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# ESOP Termination
## Phase I

A Report on the Reasons Companies
Terminate Employee Stock Ownership Plans

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This project is funded by the Employee Ownership Foundation.

This report describes the results of the first phase of a research project on the reasons companies terminate employee stock ownership plans (ESOPs). It summarizes interviews with company leaders at former ESOP companies and suggests directions for the quantitative research planned for phase 2 of this project.

The number of new employee stock ownership plans (ESOPs) established in any given year is probably between 8% and 10% of currently existing ESOPs, based on NCEO estimates. At the same time, ESOPs terminate for a variety of reasons, bringing the average net growth in the number of ESOPs to approximately 3.3% per year over the past six years (see Table 1). In other words, the rate of ESOP termination has an effect on the total number of ESOPs that is almost as large as the rate of ESOP creation. To date, the causes of ESOP termination have not been studied.

**Table 1: Number of ESOPs and ESOP Participants**

| | Number of… | | Annual increase in number of… | |
|---|---|---|---|---|
| | **ESOPs** | **ESOP participants** | **ESOPs** | **ESOP participants** |
| **2005** | 9,225 | 10,150,000 | 1.2% | 1.2% |
| **2004** | 9,115 | 10,030,000 | 2.7% | 4.5% |
| **2003** | 8,875 | 9,600,000 | 5.0% | 3.2% |
| **2002** | 8,450 | 9,300,000 | 5.0% | 4.7% |
| **2001** | 8,050 | 8,885,000 | 4.5% | 11.1% |
| **2000** | 7,700 | 8,000,000 | 1.3% | 14.3% |
| **1999** | 7,600 | 7,000,000 | | |
| **average** | | | 3.3% | 6.5% |

*Source: National Center for Employee Ownership (http://nceo.org/library/eo_stat.html)*

This article represents the first stage in a two-stage research project to explore the causes of ESOP termination. This phase of the study is limited to a small number of interviews and is not meant to provide a statistically reliable snapshot of why ESOP companies terminate their plans. It would be inappropriate to extrapolate too much from these data.

As qualitative data, this phase of the research suggests which potential causes of ESOP termination are worthy of further study and which do not seem to be. The interviews also provide stories for a number of companies that formerly had ESOPs and the insights of the leaders at these companies. The interviews, in other words, allow us to probe in depth, providing us with a better idea of what questions to ask in the second phase of the research. The second phase will include data gathered from consultants on the companies they work with or have worked with. Phase two should provide a better overall picture.

Given the limitations of this study, however, two overall trends do seem fairly clear. First, the most common reason for termination is being acquired, usually because there is an offer too good to turn down. The second most common reason is an inability to handle the repurchase obligation. Some observes have feared that ESOP repurchase obligation will ultimately be the undoing of a significant percentage of ESOPs. The relatively low rate of ESOP terminations (it is about in line with that of other benefit plans) and the secondary importance of the factor in this small sample suggests this is overstated.

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# Executive Summary

The interviews suggest that no simple or compact formula explains ESOP termination in general. A different set of casual factors affected different companies in the study, and factors that were of central or even exclusive importance at some companies were irrelevant at others.

## Companies Interviewed

The NCEO attempted to contact 51 companies and completed 30 interviews. Companies fall into three groups:

> ***Acquired companies:*** Seventeen interviews were with companies that had terminated their ESOPs in connection with being acquired. In addition, articles written about two companies were sufficiently detailed to provide useful information. Those two companies were both acquired, bringing the total number of acquired companies to nineteen.
>
> ***Terminations:*** Seven interviews were with companies that terminated their ESOPs and continued as independent companies, although one of the companies continued in shell form only, having effectively gone out of business.
>
> ***Continuing ESOPs:*** Six interviews were with companies with ESOPs that have lasted 20 years or more. The long-term ESOP companies were included to provide comparison with the companies that no longer have ESOPs.

This report will use these three terms ("acquired companies," "terminations" and "continuing ESOPs") to refer to these types of companies.

While the majority of former ESOP companies in this research project were acquired, it does not necessarily follow that the majority of former ESOP companies in the economy overall are acquired: companies that terminate their ESOPs may be less willing to participate in the survey, and representatives from companies which went out of business at the same time their ESOP terminated are more difficult to contact.

## Repurchase Obligation

Repurchase obligation was a major driver of the decision to sell the company for eight of the eighteen acquired companies for which we have a response (one company did not state how important repurchase obligation was to their decision). Two companies said that repurchase obligation played a secondary role and for another eight companies repurchase obligation had no impact on their decision to sell the company.

Relative to acquired companies, a higher portion of companies that terminated their ESOPs without a sale of the company said the repurchase obligation was an important factor in their decision. Of the six (of seven) termination companies that gave the

reason for the ESOP termination, four of the companies said repurchase obligation was an important factor.

## Acquisition Offer

Of the nineteen acquired companies, twelve stated what features of the offer led them to accept the offer. Of those twelve, eight said the most important feature of the offer they accepted was price. Premiums ranged from 0% to 180% over the ESOP appraised value, with an average of 57%.

## S Corporation Status

S corporations were approximately two-thirds of both acquired companies and termination companies, suggesting the S corporation tax advantage does not necessarily deter companies from eliminating their ESOPs. On the other hand, several interviewees said in very strong terms that S corporation status was essential in allowing them to continue as ESOPs. The results on S corporation status are unclear.

## Company Size

Relative to long-term continuing ESOPs (companies with ESOPs for 20 years or more in NCEO's database of ESOP-owned companies) the acquired companies interviewed for this study are typical in the size of their work force and slightly larger than typical in terms of revenue. At least in this small sample, termination companies are significantly smaller than the typical continuing ESOP in terms of both revenue and size of work force.

## Percentage ESOP-Owned

Most of the acquired companies interviewed were majority owned by their ESOPs, and the average percentage of shares owned by the ESOP was 83%. The termination companies interviewed had an average ESOP-ownership percentage of 62%, about the same as the 63% average ownership percentage among the long-term continuing ESOPs in the NCEO's database.

## Corporate Performance

Sixteen of eighteen acquired companies report that their performance was "strong" or "very strong" (one company did not report on its performance). By contrast, half of the termination companies reported being in a financial crisis prior to ESOP termination and only one of six described its performance as strong.

## Other Factors

A number of other issues related to the decision to eliminate the ESOP applied to a minority of companies. For some of those companies, however, these reasons were extremely important.

- Leadership issues drove ESOP termination for three of nineteen acquired companies and two of seven termination companies. The leadership issue was either the retirement of a visionary leader who supported employee ownership or the need to provide a greater equity stake to incoming managers.
- Diversification of employee retirement assets was a motivator for seven of the 26 acquired or termination companies.
- Legal liability was the sole factor that lead one company to terminate its ESOP, and four of the nineteen acquired companies said they felt a fiduciary duty to accept the acquisition offer.
- The need for strategic alliance or increased investment in the company motivated five of twelve acquired companies that provided data.

More details from interviewees on all these topics are in the rest of the report.

## Acknowledgements

The NCEO thanks the people interviewed for this project: they selflessly donated their time and insight with no personal return to themselves. The NCEO also thanks Michael Keeling, Judy Kornfeld, Rob Edwards, Anthony Mathews, Greg Hansen, and Ron Gilbert for their assistance with this phase of the research.

# 1. Methods

The interviews in this report were conducted by Loren Rodgers at the National Center for Employee Ownership. The NCEO conducted this research at the request of the Employee Ownership Foundation, which exclusively funded this project.

The contact information for the interviews came from a number of sources: The ESOP Association's President, Michael Keeling, provided information on former Association members with terminated ESOPs; the NCEO examined its membership for possible leads; the NCEO contacted service providers to find more potential companies to interview.

Where possible, the NCEO used data from companies listed in two of its databases: the Majority Employee Ownership List and the Minority Employee Ownership List. The researcher selected companies with ESOPs for 20 years or more, providing a set of 264 comparison companies. Data on these companies includes size of work force, revenues, and percentage employee owned.

# 2. Limitations

The interview summary is subject to two important limitations.

First, the results are not necessarily representative of typical ESOP companies. The small number of interviewed companies and the fact that the majority of participating companies are or were active members of the ESOP community means that their responses may not be typical of ESOPs in general. This is especially true for the continuing ESOPs—the researcher chose a very small sample of the companies that fall into this category.

Second, this analysis is entirely based on self-reported data from executives at these companies. They clearly have an interest in the interpretation of this data. Their memory may be biased and their interpretations are certainly not the only possible ones for each company. Wherever possible, the researchers attempted to obtain concrete figures in order to minimize bias.

# 3. Company Characteristics and ESOP Termination

## Company Size

Two factors may make smaller companies more likely to terminate ESOPs. First, smaller companies are likely to have extremely variable ("lumpy") repurchase obligation. The decision by a small number of individuals to retire or leave the company has a substantial impact on the cost of repurchase in any given year. In larger companies, the size of the work force ensures a more gradual and predictable change in repurchase obligation (absent a major company-wide event such as a layoff). Second, administration costs of an ESOP are also proportionally more substantial for smaller companies. One interviewee suggested that ESOPs were a poor fit for companies with under $100 million in revenue.

The NCEO's database of majority and minority employee ownership companies includes 264 records for companies that have had an ESOP for 20 years or more. Data on work force size and revenues exist for 186 and 263 of those companies, respectively. While even this data is not necessarily representative of all 20-year ESOP companies, it does provide additional data to estimate how representative the companies interviewed for the project are.

For the companies interviewed in this study, smaller companies are not more likely to terminate ESOP through a company sale. Acquired companies are approximately the same size in terms of work force (comparing median sizes) and 24% larger in terms of revenue size.

On the other hand, the interviewed termination companies are less than half the size of the continuing ESOP companies from the NCEO database in terms of median work force size; they are 32% smaller in terms of median revenue.

In terms of work force size, the continuing ESOPs interviewed for this study tend to be larger than the other interviewed companies and the long-term ESOPs in the NCEO database (based on the median size of the work force). As a result, the interviewed companies may be systematically different than typical continuing ESOP companies.

**Table 2: Work Force Size**

| | Acquired companies | Terminations | Continuing ESOPs (interviewed) | Continuing ESOPs (database) |
|---|---|---|---|---|
| Median | 200 | 80 | 310 | 190 |
| Average | 1,186[1] | 130 | 501 | 1,430 |
| Range | 50 to 13,000 | 18 to 400 | 80 to 1800 | 10 to 136,000 |

[1] Including a company with over 10,000 employees.

**Table 3: Revenue (in millions)**

| | Acquired companies | Terminations | Continuing ESOPs (interviewed) | Continuing ESOPs (database) |
|---|---|---|---|---|
| Median | $31 | $17 | NA | $25 |
| Average | $119 | $24 | NA | $90 |
| Range | $11 to $1,100 | $1 to $70 | $14 to $200[2] | $2 to $2,500 |

Clearly, however, size is not destiny for the interviewed companies. All three categories had companies ranging from fewer than 100 employees to several hundred. In addition, only one respondent mentioned the "lumpiness" of small-company repurchase obligation as a driver of ESOP termination and only two mentioned administration costs. One of the interviewees mentioning administration costs had been through a severe downsizing and had an ESOP with only four participants, driving up the per-participant administration cost.

## Company Performance

Companies making substantial profits may be more likely to terminate ESOPs for two reasons: profits translate into rapid increases in share value, making repurchase obligation grow; second, the company may find ESOPs a diversion of cash that they wish to invest in their growth.

On the other hand, profits can be a source of funds for repurchase obligation, making ESOPs less of a burden. One interviewee from a termination company said that "ESOPs are great when business is good."

The differences among the three groups of interviewed companies are substantial. The acquired companies had generally shown extremely strong performance in the period before the acquisition. By contrast, several of the interviewed termination companies were emerging from a crisis, often involving layoffs. Continuing ESOPs covered a broad range, centered on "strong" performance. One respondent from an acquired company said that "ESOPs work best if the company value is relatively flat or growing slowly." The corollary is the either poor performance or extremely strong performance may provide incentives to eliminate the ESOP.

Table 4 shows the percentage of each type of company, based on the researcher's assessment of their financial condition in the year prior to the acquisition, termination or the most recent fiscal year.[3]

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[2] Only two of the six continuing ESOP companies interviewed provided their revenue.

[3] Different performance measures were provided by different companies to gauge the strength of their performance. The performance rating is a combination of profitability, share price growth (when reported) and self assessment.

**Table 4: Financial Performance**

| | Acquired companies | Termination | Continuing ESOP |
|---|---|---|---|
| Very Strong | 9 of 18 (50%) | | 1of 6 (17%) |
| Strong | 7 of 18 (39%) | 1of 6 (17%) | 3 of 6 (50%) |
| Flat | 1 of 18 (5%) | 1of 6 (17%) | 1of 6 (17%) |
| Weak | 1 of 18 (5%) | 1of 6 (17%) | 1of 6 (17%) |
| Crisis | 0 | 3 of 6 (50%) | |

Of the seven acquired companies that were willing to share their profit margin, the average rate was 9.8%.

Several termination companies mentioned a "perfect storm" where economic difficulties led to layoffs, resulting in both a shortage of cash and high demands to distribute benefits to former participants. In some instances these companies faced a catastrophic loss of business: one company depended on, and lost, a single contract for 98% of its revenue.

In theory, poor performance should be reflected in a decrease in stock value, lessening the repurchase obligation. In practice, the decrease in stock value is often insufficient. One acquired company noted that the value of their stock dropped by 55% during a downtime. Even at the reduced price repurchase obligation increased because of increased distributions to laid-off participants.

Among the companies interviewed, acquired companies were likely to be most highly profitable and termination companies were most likely to be facing moderate to severe downtimes.

## S Corporation Status

The tax benefits of ESOPs in S corporation allow companies to build up substantial cash. These benefits may make S corporations more likely to maintain their ESOPs for two reasons: first, they will have sufficient cash to fund their repurchase obligations; second, they will want to maintain the unique benefits of S corporation ESOP ownership. The tax benefit of being an S ESOP is not directly incorporated into the valuation of the firm. Willing buyers of S ESOP corporations would generally terminate the ESOP and/or the S status, so the tax benefit would not inure to them. On the other hand, the increase future cash flows resulting from reduce taxation should increase the value of S corporation stocks over the long term. In addition, the S corporation status only provides a tax advantage to profitable companies.

Many of the interviewees felt strongly that the S corporation ESOP tax benefit was an extremely important contributor to the ability of ESOPs to endure. Several interviewees

from an acquired companies said that S corporation benefits allowed them to remain ESOP-owned for longer than would have been possible otherwise. One said, "before converting to S corporation status, I used to joke that we would be the only successful company to go bankrupt. I can't imagine how we would have survived as a C corporation."

Among the companies interviewed, Table 5 shows the portion that are S corporations.

**Table 5: Number of Companies that are S Corporations**

| | Acquired companies | Termination | Continuing ESOP |
|---|---|---|---|
| S Corporations | 11 of 17 (65%) | 4 of 6 (67%) | 4 of 5 (80%) |

While the interviewed continuing ESOPs are most likely to be S corporations, the numbers are too small to draw conclusions. In addition, among the interviewed acquired companies and termination companies, the majority in each case are also S corporations.

The results on S corporations are mixed: several interviewees stressed the importance of S corporation status to the viability of their ESOPs, but a majority of both acquired and termination companies are S corporations. (See also Chart 1 under Repurchase Obligation.)

## Age of Work Force

This phase of the research did not gather information about the age of each company's work force. Several interviewees, however, mentioned the age of their work force, or the ages of specific key employees in their work force, as reasons to terminate the ESOP.

## Age of ESOP

None of the interviewees specifically mentioned diversification as a reason to terminate the ESOP, although for some of the companies diversification requirements increased their repurchase obligation. (See the section on repurchase.)

Of the termination companies interviewed, none was approaching the 10 year mark: with one exception (at twelve years) all of the termination companies were well into the period where participants would be eligible for diversification. The average age of ESOPs among the termination companies is 16 years.

Among acquired companies, the picture is similar. Only two of eighteen had their ESOPs for fewer than 10 years and most were well into the diversification period. Twelve had their ESOPs for 14 years or longer.

More broadly, the age of the acquired companies and the termination companies was almost identical: both sets of companies had an average ESOP age of 16 years. The

median age for acquired companies was 15 and the median for termination companies was 14. (Continuing ESOP companies are excluded: the screening criteria for them was that they had an ESOP for 20 years or more.)

## Ownership Culture

Any assessment of ownership culture based on a brief interview with a single person at a company should be viewed with extreme caution. With that in mind, the NCEO attempted to determine a rough approximation of the strength of ownership culture at each of the interviewed companies. Each company was rated as having a "strong," "partial," "modest" or "weak" ownership culture, as Table 6 shows.

**Table 6: Strength of Ownership Culture**

| | Acquired companies | Termination | Continuing ESOP |
|---|---|---|---|
| Strong | 5 of 12 (42%) | 2 of 7 (28%) | 4 of 4 (100%) |
| Partial | 2 of 12 (17%) | | 0 |
| Modest | 4 of 12 (33%) | 3 of 7 (43%) | 0 |
| Weak | 1 of 12 (9%) | 2 of 7 (28%) | 0 |

Many acquired companies have strong ESOP cultures. One interviewee said "I never realized what we had created until after the sale. There was an outpouring of notes of appreciation from employees—we had something special." Termination companies are quite diverse with regard to ownership culture. One respondent said that their ownership culture had been strong, but it got weaker as the company increased in size: at the point they terminated the ESOP, company management did not have much confidence in its ability to maintain an ownership culture. Clearly the most striking result is the strength of the continuing ESOP companies interviewed in this study, all of which report strong ownership cultures.

As with all the data here, it is impossible to infer causality. For example, the relatively weak ownership cultures at termination companies could be either the cause or the effect of the economic difficulties they are facing.

## Percentage of Shares Owned by ESOP

Only one interviewee who raised the issue of the percentage of shares owned by the ESOP as a motivation for plan termination—that company wanted to maintain a substantial pool of shares to offer to key employees outside the ESOP. It stands to reason, however, that a larger ownership stake increases the repurchase obligation and thereby the potential motivation to terminate the ESOP. The percentage ownership in each type of company, plus the long-term ESOP companies from the NCEO database, is in Table 7.

**Table 7: Percentage of Shares Owned by the ESOP**

| | Acquired companies | Terminations | Continuing ESOPs (interviewed) | Continuing ESOPs (database) |
|---|---|---|---|---|
| Median | 93% | 58% | 100% | 65% |
| Average | 83% | 62% | 92% | 63% |
| Range | 44% to 100% | 15% to 100% | 64% to 100% | 5 to 100% |

Among the companies in this study, acquired companies generally have a higher percentage of shares in the ESOP, higher than both termination companies and long-term ESOPs in the NCEO database. In fact, only two acquired companies have minority ESOP ownership. Termination companies in the study tend to have a percentage of ESOP ownership that is approximately the same as the average for long-term ESOP companies. (Note that the interviewed continuing ESOP companies have much higher levels of ESOP ownership than the long-term ESOPs in our database, so these results cannot be taken to be statistically meaningful.)

# 4. Repurchase Obligation

Repurchase obligation is extremely important to some companies in this study; others said it was irrelevant or nearly so.

## Companies Where Repurchase Obligation is Important

Many interviewees said that repurchase obligation was a major driver of their decision to terminate their ESOP or to accept an offer to buy the company. Still, none of the acquired companies and only one of the termination companies gave repurchase obligation as their sole reason for ending the ESOP.

An extreme situation is illustrated by one of the termination companies. In the face of increasing economic difficulties, the company sought to maintain its ESOP using all means at its disposal, eventually using a revolving line of credit to pay its repurchase obligation. Its bank eventually forced them to stop, effectively leaving them no choice but to terminate the ESOP. Other companies, especially those that have been forced to lay off ESOP participants, find themselves simply unable to afford repurchase obligation.

More often, however, companies anticipated future problems with repurchase and accepted a sale offer or terminate the ESOP in order to prevent such problems from arising. For example, the SEC filing in support of the acquisition of ESOP company Raleigh, Schwarz & Powell by Brown and Brown notes that the company

> *projects that the volume of retirement purchases in the next two to ten years will outstrip the ESOP's capacity to acquire shares on a tax beneficial basis. Acquiring shares of retiring shareholders and ESOP participants with after-tax cash flow will inhibit Raleigh, Schwarz &*

*Powell's ability to remain competitive by limiting the cash and other resources available to continue the expansion necessary to effectively compete."*[4]

One respondent from an acquired company noted that current repurchase had not been a problem but that the age of the work force (with 50% of employees over age 55) would have soon caused repurchase to become untenable.

Other companies, while not expecting the repurchase obligation to drain the company, recognized the possibility of that occurrence. They felt that the risk, even if small, was a motivation to terminate the ESOP. One interviewee noted that he had experienced the "perverse nature" of increasing repurchase obligations during an economic downturn and wished to prevent that possibility from arising again.

## Companies Where Repurchase Obligation is Not Important

At the other extreme, a number of interviewees reported that repurchase obligation was not even a minor concern. One interviewee from an acquired company said that the repurchase obligation "was not a factor in any way," noting that the S corporation tax shield provided far more money than they required to repurchase shares. Another acquired company noted that they projected that they would be able to fund their repurchase out of current earnings indefinitely; on top of that, the company had a sinking fund set aside for repurchase.

## Interview Results

Based on the interviews, the researcher classified the importance each company assigned to repurchase obligation. For companies that were acquired or that terminated their ESOPs, the importance is relative to their actual decision. The results are in Table 8. (Note: in the table, "a primary reason" means that no reason was more important than repurchase obligation, but other reasons were equally important. An "important reason" means that other reasons were more important than repurchase obligation.)

**Table 8: Importance of Repurchase Obligation in Decision to end ESOP**

| Repurchase obligation is… | **Acquired companies** | **Termination** |
|---|---|---|
| …the **sole reason** we terminated the ESOP. | | 1 of 6 (17%) |
| …**one of the primary reasons** we terminated the ESOP. | 3 of 18 (17%) | 1 of 6 (17%) |
| …an **important reason** we terminated the ESOP. | 5 of 18 (28%) | 2 of 6 (33%) |
| …**contributed to** our decision to terminate the ESOP. | 1 of 18 (6%) | |

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[4] Registration of Securities Issued in a Business-Combination Transaction, Form S-4, August 13, 2001. SEC file 333-67408 (http://www.secinfo.com/dsVsf.4fdP1.htm)

| …**had a minor impact** on our decision to terminate the ESOP. | 1 of 18 (6%) | 1 of 6 (17%) |
| --- | --- | --- |
| …**played no role** in our decision to terminate the ESOP. | 8 of 18 (44%) | 1 of 6 (17%) |

Repurchase obligation was an irresistible force pushing some interviewed companies to eliminate their ESOPs; its importance for a portion of the ESOP community is extreme. At the same time, for a substantial number of companies in this study, repurchase was nearly irrelevant to the decision to end the ESOP.

## Continuing ESOPs

For continuing ESOPs, the importance of repurchase obligation reflects the company's level of confidence in its ability to meet its repurchase. Half of continuing ESOPs rated repurchase obligation as a minor concern, although none of them said it was irrelevant. Two of six interviewed continuing ESOP companies said that repurchase obligation is an important challenge and one reported that it was one of the primary challenges facing them as a company.

One C corporation reported that, because of ESOP repurchase obligation, in the long term the company "will likely not survive." The company found an interim solution by recruiting an outside investor to purchase approximately one-third of the company. The interviewee felt, however, that two features of the deal will be nearly impossible for other ESOP companies to find: (1) the outside investor purchased shares at the ESOP value, while most financial investors refuse to pay more than 60 to 70% of fair market value, and (2) the investor did not require any puts or other liquidation rights.

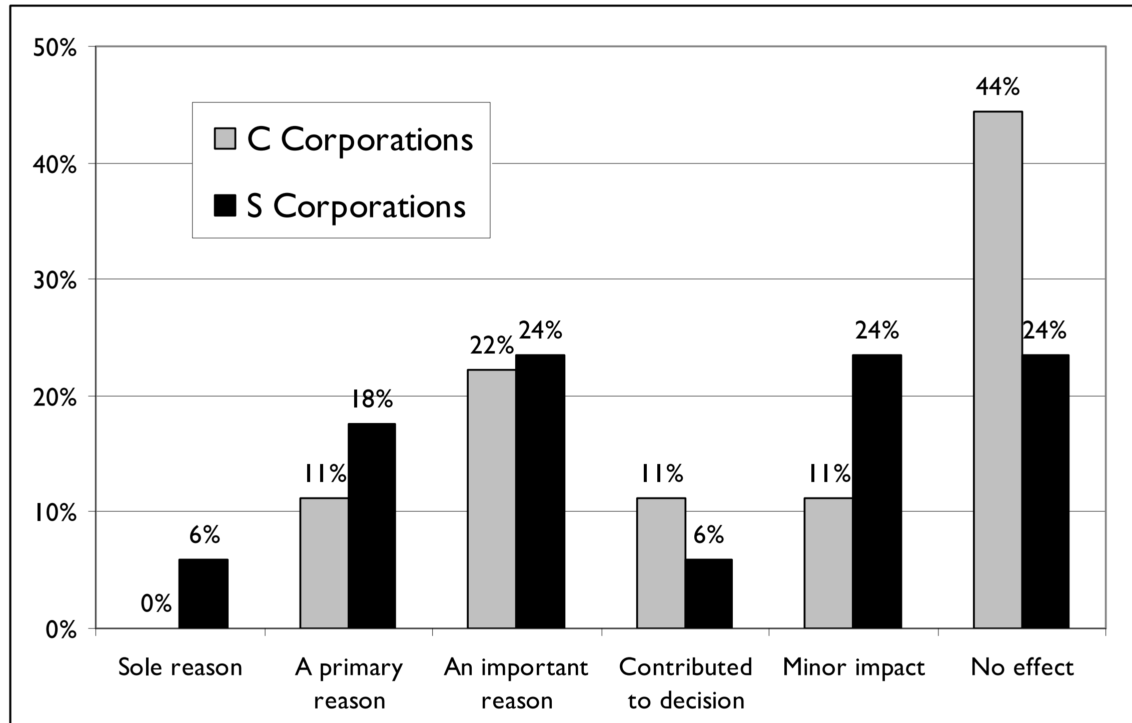
Another continuing ESOP company noted that the company continually evaluates its ESOP and will terminate it at whatever point it determines that the ESOP will compromise the continued growth of the company.

Clearly, the interviewed continuing ESOP companies reflect the same diversity of perspectives as the acquired companies and termination companies: repurchase obligation is extremely important for some companies and nearly irrelevant for others.

## S Corporation Status and Repurchase Obligation

Each company was classified in terms of the importance it gave to repurchase obligation—the ratings are the same as in Table 6.[5] The data in Chart 1 show that C corporation are, surprisingly, *more* likely to see repurchase obligation as a non-issue than S corporations.

**Chart 1: Importance of Repurchase Obligation for Interviewed Companies**

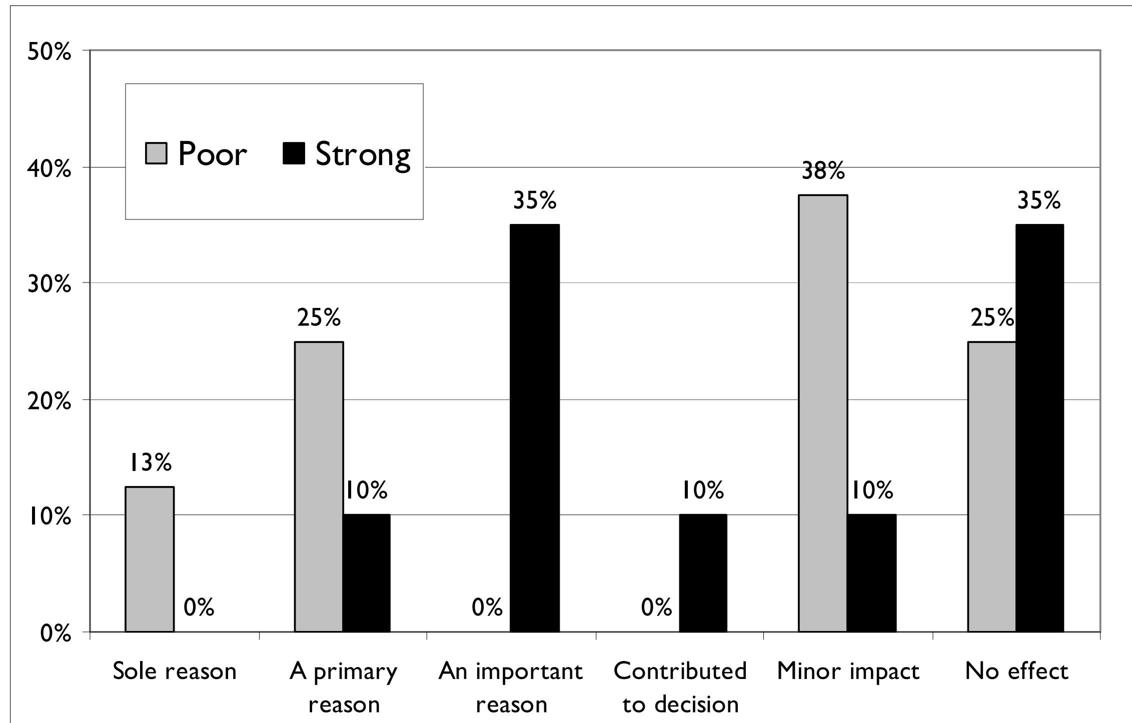



[5] The ratings were adjusted as appropriate for continuing ESOP companies. Note that these are imperfect measures and reflect the researchers impression of the importance as stated by the interviewees.

## Performance and Repurchase Obligation

As discussed above, performance has a complex impact on ESOP termination: both weak and very strong performance can lead to the dissolution of the ESOP. The data on company performance (see Table 4) and its relationship to repurchase obligation is displayed in Chart 2.

**Chart 2: Importance of Repurchase Obligation by Company Performance**




In this chart the top two performance categories ("strong" and "very strong" from Table 4) are combined into "strong"; the bottom three categories ("flat," "weak," and "crisis") are combined into "poor."

The chart shows that there is no simple relation between performance and the importance of repurchase obligation among the interviewed companies. Poor performance is somewhat more likely to be associated with extremely high levels of importance of repurchase obligation, but a substantial number of both poor and strong performers in the study rate repurchase obligation as having little or no impact on their company.

# 5. Offers to Purchase the Company

Among the interviewed acquired companies, the average premium over their appraised stock value was 57%, and the median premium was 45%. The premiums ranged from a low of 0% to a high of 180%. Table 9 shows the distribution of premiums for the acquired companies that were willing to share that information.

**Table 9: Size of Premium Over ESOP Appraised Value**

| | Acquired companies |
|---|---|
| 0 to 10% premium | 3 of 15 (20%) |
| 11 to 40% premium | 5 of 15 (33%) |
| 41 to 80% premium | 3 of 15 (20%) |
| 81 to 180% premium | 4 of 15 (27%) |

Many respondents from acquired companies expressed great satisfaction in the sale price and terms. They used glowing terms to describe the benefits of the sale. The characteristics they discussed in terms of why they accepted the offer are listed in Table 10. (Note that percentages in Table 10 do not add to 100%—companies could indicate more than one reason.)

**Table 10: Reasons for Accepting the Acquisition Offer**

| | Acquired companies |
|---|---|
| Size of 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 acquiring company | 3 of 12 (25%) |

Other Items, each mentioned by a single company, were: to provide a better benefits package to employees, to provide more career advancement opportunities, and to remove the risk of legal liability.

The number of offers a company receives in a typical year may influence how likely it is to be acquired. Of the companies that provided information about how many offers they received in a typical year, the results are in Table 11. Clearly the number of termination and continuing ESOP companies is too small to draw conclusions, but at least from this set of companies, there does not appear to be a major difference in the number of offers received among acquired, termination and continuing ESOP companies.

**Table 11: Number of Offers in a Typical Year**

| | Acquired companies | Termination | Continuing ESOP |
|---|---|---|---|
| None / No Serious Offers | 9 of 14 (64%) | 2 of 4 (50%) | 2 of 4 (50%) |
| Occasional Offers | 1 of 14 (7%) | 1 of 4 (25%) | 1 of 4 (25%) |
| Moderate to Frequent Offers | 4 of 14 (28%) | 1 of 4 (25%) | 1 of 4 (25%) |

The only data included in this research project that sheds light on employee reactions to outside offers is from what companies reported about employee votes. Of the 18 acquired companies that provided this data, eight (44%) did not have an employee vote on the acquisition. Of the ten that did have a vote, six reported about the vote margin, and all said that the vote was "near unanimous," with percents in favor ranging from 95% to 99%.

Overall, offers seem to affect the decision to end an ESOP among the companies in this study in two ways: first, some companies found that the offer's terms were too good to refuse. Even if the offer was unsolicited, they felt they needed to accept it. Second, companies may have solicited offers or accepted an offer that was made at a time when other factors, such as repurchase obligation, were forcing them to some action.

# 6. Company Management

## Visionary Leader

The interviewee at one continuing ESOP company suggested that a common cause of ESOP establishment is the vision of a single company leader. Over time, that leader will retire and the company may not be able to find a replacement manager who shares the vision of the original leader. As an example, at one acquired company the interviewee reported that the need to bring in a new management team was the sole reason for the sale. Overall, four interviewees (two from acquired companies, one from a terminated ESOP, and one from a continuing ESOP) said that an individual visionary leader is a key factor in the establishment and continuity of an ESOP.

By contrast, three acquired companies specifically said that the status of the original visionary leader at their company did not affect their decision. Overall, the majority of interviewees did not mention this issue as a concern in any way, suggesting that this issue was significant in the termination of the ESOP or the sale of the company for a small number of interviewed companies.

Among the continuing ESOP companies, the range of opinion about the role of leadership commitment to employee ownership was wide. Two companies had official corporate commitments that were broader than the personal wishes of the current management team. At one of those companies, "perpetuality" of the ESOP is an official corporate goal. Another continuing ESOP company considered terminating the ESOP

but, after review, decided to take that option “off the table.” On the other hand, one company said explicitly that it is not committed to the ESOP and continually evaluates how well it is contributing to the company.

### Equity for Management Compensation

Five companies mentioned the need to take stock out of the ESOP in order to have more equity available for managers or key employees (three acquired companies and two termination companies). One company projected that continuing to contribute to their ESOP would soon result in the ESOP owning 70% of the company’s shares; their target was to have at least 50% of shares available for a key set of employees. Another company reported a specific incident when they failed to hire a new manager because it was unable to offer a sufficient equity stake. Another interviewee said that her company had gradually provided more equity to key employees: their non-ESOP ownership stake made the ESOP less important.

### ESOPs as Ownership Transition

One interviewee also suggested that ESOP’s role in facilitating the transition from ownership by the founder or a family may result in the ESOP being a temporary structure—after the owner’s shares have been repurchased and the tax advantages gained, the need for the ESOP may have passed and the company seek to return to “traditional” ownership.

## 7. Diversification

Diversification does seem to be a substantial concern at some of the companies interviewed, especially following Enron’s bankruptcy. Seven companies mentioned diversification of employee retirement benefits as a concern that led them to accept a proposed acquisition or to terminate their ESOPs. For example, one interviewee from an acquired company said

> *My main concern is protecting the retirement assets of many, many families. The offer allowed us to lock in a level of value for employees that we would not have been able to achieve for several years, and do so risk free. [The sale was] the antithesis of Enron—money went to employees instead of Wall Street.*

Although the research project did not interview ESOP participants directly to learn their interpretations of the end of the ESOP, several respondents had stories suggesting that employees were happy to reduce their concentration of wealth in employer stock. Another interviewee said that “employees are much happier with the 401(k) than they were with the ESOP.” Another said that the 401(k) felt more tangible to employees because of the monthly statements and the ability to choose investment assets.

Another termination company reported that cash was more important than diversification: after termination, 50% of employees paid the penalties and took cash instead of rolling assets over into the new retirement plan or an IRA.

## 8. ESOPs as Incentive to Leave

While only two interviewees (both from acquired companies) mentioned this concern, it was of significant importance to one interviewee, who said he knows of numerous cases at his company where participants left the company in order to use their ESOP balances to buy cars, houses, or avoid personal bankruptcy. By contrast, another respondent who mentioned this as a concern said that the company had a two-year waiting period before distributing the value of ESOP accounts. To the best of his knowledge, no one had yet left the company for this reason, but he worried that they might if the company had economic challenges.

## 9. Legal Liability

Four acquired company respondents said that they felt a fiduciary obligation to accept the acquisition offer. One said, "I felt a fiduciary obligation to consider the offer: my job is to get the stock price up." Another said, "under ESOP structure, it would have been hard to say no."

One respondent said that the fiduciary perspective mostly came into play in determining which offer to accept.

In addition, one respondent from a termination company said that the "fear of inadvertently violating a rule or provision of ERISA and being sued" was their primary reason for terminating their ESOP. She added, "if it wasn't for fiduciary liability, I would recommend that the company return to ESOP ownership."

Fiduciary liability appears to play a secondary role in leading some companies to accept an outside offer. More significantly, it is an issue of significant enough concern to some companies to lead them to question the continued viability of maintaining an ESOP.

## 10. Hypotheses

Interview data with a small number of companies that are not necessarily representative of ESOP companies overall will not support conclusions about the causes of ESOP termination. The interviews, however, are consistent with some hypotheses about ESOP termination and inconsistent with others. One clear feature emerging from the interviews is that a different set of hypotheses pertains to different companies—no simple or compact formula will explain ESOP termination.

Table 12 below describes each hypothesis and summarizes the relevant findings from this research project. The table shows how well the interviewed companies fit each hypothesis.

**Table 12: Hypotheses for ESOP Termination**

<table>
<tr><td colspan="3">Company characteristics</td></tr>
<tr><td>1.1</td><td>Small companies are more likely to terminate ESOPs.</td><td>Inconsistent with interviewed acquired companies<br>Consistent with interviewed termination companies</td></tr>
<tr><td>1.2</td><td>Highly profitable companies are more likely to terminate ESOPs.</td><td>Consistent with acquired companies interviewed</td></tr>
<tr><td>1.3</td><td>Highly profitable companies are less likely to terminate ESOPs.</td><td rowspan="2">Consistent with termination companies interviewed</td></tr>
<tr><td>1.4</td><td>Companies facing severe downturns are more likely to terminate ESOPs.</td></tr>
<tr><td>1.5</td><td>S corporations are less likely to terminate ESOPs.</td><td>Mixed</td></tr>
<tr><td>1.6</td><td>Companies with older workforces are more likely to terminate ESOPs.</td><td>Insufficient data</td></tr>
<tr><td>1.7</td><td>Companies approaching 10 years since the establishment are likely to terminate ESOPs to avoid repurchase obligation stemming from diversification requirements.</td><td>Inconsistent with interviewed companies</td></tr>
<tr><td>1.8</td><td>Companies with strong ownership cultures are less likely to terminate their ESOPs.</td><td>Consistent with interviewed companies</td></tr>
<tr><td>1.9</td><td>Companies where the ESOP owns a substantial percentage of shares are more likely to terminate their ESOPs.</td><td>Consistent with interviewed acquired companies<br>Inconsistent with interviewed termination companies</td></tr>
<tr><td colspan="3">Repurchase obligation</td></tr>
<tr><td>2.1</td><td>The inability to afford the current obligation to repurchase shares from participants who leave the company forces some companies to terminate their ESOPs.</td><td rowspan="2">Consistent with a minority of interviewed companies</td></tr>
<tr><td>2.2</td><td>Current repurchase obligation forces companies to underinvest in their own growth, leading them to terminate their ESOPs.</td></tr>
</table>

| | | |
|---|---|---|
| *2.3* | The projected inability to afford the future obligation to repurchase shares from participants who leave the company forces some companies to terminate their ESOPs. | Consistent with about half of acquired companies interviewed, and inconsistent with the other half. |
| *2.4* | Future repurchase obligation would force companies to underinvest in their own growth; to avoid this situation, companies terminate their ESOPs. | Consistent with a majority of termination companies interviewed. |
| **Company management** | | |
| *3.1* | Employee ownership depends on strong leadership by a visionary individual; when this individual leaves, companies terminate their ESOPs. | Consistent with a minority of interviewed companies. |
| *3.2* | Incoming / rising managers require a larger ownership stake than is possible while maintaining the ESOP. | Consistent with a minority of interviewed companies. |
| *3.3* | The ESOP was established as a transitional vehicle to purchase a block of shares from the owner; after that was accomplished, the ESOP was no longer required. | Insufficient data |
| **Employee diversification and preferences** | | |
| *4.1* | Employees resist concentration of wealth in employer securities and consequently undervalue the ESOP. | Consistent with a minority of interviewed companies. |
| *4.2* | Management wants to provide a safer, more diversified retirement plan for employees. | |
| *4.3* | Management worries that employees will leave the company to gain access to the value in their ESOP accounts. | Consistent with a minority of interviewed companies. |
| **Offers to purchase the company** | | |
| *5.1* | Management supports an outside offer to purchase the company. | Consistent with interviewed companies |
| *5.2* | ESOP participants support an outside offer to purchase the company. | Consistent with interviewed companies |
| **Legal liability** | | |
| *6* | The company wants to avoid legal liability resulting from ERISA. | Consistent with a minority of companies |

# 11. Next Steps

Drawing on these interviews, feedback from people reviewing this report, and discussions with service providers, the NCEO will collect data from ESOP administration firms to test hypotheses about ESOP termination in a using quantitative analysis for a larger number of companies.