Problems with ESOPs

An employee stock ownership plan (ESOP) is a retirement plan in which investments are made primarily in the employer’s stock. The value of an ESOP account can grow in two ways – if the value of the stock increases or if additional shares are allocated to the participant’s account. Conversely, an ESOP account’s value will shrink if the stock value decreases or if share allocations end. As a result, the value of a retiree’s ESOP account is heavily dependent on a company’s financial performance.

This fact sheet describes the types of ESOPs, outlines risks associated with them, and suggests steps that people with ESOPs can take to reduce those risks.

There are three types of ESOPs, each with its own rules:

- ESOPs that hold publicly-traded employer stock;
- ESOPs that hold privately-traded employer stock; and
- ESOPs that have used a bank loan to buy employer stock (these are also known as leveraged ESOPs)

ESOPs that hold publicly-traded employer stock

This type of ESOP holds employer stock that is traded on a national securities exchange, such as the New York Stock Exchange.

ESOPs that hold privately-traded employer stock

This type of ESOP holds employer stock that is not traded on a national securities exchange. When an employee retires or leaves the company, employers are required to either offer distributions in the form of cash or to buy the stock that is paid out from the plan. In both cases, a “fair valuation method” must be used to determine the cash amount.

Leveraged ESOPs

A leveraged ESOP is one in which the ESOP has used a loan to buy either privately- or publicly-traded employer stock. The acquired stock is held in a separate ESOP account which then allocates shares to participant accounts as the debt is repaid through employer contributions.

ESOPs can be stand-alone plans or part of a 401(k) plan.

Common ESOP Risks

- As with 401(k) plans, it is extremely risky for ESOP participants to have too much of their overall retirement savings in any single stock, particularly employer stock.
However, unlike 401(k) plans, which generally contain diversified investments, ESOPs are by definition invested solely in the employer’s stock.

- A company’s financial circumstances can affect the value of its stock, thus lowering the stock’s value and threatening the value of employees’ ESOP accounts.
- If a company with an ESOP is struggling financially and has to lay off workers, the plan must cash out those workers’ shares in the ESOP, which can create even more cash-flow problems and lead to more layoffs, creating a “death spiral” that could ultimately sink the company – and the value of the employees’ ESOP accounts.
- If a company’s ESOP is invested in privately-owned stock, the risks listed above are even greater, because the value of the stock is not determined by the stock market but by a third party, who may or may not be unbiased.

**Best practices for people with ESOPs**

Because of the risks mentioned above, many experts believe that all ESOP participants should:

- Transfer ESOP balances out of employer stock into other investments, particularly when the value of the employer’s stock is too large a portion of the total retirement plan investments, such as more than 10 or 20 percent.
- If an ESOP is also part of a 401(k) plan, participants are entitled to diversification rights, which include the right to transfer out of publicly-traded employer stock after three years of service.
- If the stock is privately-traded or if the ESOP is not part of a 401(k) plan, participants only receive these diversification rights after reaching age 55 and participating in the ESOP for at least 10 years.
- Consider receiving any payouts in the form of cash that is directly rolled over into an IRA or 401(k) plan to avoid incurring tax penalties and so that the money can be invested in diversified funds rather than in a single stock.
- Contact a pension lawyer right away if the employer does not make a payment when it is due. Free legal assistance is available from the [Pension Counseling and Information Program](#).

**Special concerns and suggestions for people with ESOPs that hold privately-owned employer stock:**

- If the employer’s stock is privately-traded, take any cash payments you may be entitled to as soon as possible. This will enable you to avoid the risk of possible investment loss that may occur if the employer encounters financial trouble and the stock value declines.

Most ESOPs permit lump-sum payments of participant account balances when the employee stops working for the employer. But if the employer encounters financial trouble, it can amend the plan – without notice to employees and effective immediately – to rescind this right and delay payouts for as long as seven years after termination of employment. Even then, employers are permitted to pay out participant balances in installments over five years.
If your ESOP holds privately-traded employer stock, find out if the person who values the stock held in the ESOP is independent of the employer and has professional training and experience in valuing stock that is privately traded.

It is difficult to determine the exact value of an employer’s stock if it is not traded on a market. There is a history both of valuations being performed by a person with no professional experience or training in valuations of privately-traded stock and of valuations being manipulated to the detriment of plan participants.

For more information about ESOPs, see our working paper, “Employee Stock Ownership Plans: Are They Worth the Risks?”