Pitfalls In Selling Stock To Fund ESOP Repurchase Obligations - Part I
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ESOPs often choose to make benefit distributions in the form of cash, rather than in company stock. Some of these ESOPs obtain the necessary cash by selling company stock to the company. This sale transaction raises two fiduciary issues under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). First, the sale is a prohibited transaction under Section 4975(c)(1)(A) of the Internal Revenue Code of 1986, as amended ("Code"), and Section 406(a)(1)(A) of ERISA, unless the sale meets the exemption in Section 408(e) of ERISA. Second, under Section 404(a)(1) of ERISA, the fiduciary must satisfy itself that the decision to sell company stock is in the best interests of the ESOP's participants.

To satisfy the prohibited transaction exemption, the fiduciary must obtain a valuation opinion letter from the ESOP's independent appraiser, dated as of the sale date, that states that the purchase price paid to the ESOP is not less than the fair market value of the company stock. The ESOP cannot rely on the prior year end appraisal to satisfy this requirement. While the updated stock valuation from the appraiser solves the prohibited transaction problem, it may create additional administrative issues for the ESOP, discussed below. In addition, while the sale of company stock may achieve the company's objectives, the fiduciary may only sell company stock if the sale is in the best interests of the ESOP participants.

The first part of this Article will address the administrative and fiduciary issues associated with obtaining the updated valuation opinion letter. The second part of this Article (to be published shortly) will discuss methods to fund repurchase liability without involving a sale of company stock by the ESOP.

Administrative and Fiduciary Concerns

Although a company and its ESOP may prefer to make distributions in cash, an ESOP is generally required to offer benefit distributions in the form of company stock, unless the company is an S corporation or the company restricts ownership of its stock to employees and the ESOP in accordance with Code Section 409(h)(2).

Rarely will an ESOP have sufficient cash to fund all benefit distributions indefinitely. Since the assets of the ESOP are invested largely in company stock, an ESOP may find it difficult to obtain the cash needed to fund benefit distributions. For example, the company may have concluded that it does not want to make additional tax deductible contributions to the ESOP, or the company may already be making contributions up to the limits permitted under the Code, in which case it would not be able to make any additional annual contributions to fund the benefit distributions.

To achieve the objectives of (1) making ESOP distributions in the form of cash, and (2) making no additional contributions to fund this obligation, the ESOP may be led to conclude that it should sell company stock to obtain cash. The stock sale provides the ESOP with cash but avoids any additional contributions, since the payment of the purchase price to the ESOP is not a contribution.

As previously mentioned, the ESOP fiduciary must obtain an updated valuation opinion letter from the ESOP's independent appraiser, as to the fair market value of company stock. The ESOP cannot rely on the fair market value determined as of the prior year-end. This is the position of the Department of Labor ("DOL") in DOL Prop. Reg. 2510.3-18(b).

Although the updated valuation is required under ERISA, the existence of this additional valuation raises other concerns for the fiduciary. Let's assume that the company's fair market value is higher at the time of the update than at the prior year-end. The ESOP cannot legally sell shares to the company for less than the updated fair market value. If the ESOP sells at the higher current price, who is entitled to the increased value? The former employee may only be expecting to receive the prior year-end value that appeared on his last annual statement (and the ESOP document may state explicitly that this is the value used for all distributions). The ESOP could provide that the former employee would only receive the prior year-end value, and that the excess value would be allocated to all other participants as an item of net income of the trust for the year. Alternatively, the ESOP fiduciary could decide to pay the increased value to the former employee, resulting in a "windfall" to the former employee.

If the ESOP does not pay the former employee the higher updated price, the former employee could assert he is entitled to the excess sales proceeds, since the shares sold were from his account. On the other hand, active employees could assert that the former employee is only entitled to the prior year-end value and that the additional purchase price should be allocated to all ESOP participants.

What if the updated value is lower than the prior year-end fair market value? The ESOP could sell the stock to the company for the higher price determined as of the prior year-end, since Section 408(e) of ERISA would permit the ESOP to sell the stock for more than its fair market value. However, the issue of who is entitled to this premium presents itself again. If the ESOP document permits interim valuations, the active employees may have a superior claim to the premium. The former employee may argue that the fiduciaries breached their ERISA duties by obtaining the interim valuation which resulted in a reduction in his benefits. If the company pays the lower interim value, then the former employee would only receive the lower, updated amount for his shares. He might argue that obtaining the interim valuation was itself a violation of ERISA by the ESOP's fiduciaries.

In addition to the foregoing administrative and fiduciary issues, the fiduciary of the ESOP must consider whether his decision to sell Company stock is in the best interests of ESOP participants. The mere existence of the updated valuation opinion does not fully discharge the fiduciary's responsibilities under ERISA. Courts have established a presumption in favor of an ESOP fiduciary that is buying company stock. However, no such presumption protects a fiduciary that is selling company stock. Often, the reasons to sell company stock to fund benefit distributions (as identified above) are to further the interests of the company, but not necessarily the interests of the ESOP. If the ESOP owns all of the stock of the Company, it may be easier for the ESOP fiduciary to conclude that actions which are in the best interest of the company are also in the best interests of the ESOP participants. Otherwise, the ESOP fiduciary must consider the drop in the ESOP's percentage ownership in the company as a factor in agreeing to sell company stock.

A fiduciary who does not wish to sell company stock to raise cash could consider simply distributing shares of stock to participants. However, if the company is an S corporation, such an action could result in the loss of its S corporation status if an ineligible person thereby becomes a shareholder. Also, if the company is a C corporation and does not have an ownership restriction in its certificate of incorporation or by-laws, the distribution of shares could result in permanent share ownership by former employees.

Conclusion

Because the prohibited transaction rules require the ESOP to obtain an updated valuation, the stock sale may create a dilemma for the ESOP's fiduciaries. Whether the fair market value is higher or lower than the prior year-end fair market value, the company and ESOP may find themselves in a position of having to take actions that harm either former employees or active employees. Moreover, the fiduciary of the ESOP may have difficulty demonstrating that a sale of company stock was in the best interests of the ESOP participants under ERISA.

The second installment of this article will describe alternative methods for funding benefit distributions.

Editor's note: this posting is based in part on an article that appeared in The ESOP Report of The ESOP Association several years ago.