period of potentially declining value.

Combine Approaches

Given the varying benefits and consequences of each approach to distribution policy, it is certainly possible to find a comprise using a combination of approaches. For example, a company with high turnover in the first few years of service among participants with small, only minimally vested account balances may adopt a distribution policy with a lump sum threshold (say $5,000 or $10,000) under which accounts are paid in an immediate lump sum while accounts exceeding the threshold are paid in installments. Instead of a delay of five years before beginning installment payments, a company could begin paying installments in the first year following termination. Furthermore, the same company could adopt a minimum installment amount where accounts over a certain threshold are paid in up to five annual installments, with a minimum installment amount equal to 1/5th of the account balance or a certain amount ($10,000 for example), whichever is greater. Lump sum and minimum installment amount thresholds can effectively distribute relatively smaller account balances sooner while providing the ability to plan and smooth out distribution of larger accounts.

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Communication & Application

No matter the choices, companies should document and communicate their distribution policies clearly and apply them consistently, in a non-discriminatory manner. For instance, a distribution policy may dictate that the timing or form of distribution varies by termination reason (e.g., Normal Retirement, death, disability, turnover); however, a company cannot decide to pay specific individuals in a manner which differs from others who terminated for the same reason.

Choosing a distribution policy is a balancing act. Companies must weigh the consequences of each strategy and align their choices with the company's values and financial situation. A comprehensive analysis of a company's ESOP RO integrated into a company's financial projections is required to assess whether a company will have enough cash to meet ESOP RO and its other business needs under a range of distribution policy approaches. In some cases, a combination of approaches is best. ■

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