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Insights

COVID-19 and ESOP Distribution Policies: Dealing with Down Times in an ESOP Company

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When preparing this Alert, I recalled a presentation I did in 2008 called "Dealing with Down Times in an ESOP Company." Well, here we are 12 years later, but the impact of the COVID-19 pandemic on many ESOP companies is even worse than the 2008 recession.

In addition to the difficult issues faced by many companies during "Down Times," an ESOP company faces unique issues, in light of the employer stock in the participants' ESOP accounts, the foremost being the repurchase obligation, which is closely related to the stock valuation. Fortunately, there is flexibility built in to the ESOP rules that may allow an ESOP plan sponsor to adapt the terms of the plan to avoid the potentially disastrous effect of a sudden drop in the company's fair market value. This Alert is intended to give you some ideas for handling the repurchase obligation and the stock valuation at your ESOP company.

Interim Valuation

There has been a plethora of ideas about interim valuations. If your prior year end value appears to be much higher than your summer 2020 value, you may consider having your trustee and appraiser perform an interim valuation to be used for distribution and diversification payments. In your consideration, include the effect that doing or not doing an interim valuation may have on participants who are eligible to diversify. If you don't do an interim valuation, the number diversifying may drastically increase in order to get the higher pre-COVID 19 value, thereby increasing your repurchase obligation in 2020 over and above usual. But if you do an interim valuation, those same participants may decide not to diversify and wait until next year or the year after, thereby increasing the repurchase obligation in future years.

Changes to Distribution Policy

There are several ways in which you may be able to modify your ESOP's distribution provisions in order to reduce the cash needed for paying distributions in 2020.

Payment Method: If the ESOP currently pays distributions in a single sum or in two or three installments, you can amend the plan or distribution policy to provide for payment in annual installments over 5 years (or more for larger account balances). If the ESOP currently pays distributions in installments, you can amend the plan or distribution policy to allow participants already in pay status to suspend installment payments for 2020, or even longer. Additionally, a mandatory cash-out distribution for balances of $1,000 or less, or $5,000 or less, depending on the terms of your ESOP, can be removed by an amendment and put back in the plan in a later year.

Distribution Timing: It is possible you may increase the delay in the timing of payments (although there is not complete consensus in the ESOP community). If the ESOP pays or begins paying distributions in the year

following the year of termination for all participants, you may be able to increase the delay for paying distributions for regular terminations (not retirement, death or disability)for up to five years.

Form of Payment: It is likely the ESOP allows distributions to be paid in cash or in company stock (if it doesn't, it can be amended). If distributions are paid in stock with a put back to the company, the company may be able to pay for the stock over a five-year period using the current stock value by paying the first installment then issuing a promissory note for the remainder, with reasonable interest and adequate security. Because there are certain restrictions to this procedure it is not often used, but it can be helpful if you can meet the requirements.

In sum, it's important to remember that ESOPs are not etched in stone, but can often be amended, particularly in "Down Times," like the current pandemic. If you would like to discuss whether an interim valuation is available under your ESOP or how to amend your ESOP's distribution provisions to reduce cash outlay in 2020, please contact Lisa A. Durham or Sharon B. Hearn or another member of Krieg DeVault's Employee Stock Ownership Plan Practice Group for assistance.