Why Are ESOPs Terminated?

New data provide definitive answers

Over the last 30 years, the NCEO estimates that about 3% to 4% of all ESOPs are terminated, a rate in line with other defined contribution plans. There is some evidence that these rates have actually declined to well under 3% in the last five years. This may be a result of more companies becoming S corporation ESOPs and now both wanting and being able to stay ESOP long term or it may just be random variation in the data.

Until now, however, we have not had good information on just what causes ESOP terminations, although we did do an impressionistic study of a limited number of companies earlier this year.

The data are based on a survey of 23 large plan administration and ESOP advisory firms. They are collectively responsible for over 3,300 plans. Some of the firms based their responses on an analysis of actual data; others relied on estimates. The results did not vary significantly between the two groups, however. The results show that attractive offers, not difficulty with repurchase, are the main cause of terminations.

Termination Rates

We asked respondents to tell us how many of their clients terminated their plans over the last 10 years. On an annual basis, the number works out to a little over 2% per year. That this figure is lower than our estimates based on IRS data could be from at least three factors. First, the respondents may be optimistic in how they view their own results. Because the data from those using actual numbers was not different from those providing estimates, however, this seems unlikely. More likely is that ESOPs using these well-established providers are getting better advice. Companies that seek out these providers may also be more committed to their plans in the first place.

Causes for Termination

Next, we asked respondents to tell us why plans were terminated. Nineteen respondents provided data on 455 plan terminations. In addition, one respondent had 50 banks terminate their plans when merged with other banks. Because this seemed a special circumstance, we did not include these numbers in the calculations below. The table below gives the percentage of terminations in each category, with the absolute number listed in parentheses.

Reasons for Plan Termination

The company was performing well financially but could not manage its repurchase obligation or expected not to be able to do so in the future	13.2% (60)

The company could handle its repurchase obligation, but received an attractive offer it could not turn down	51.2% (233)
The company was dissatisfied with the ESOP for reasons other than repurchase problems	15.6% (71)
The company was in financial difficulty and needed to cut costs	13.1% (60)
The company never intended the plan to be permanent; it was just used to buy out an owner with the intention of terminating the ESOP at a later date	2.2 (9)
Other	5.3 (22)

Difficulty handling repurchase is still an issue, but only for a distinct minority of companies. This is even truer if we look at companies that have had their ESOPs 10 years or more. Presumably, repurchase should become more of an issue as time goes on. But the data show that only 8.5% of these mature companies terminated because of difficulties with repurchase. Perhaps not surprisingly, companies that had stuck with their ESOPs this long almost never terminate because of dissatisfaction with the plan, and very few have financial problems. Instead, about 85% choose to sell to another buyer, even though they could handle repurchase.

The Impact of S Status

One of the most striking changes in ESOPs in the last decade is the growth of 100% S ESOPs. Out of the sample, 27% fell into this group, while 12.2% were minority S ESOPs. Also striking was that 22% were majority C ESOPs (many of whom will likely become 100% S ESOPs in the future), while 39% had ESOPs owning a minority of the shares. Looked at differently, 49% of the companies were majority or 100% ESOP owned. This may somewhat overstate the entire universe of ESOPs, but given that this group represents over one-third of all the plans, the numbers cannot be too far different. This percentage is at least twice what it was in the mid-1990s and probably four times what it was in the 1980s.

One expected impact of being an S ESOP is to make it easier to handle the repurchase obligation because of the enhanced cash flow the tax benefits provide. The data bear this out. Among those respondents providing data, just 11% of S companies terminated because they could not handle repurchase obligations even though they were financially solid businesses, compared to 21% of the C companies (the number do not precisely match the overall data because only 12 respondents provided usable data on this question).

The data provide considerable encouragement that ESOPs are an increasingly stable and significant business form, not a transitional tool.

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