CHAPTER **9**

ESOPs

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¶ 900 What Is An ESOP?

The Technical: An ESOP is a tax qualified retirement plan that meets the requirements of both Section 401(a) of the Internal Revenue Code of 1986, as amended ("IRC") applicable to defined contribution plans, and the additional requirements of IRC Section 4975(e)(7) necessary to be an "employee stock ownership plan." For purposes of IRC Section 401(a), the ESOP can be either a "stock bonus plan" or a combination of a stock bonus plan and a "money purchase pension plan." To be an ESOP, the plan must state that it is designed to invest primarily in stock of the employer. An ESOP is a plan that also satisfies the requirements applicable to ESOPs under Section 407(d)(6) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

The Practical: An ESOP is designed to be a shareholder of a company alongside its role of providing retirement benefits to employees. Unlike other retirement plans, the ESOP can borrow money to purchase employer stock, allowing it to accumulate significant amounts of stock. In addition, the Code provides a number of special tax benefits to incentivize business owners to sell stock to the ESOP.

¶ 900.1 Tax Code Requirements – IRC Section 401(a) and 4975(e)(7)

A. Retirement Plan Requirements in General

An ESOP must comply with the requirements of IRC Section 401(a) applicable to defined contribution plans. For example, an ESOP must meet: the minimum eligibility and participation requirements of IRC Section 410(a) and (b), the minimum vesting rules of IRC Section 411, the nondiscrimination requirements of IRC Section 401(a)(4) relating to benefits for "highly compensated employees" (*see* IRC Section 414(q)) relative to non-highly compensated employees, the limits on contributions and annual additions to the plan under IRC Sections 404(a) and 415(c) and exclude consideration of an employee's compensation in excess of the limits under IRC Section 401(a)(17) (as adjusted annually and currently $245,000).

B. Additional ESOP Requirements

For a plan to go beyond being merely a tax qualified defined contribution plan and meet the additional requirements to be a stock bonus plan and an ESOP, additional IRC and ERISA requirements must be met.

Employer Securities. The plan must be "designed to invest primarily" in employer securities. This requirement has generally been interpreted to mean more than 50% of the plan's assets. In addition, it has generally been interpreted to mean that the plan may from time to time have less than 50% of its assets invested in employer securities, so long as the plan is designed to invest in employer securities. These positions are derived from a 1983 Department of Labor Advisory Opinion, although the Advisory Opinion is not conclusory on these points.[1]

Types of Employer Securities. Section 407(d)(5) of ERISA and the applicable regulations essentially define "employer securities" for ESOP purposes as being stock (some forms of publicly traded debt not relevant here are also permissible). Under ERISA, any class of stock whether it be voting, non-voting common or preferred would qualify. However, IRC Section 409(l) provides additional requirements, and these are important because the IRC ESOP tax benefits discussed below, such as IRC Section 404(k) (dividend deduction), IRC Section 1042 (tax deferred sale), IRC Section 512(c) (the UBIT exemption) and the ability to leverage the ESOP are all dependent on the use of employer securities that meet the additional requirements of IRC Section 409(l).

For an employer that does not have common stock which is readily tradable on an established securities market, IRC Section 409(l) permits the use of: (i) common stock issued by the employer having a combination of voting power and dividend rights equal to or exceeding that class of common stock of the employer having the greatest voting power and the class of common stock having the greatest dividend rights; or (ii) noncallable preferred stock if it is convertible at any time into qualifying common stock, if the conversion price (as of the date of the acquisition) is reasonable; provided, that preferred stock shall be treated as noncallable if after the call there will be a reasonable opportunity for a conversion. In the Internal Revenue Manual, a conversion premium of 20% to 30% is generally considered to meet the reasonableness standard.[2]

An ESOP may own shares of stock that do not meet the requirements of IRC Section 409(l), and may also own other assets such as cash or mutual fund shares, so long as these assets do not cause the ESOP to fail the "primarily invested" requirement.

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[1] Department of Labor Advisory Opinion 83-6A (January 24, 1983).

[2] Internal Revenue Manual (April 1, 2006) Section 4.72.4.2.10 – Qualifying Employer Securities.

Valuation of Employer Securities. Trustees of all pension plans are required to make a good faith determination of the fair market value of plan assets each year (see ERISA Sections 103(b) and 3(26)). However, IRC Section 401(a)(28)(C) imposes a specific requirement for ESOPs. The IRC requires the ESOP to obtain a valuation of employer securities, conducted by an "independent appraiser." IRC Section 401(a)(28)(C) references the rules of IRC Section 170(a)(1), but the IRS has not provided any useful guidance on the requirements for determining whether a particular appraiser, who may have other relationships with the company or other shareholders. ERISA Section 3(18)(B) also creates the need for an independent appraiser for ESOPs in order to comply with the "prohibited transaction" rules of ERISA Sections 406 and 407 and IRC Section 4975. However, as discussed below, the Department of Labor has provided little guidance for interpretation of this rule.

Right to Distribution in Employer Securities/Put Option. See the discussion in **¶ 905**, below.

Voting Rights. ESOPs usually provide that the trustee, rather than individual participants, vote the shares of stock owned by the ESOP. In some instances, as described in IRC Section 409(e), participants are required to be given the opportunity to instruct the trustee as to the voting of the shares allocated to their ESOP accounts.

Diversification. Once a participant attains at least age 55 and has at least 10 years of participation in the ESOP, he must be offered the opportunity to diversify a portion of his account that is invested in employer stock. Once he qualifies, he has the right to elect to diversify up to 25% of his account for five years (on a cumulative basis). In the sixth and final year of the eligibility period, he has the right to diversify up to 50% of his company stock balance. The ESOP may choose to create three or more diversified funds within the ESOP and provide participants with the right to direct the investments. The ESOP may also simply distribute the cash equivalent benefit to the participant or transfer the amount to a self directed 401(k) plan.

IRC Section 409(p) S Corporation Anti Abuse Rules. See discussion in **¶ 905**, below.

¶ 900.2 ERISA Requirements

ESOPs, like all tax qualified retirement plans, are regulated by both the tax rules of the IRC and the pension benefit protection rules of ERISA. ERISA contains requirements that in some instances, parallel the IRC requirements, and in some instances, such as the reporting and disclosure rules, create additional requirements. The following section focuses on the fiduciary requirements of ERISA.

A. Fiduciary Standards

ERISA Section 404(a) contains the basic standards that a fiduciary of a pension plan such as an ESOP must follow:

"a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title and Title IV."

Key concepts include the "exclusive purpose" requirement, the "prudent man" standard and the requirement to follow the terms of the written plan documents. The requirement in ERISA Section 404(a)(1)(C) to diversify plan assets is clearly inconsistent with the concept of an ESOP. However, ERISA Section 404(a)(2) provides that an ESOP that qualifies as an eligible individual account plan (as defined in ERISA Section 407(d)(3)) is exempt from the diversification requirement, as well as the prudence requirement to the extent that it would require diversification.

B. Prohibited Transaction Compliance

IRC Section 4975 and ERISA Sections 406 and 407 create overlapping rules that general restrict a retirement plan from engaging in a purchase or sale of assets with a "party in interest" as defined in ERISA Section 3(14) or a "disqualified person" as defined in IRC Section 4975(e)(2) or borrowing from such persons.

ERISA Section 408(e) creates an exemption that permits a plan to purchase stock from these related parties, so long as the plan does not pay more than "adequate consideration" (as defined in ERISA Section 3(18)) and no commission is charged. Adequate consideration has been addressed in Department of Labor proposed regulations[3] although the proposed regulations have never been finalized. The proposed regulations define "adequate consideration" by reference to fair market value, determined using a Rev. Rul. 59-60[4] approach.

[3] Prop. DOL Regs. §2510.3-18 (5/17/88)

[4] Rev. Rul. 59-60, 1959-1 C.B. 237

IRC Section 4975(d)(3) and ERISA Section 408(d)(3) create an exemption for the loan made to the ESOP by either the plan sponsor, the seller or other related party. The requirements are detailed in Treasury Regulation Section 54.4975-7.[5]

¶ 901 ESOP Tax Incentives

¶ 901.1 S Corporation Shareholder

A. ESOPs Are Eligible

Effective January 1, 1998, ESOPs became eligible shareholders of S-corporations under IRC Section 1361. In addition, IRC Section 512(e)(3) was amended to provide that an ESOP would not be subject to unrelated business income tax on S-corporation income with respect to shares held by the ESOP that are qualified employer securities under IRC Section 409(l).

B. ESOPs are Exempt from UBIT

The portion of an S-corporation's income allocable to an ESOP shareholder is effectively exempt from federal income tax, as neither the corporation nor the shareholder pays any current income tax on the earnings. If the ESOP owns 100% of the S-corporation's stock, none of the earnings are subject to current federal income tax. These earnings are indirectly subject to tax in future years when participants receive taxable benefit distributions and the value of the distributions includes the ESOP/S-corporation tax benefit.

C. Certain ESOP Benefits Not Available

An ESOP maintained by an S-corporation is denied certain of the ESOP tax benefits. These include: (i) dividend deductions under Section 404(k); (ii) tax deferred sale treatment under IRC Section 1042, (iii) enhanced annual addition limits of IRC Section 415(c)(6), (iv) exclusion of interest expense from the deduction limits of IRC Section 404(a)(9) and (v) deferral of benefit distributions until an ESOP loan is repaid in full under IRC Section 409(o).[6]

D. Anti-Abuse Rule

S-corporation ESOPs must comply with IRC Section 409(p) or face an onerous set of tax consequences. See discussion in ¶ 906 below.

E. Check for State and Local Taxes

Some state income tax laws may still be applicable. For example, California imposes a 1.5% income tax on all S-corporations, and Mississippi does not follow federal law on the UBIT exemption of IRC Section 512(e)(3).

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[5] Treas. Reg. Sec. 54.4975-7

[6] The cross-reference in IRC Section 409(o)(1)(B) to a "loan described in" IRA Section 404(a)(9) creates some uncertainty as to the applicability of the deferral provision to an S-corporation.

¶ 901.2 Tax Deferred Sale Treatment under Section 1042

A. Shareholders Can Avoid All Capital Gains

Since 1984, Section 1042 has provided owners of stock in a closely-held company with the opportunity to sell shares to an ESOP and defer or permanently avoid capital gains tax on the transaction.

1. **Requirements.** In order to qualify, a selling shareholder must meet the following requirements:

   The shareholder must sell stock in a C corporation that is not "publicly traded" (within the meaning of Treas. Reg. Sec. 54.4975-7(b)(iv)) .

   The shareholder must have a three-year holding period in the shares to be sold, determined under the regular holding period rules, and the transaction must otherwise qualify for capital gains treatment (e.g., not a dividend).

   The shareholder must not have acquired the shares in connection with the performance of services under Section 83 or through an employee stock option plan.

   The ESOP must own immediately after the transaction at least 30% of each class of outstanding stock or 30% of value of all outstanding stock of the employer.

   The shareholder must "rollover" proceeds from the ESOP transaction within 12 months into "qualified replacement property" (QRP). QRP is generally stocks or bonds of U.S. operating companies. Passive income entities such as mutual funds do not qualify.

2. **Additional Considerations**

   The shareholder, certain related individuals, and greater-than-25% owners generally cannot participate in allocations of stock acquired by the ESOP in a 1042 transaction (see IRC Section 409(n)).

   If the ESOP disposes of Section 1042 stock in less than three years (with certain exceptions), the employer owes a 10% excise tax determined based on the amount realized by the ESOP on the disposition of the shares.

3. **Recapture of Deferred Gain**

   If the shareholder disposes of QRP, the disposition will trigger the recapture of the capital gain originally deferred on the sale to the ESOP. Dispositions that do not trigger the recapture include tax-free reorganizations under IRC Section 368, death of the seller, or dispositions by gift.

¶ 901.3 Deductibility of Principal Payments on Debt

A. Contributions

The ESOP repays principal and interest with tax deductible employer contributions made to the retirement plan. IRC Section 404(a)(3) generally limits contributions to a defined contribution plan to 25% of eligible payroll. However, IRC Section 404(a)(9) permits a C corporation that sponsors a leveraged ESOP to deduct annual contributions of up to 25% of eligible payroll to the extent used by the ESOP to make principal payments on its debt, and in addition, allows contributions used by the ESOP to make interest payments without regard to the 25% limit. In structuring a transaction, the parties can focus on the relationship of the eligible payroll of the company to the principal amount of debt to be incurred by the ESOP.

B. Efficient Use of Pre-Tax Dollars

Over the life of an ESOP loan, an employer can make tax deductible contributions equal to the amount of the loan. The ESOP uses these contributions to pay back the debt. In this sense, the employer is deducting the principal cost of the debt for the transaction. Compare the case of a management buyout of a company without an ESOP. While the company is able to deduct the interest expense on its financing, the principal must be repaid in after tax dollars. By using the ESOP, a company will be able to more easily raise the funds needed for the transaction and will find that the true cash cost of repaying the debt is lower.

B. S Corporation More Limited

IRC Section 404(a)(9) does not apply to an S-corporation. The S-corporation may only deduct ESOP contributions under IRC Section 404(a)(3). The S-corporation is effectively limited to a 25% of payroll deduction limit, including both interest and principal.

C. Annual Addition Limits Apply

Annual contributions to an ESOP must meet the annual allocation limits of IRC Section 415(c). IRC Section 415(c)(6) gives a C corporation the ability to exclude interest and forfeitures from the annual limits on allocations. In addition, the IRS has permitted leveraged ESOPs to base on the amount of the annual addition on the fair market value of the shares allocated to a participant's account for the year if lower than the contribution made by the employer.

¶ 901.4 Deductibility of Certain Dividends – Section 404(k) Permits Three Methods

A company may qualify for a tax deduction for dividends paid to an ESOP in one of three ways identified in paragraphs A –C below.

A. Loan Payments

An ESOP may use cash dividends it receives to make payments on the loan incurred to acquire the shares on which the dividends were paid. The ESOP cannot use dividends it receives on non-leveraged shares to make a loan payment. If the dividends are paid to the ESOP on leveraged shares that have previously been released from the ESOP suspense account and allocated to a participant, then the participant must receive an allocation of additional shares with a fair market value equal to the cash dividend used to make the loan payment.

If cash dividends are so used by the ESOP, the employer will be entitled to a deduction for the dividends.

B. Cash to Participants

The employer will also be eligible for a tax deduction for cash dividends that are paid by the ESOP to the participants in the ESOP. Alternatively, the employer may pay the dividends directly to ESOP participants without running the cash through the ESOP trust. ESOP passes the dividend through to ESOP participants in cash.

C. Participant Election

The ESOP may provide participants with an election to receive a dividend in cash, or to have the ESOP reinvest the cash in additional shares of the employer's stock. When this third option was added to the IRC by the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16, 6/7/2001), the Secretary of Treasury was given authority to disallow deductions for dividends to an ESOP that are an evasion or avoidance of income tax. The Conference Report on this provision notes that if a company's stock is not readily tradable on an established securities market, " . . . the reasonableness of that dividend is determined by comparing the dividend rate on stock held by the ESOP with the dividend rate for common stock of comparable companies whose stock is primarily and regularly traded on an established securities market. Whether a corporation is comparable is determined by comparing relevant corporate characteristics such an industry, corporate size, earnings, debt-equity structure and dividend history."

D. S Corporation

An S-corporation is not permitted to deduct dividends it pays to an ESOP. However, the ESOP of an S-corporation is permitted to use dividends from allocated shares so long as fair market value rule of IRC Section 4975(f)(7) is met.

¶ 901.5 Rollover and NUA Treatment for Participants

A. IRA Rollover

ESOP benefit distributions qualify for regular tax free rollover treatment and are subject to the same rules applicable to other tax qualified retirement plans.

B. NUA

In addition, employer stock held by an ESOP (and other qualifying defined contribution plans) that is distributed in a lump sum may qualify for "net unrealized appreciation" (referred to as "NUA"). The participant is taxed upon distribution of the shares only on the amount equal to the ESOP's cost basis in the shares. The value of the shares in excess of the ESOP's basis, which is the NUA, is not taxed upon distribution. Rather, the NUA is taxable only when the participant later disposes of the shares. In addition, the NUA is taxable as capital gain, rather than ordinary income, regardless of the participant's holding period in the shares. Each participant receiving a distribution of shares should determine whether use of the NUA benefit is superior to the tax deferral that can be achieved through a tax free rollover of the distribution.

¶ 902 Some Common Uses of ESOPs in Ownership Succession Planning

¶ 902.1 Minority Interest Stock Purchase

A. ESOP is Combined with a Non-ESOP Purchase for Immediate or Gradual Ownership Transition.

For a variety of reasons, ownership transition of a family business may take place in a series of steps over a number of years, rather than in a single transaction. A family that owns a business may wish to retain control may wish to transfer control to the next generation or to successor management gradually. Financing for a transaction involving 100% of the equity value may not be possible.

An ESOP can be used to purchase 30% (or more) of the stock of a C corporation on a tax deferred basis, as described above. A family may wish to take the first step in the gradual succession plan in this manner. It provides the ability to take 30% or more of the value of the company out on a tax deferred basis. The family could retain voting and management control. The ESOP transaction could be combined with a management equity incentive plan designed to provide management with a piece of the equity if pre-established performance targets are met. This strategy works well for a company with a strong successor management team in place. The program also works well for a company still developing its successor management. Management would only vest in the awards if they remain employed for a vesting period and meet or exceed very specific projected performance targets. These performance standards would usually be tied to the projections the company gives the ESOP independent appraiser to determine the fair market value of the stock.

The value paid by the ESOP would need to reflect both a minority interest and a marketability discount. The marketability discount is often ameliorated by the put option the Company is legally obligated to provide to ESOP participants.

The leveraged ESOP transaction generally causes a drop in the per share value of the stock. The drop derives from the combination of the additional debt added to the company and the fact that the shares sold remain outstanding (owned by the ESOP) rather than being retired as treasury shares. Shareholders should be advised of this effect so that they understand the temporary value decline their shares may suffer to the extent they do not sell shares into the transaction.

The temporary decline in value creates some obvious estate planning opportunities. For example, the period following the transaction may be a good time for gifting the lower value stock.

Following a successful ESOP implementation, it may desirable to keep the ESOP permanently at the 30 to 49% ownership level and then look to other strategies to transfer the remaining equity to family and successor management. The IRC Section 1042 transaction in effect reduces the size of the equity interest that needs to be transferred from one generation to another. A management equity incentive plan that includes options may provide a cashless way for management to earn a significant minority interest over and above the 30% ESOP interest, while building share value for all stakeholders. Gifting of shares following the leveraged ESOP transaction may also permit the transfer of a substantial percentage of the equity to the next family generation.

B. ESOP Purchases Control in a Series of Transactions

For some companies and some shareholders, the minority interest and marketability discounts applied to an ESOP stock purchase are so unattractive the ESOP is not feasible. Companies in this position might consider a staged purchase where the shareholders sell the ESOP both a minority interest in the business up front, along with an option pursuant to a binding written agreement to purchase control in the future. ESOP fiduciaries may be in a position to pay a controlling interest value in the transaction, on the strength of the option provided to acquire the rest of the control block in the future. In DOL Prop. Regs. §2510.3-18, the Department of Labor suggests such an approach is feasible. The proposed regulations provide that it is permissible for an ESOP to pay a controlling interest value where

> "Actual control (both in form and in substance) is passed to the purchaser with the sale, or will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the sale"

In footnote 8 to the Proposed Regulations, the Department of Labor stated:

> "Similarly, if the plan purchases employer securities in small increments pursuant to an understanding with the employer that the employer will eventually sell a controlling portion of shares to the plan, a control premium would be warranted only to the extent that the understanding with the employer was actually a binding agreement obligating the employer to pass control within a reasonable time."[7]

In the past the Department of Labor investigated several of these transactions and asserted a prohibited transaction violation. The DOL claimed the ESOP paid a control interest value for a 30% purchase and therefore paid a price exceeding adequate consideration. Although a couple of these cases were settled by the selling shareholders paying substantial amounts to the ESOP, many others were resolved with the Department of Labor without any adjustments. The design of

[7] *See Donovan v. Cunningham,* 716 F.2d at 1472-74 (mere intention to transfer control not sufficient).

such a transaction requires careful planning. ESOP fiduciaries should consider obtaining either voting control up front with the purchase of the first 30% (through a proxy or other means) or design the transaction to ensure that control will be passed within just a few years of the first transaction. In addition, the ESOP fiduciary will want a contractual commitment from the company and/or the shareholders to provide financing for the option exercise in the future, as the ESOP will not have the wherewithal to exercise an option in the future on its own.

C. Use of Convertible Preferred Stock for Minority Transaction

IRC Section 409(l) allows for the use of qualifying convertible preferred stock with a conversion premium. Assume the ESOP would buy 30% of the stock of a $10 million company for $3 million. However, the appraiser applies a 25% discount for lack of marketability and minority interest considerations, so that the value of the 30% is limited to $2.25 million. The Company creates a convertible preferred stock that (i) has a par value of $100 per share, (ii) pays an annual preference dividend to the ESOP of 5%, (iii) permits the conversion of the preferred into common at $80 per share, and (iv) has a liquidation preference of $100 per share. The ESOP appraiser determines that the value of the dividend and liquidation preferences exceeds the $20 per share premium the ESOP will have to pay for the common stock upon conversion. Then, the ESOP will be able to purchase the 30% block of convertible preferred for $3 million. The stock would be convertible on the first day into $2.4 million of common stock. From the seller’s view point, the seller has received the desired purchase price and has only given up current equity with a value of $2.4 million. If the Company performs well, the preferences will have a small value. On the other hand the seller should understand that if the company performs poorly, the conversion features would result in the ESOP having more than 30% of the equity value.

D. Financing

Minority interest ESOP transactions have often been financed through a single bank loan. Prior to the current difficulties in the banking industry, many companies were able to obtain senior bank debt equal to 2.5x to 3x of EBITDA. If a company were valued at 7x of EBITDA, 100% bank financing would be feasible. Currently, banks are not making significant loans in excess of liquidation value of hard assets. Sellers are being asked to finance a portion of the transaction by accepting a subordinated promissory note. Some mezzanine funds have financed ESOP transactions and are looking for more transactions. These funds can sometimes put up the cash needed to avoid seller financing.

¶ 902.2 100% ESOP Leveraged Buyout

A. Often Used in Combination with S Corporation Conversion

A 100% ESOP buyout has often been used to combine the two most valuable ESOP tax benefits: the Section 1042 tax deferred sale and the 100% ESOP owned S corporation. A C corporation would arrange with its shareholders for a 100% buyout. Assuming the shareholders qualify, they would avoid capital gains tax on the sale of their stock to the ESOP. The ESOP, as the new 100% shareholder, would plan to elect S corporation status for the company at the beginning of its next tax year. For a C corporation with strong cash flows, it is often the case that the 40% or more of cash flow saved from avoiding income tax allows for substantially faster amortization of large amounts of debt financing.

If the proposed ESOP company is already an S corporation, the shareholders have a choice to make. If the 1042 benefit is of great value to them, they could have the company break its S election immediately before the ESOP stock purchase. Then, with the company a C corporation, the shareholders can sell to the ESOP and elect 1042 treatment. Under the S corporation rules, the company would be prevented from reelecting S status for 5 years. The IRS has specifically ruled that it will not waive the 5 year waiting period even though the ESOP transaction constituted a change in control transaction. However, it is important to assess the tax tradeoffs. It is possible that breaking the S election will not cause large C corporation income taxes during the 5 year period because the ESOP tax deductions for debt amortization may largely offset taxable income. On the other hand, forgoing 1042 and staying as an S corporation may also afford benefits. Consider that if the S corporation is not a taxpayer it will have an incentive to pay down the "inside" ESOP loan slowly, releasing shares to participants on a schedule driven by retirement benefit levels. As a C corporation, the company may be tempted to make contributions much larger than normalized retirement benefits in order to accelerate the deductions associated with ESOP financing.

Consider the case of a company that has a minority ESOP, is an S corporation, and the shareholders are not interested in the IRC Section 1042 tax benefit. It is possible to create a 100% ESOP-owned S corporation without the ESOP buying any stock in the transaction. The current non-ESOP shareholders can have the company redeem their remaining shares. Once the redemption is completed, the ESOP owns 100% of the outstanding stock. This approach avoids the ESOP engaging in a prohibited transaction for which an exemption meeting all of the Code and ERISA requirements would otherwise needed. Of course, the trustee of the ESOP would want to review the terms of the transaction with the company and its own appraiser to be sure the transaction is fair to the ESOP.

B. Financing Through Seller Subordinated Promissory Notes

As mentioned above, it would be very difficult for any company even in times of generous credit availability, to obtain a bank loan for 100% of its equity value. In today's environment, it is difficult for many companies to obtain bank term loans in excess of 20 to 30% of equity value. Seller financing has become an important tool and getting ESOP transactions financed in the past couple of years. More often than not, sellers attracted to the ESOP are not focused on immediate 100% liquidity as a principal goal of a transaction. In addition to liquidity, these shareholders may be focused on preserving the legacy of the business, rewarding key employees who have been an important part of the success of the company, and earning a fair return on the proceeds they receive from the ESOP. For these shareholders, a transaction that provides a modest percentage of cash up front, in the 10 to 30% range, may be acceptable and desirable. The parties to the transaction may look to the mezzanine debt market to determine a fair rate of return on the subordinated promissory note the seller may be receiving. In the mezz market, rates of return in the 10 to 20% range are common, and are obviously quite specific to the company and industry involved. Shareholders may find the seller note attractive because (i) the rate of return exceeds the investment alternatives available to them even if they were to receive all cash in the ESOP transaction, and (ii) the shareholders are usually in a good position to access the credit risk associated with the notes.

In setting the rate of return on seller notes, it is important to develop good market data on rates of return that would be earned in arm's length transaction in the market place. At the same time, it is worth remembering that the shareholders are usually "parties in interest" under ERISA with respect to the ESOP, and that the rate of return earned could be subject to scrutiny by the IRS or DOL. For that reason, shareholders might look to the low end rather than the high end of the market data for structuring an ESOP transaction.

¶ 902.3 Non-Leveraged ESOPs

A. Provides Current Retirement Contributions on a Cashless Basis

A company may wish to establish an ESOP and make annual contributions in the form of company stock. This non-leveraged approach provides a tax benefit to the company in the form of a cashless deduction equal to the fair market value of the shares contributed. The dollars do "double duty" because the shares contributed create a current employee benefit. Consider a company that feels it needs to contribute 3% of pay into a profit sharing plan to be competitive. The company could avoid the current cash expense by contributing shares to an ESOP with a fair market value equal to the 3% target.

B. Use by Davis Bacon Prevailing Wage and Government Contractors

Many construction companies with nonunion workforces are required to provide minimum wages and benefits on certain projects designed to give nonunion employees benefits comparable to union workers. Often, these prevailing wage-type projects will permit some discretion to the employer on funding the minimum benefits. An employer could contribute shares of stock to an ESOP and so long as the ESOP met the requirements for a benefits plan under the prevailing wage laws, the employer could meet the expense on a non cash basis.

A large number of federal government contractors have implemented ESOPs as part of their ownership succession strategy. In addition to the other benefits mentioned in this outline, the government contractor can usually design the ESOP contributions to fit within their reimbursable wage and benefit costs. So for example, if a contractor is able to contribute 5% of payroll to a pension plan and fit the cost into their overhead charges, the contractor could contribute 5% of payroll to a leveraged ESOP that has purchased all or a portion of the company. The DCAA has exhibited some hostility towards ESOPs, often directed at the valuations obtained from the ESOPs appraiser. However, the most recent pronouncements from the Cost Accounting Standards Board relating to ESOPs are facilitating rather than thwarting ESOP transactions. As with many industries, when larger companies are in acquisition mode and paying large premiums for companies, the ESOP structure becomes less attractive to some owners. Conversely, when the M&A market cools, the ESOP may be the best alternative succession model.

¶ 903 Case Law and Regulatory Gloss on ERISA Fiduciary Standards

As noted in **900.2** above, ESOP fiduciaries are subject to the "exclusive purpose" and "prudent man" standards of ERISA Section 404(a), but are exempt from the general duty to diversify the investment of plan assets. Obviously, an ESOP could not exist if the fiduciaries were required to both invest primarily in qualifying employer securities and to diversify plan assets. Several circuit courts have addressed this potential conflict and resolved the matter in a manner favorable to fiduciaries.

¶ 903.1 Presumption in Favor of ESOP Fiduciaries

A. ***Oremet*, *Moench*, *Kuper*** and Subsequent Developments

In *Moench*,[8] the Third Circuit considered the responsibilities of an ESOP fiduciary that held and continued to invest in employer stock and a time when the company's fortunes were declining. The court overturned the district court's broad conclusion that since the plan document required investments exclusively in company stock, the fiduciary had no discretion to diversify. Instead, the circuit court held that an ESOP fiduciary's decision to hold and acquire employer stock under such circumstances would be overturned only if a court found an abuse of discretion by the fiduciaries. The court articulated a presumption in favor of ESOP fiduciaries who acquire or hold employer stock.

B. Sixth Circuit[9]

Later in *Kuper*, the Sixth Circuit came to a similar conclusion, bolstering the rebuttable presumption in favor of ESOP fiduciaries.

C. Ninth Circuit[10]

In *Wright*, the Ninth Circuit seemed to go even further. While not specifically adopting the rebuttable presumption of *Moench*, the Ninth Circuit seems to have followed the approach of *Moench* and *Kuper*, and further raised the question of whether an ESOP fiduciary could ever be responsible for a fiduciary breach for holding stock, since it is the intent of the statute. However, we would note that in *Syncor*,[11] the Ninth Circuit seemed to backtrack a bit on whether it supported the

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[8] *Moench, et al. v. Robertson*, 62 F.3d 553 (3d Cir. 1995).

[9] *Kuper v. Iovenko*, 66 F. 3d 1447 (6th Cir. 1995).

[10] *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090, 1417 (9th Cir. 2004).

[11] *In re Syncor ERISA Litigation,* 516 F.3d 1095 (9th Cir. 2008).

Moench rebuttable presumption. Note that *Kirschbaum*[12] represents support for the presumption in the Fifth Circuit as well.

D. Stock Drop Cases and *LaRue*

In the U.S. Supreme Court decision, *LaRue v. DeWolff*,[13] the Court at least partially defeated a defense plan sponsors had been using to have ERISA fiduciary stock drop cases dismissed (although LaRue is not itself a stock drop case). The company sponsored a 401(k) plan and investment decisions were controlled by plan participants. Mr. LaRue was a participant and he claimed that the plan's fiduciaries failed to follow his investment instruction to sell securities in his account and this failure resulted in a loss of $150,000 in the value of his account. He sued the plan's fiduciaries under Section 502(a)(2) of ERISA. This section gives a plan participant the right to bring a lawsuit for “appropriate relief” under Section 409 of ERISA. Section 409 of ERISA provides:

> “Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary. A fiduciary may also be removed for a violation of section 1111 of this title.”

The circuit courts of appeals around the country had split over the interpretation of this section. Some circuits held that the references in Section 409 to “losses to the plan” and “restore to such plan” meant that only a loss suffered by the “entire plan” was subject to a remedy under Section 502(a)(2). Other courts found that an individual participant could bring a fiduciary breach claim for losses suffered by his individual plan account without any other loss to the plan as a whole.

In resolving this circuit court split in favor of permitting lawsuits on behalf of individual participants, the LaRue opinion contains the following highlights:

The Court reexamined its opinion in *Massachusetts Mut. Life Ins. Co. v. Russell*.[14] In *Russell*, the Court found that Section 502(a)(2) authorized recovery for a breach of fiduciary duty under Section 409 only for the plan as an entity, and did not permit individuals to bring suit when they did not seek relief on behalf of the plan as a whole. Russell involved a participant in a disability plan who received his benefits but claimed consequential damages relating to the delay in the startup of the payments.

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[12] *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243 (5th Cir. 2008).

[13] *LaRue v. DeWolff*, 552 U.S. 248 (2008).

[14] *Massachusetts Mut. Life Ins. Co. v. Russell, 473 U.S. 134 (1985).*

In *LaRue*, the Court found the “entire plan” concept should be restricted to defined benefit plan cases (the Court included long term disability plans in this category). The Court found the concept inapplicable to defined contribution plans (like and ESOP) in which benefits are determined on an individual account balance basis.

Justices Roberts and Kennedy concurred in the result in favor of LaRue, but they wrote a separate concurrence in which they suggested that LaRue's remedy is under Section 502(a)(1)(B) rather than under Section 502(a)(2). Section 502(a)(1)(B) allows a participant to sue “ . . . to recover benefits due to him under the terms of his plan, to enforce his rights under the terms of the plan, or to clarify his rights to future benefits under the terms of the plan.” It is possible that LaRue might win his case under either section; however, forcing participants to sue under 502(a)(1)(B) provides employers with some additional procedural defenses that would not be available in a breach of fiduciary duty case under Section 502(a)(2).

Justices Thomas and Scalia filed an additional concurring opinion. They made the point that the loss to LaRue's account was a “loss to the plan” even if it did not affect all accounts within the plan. They saw no reason to distinguish defined benefit plans from defined contribution plans for this purpose.

¶ 903.2 Indemnification of ESOP Fiduciaries

ERISA fiduciaries, including those of ESOPs, have generally been indemnified by the plan sponsor for losses they may suffer in connection with a claim that the fiduciary breached its ERISA fiduciary duties or otherwise violated ERISA.

A. Historical Position of DOL and ERISA Section 410

ERISA Section 410 has always provided that exculpatory provisions purporting to relieve a fiduciary of responsibility or liability for the ERISA duties is void. However, ERISA has also always permitted an employer to purchase insurance to cover the fiduciary's potential liability. The Department of Labor (“DOL”) took the position that an indemnification agreement that acts like insurance would also be a permissible form of fiduciary protection and would not violate the prohibition on exculpatory provisions (29 C.F.R. 2509.75-4).

B. Couturier, Kelly Moore Cases

The Ninth Circuit has raised serious questions about the viability of standard indemnification agreements in its decision in *Johnson v. Couturier*.[15] In *Couturier*, the 9th Circuit refused to permit advancement of legal fees to defendant ESOP fiduciaries promised under an indemnification agreement. In *Fernandez v. K-M Industries Holding Co., Inc.*,[16] a district court in the 9th Circuit followed and

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[15] *Johnson v. Couturier*, 2008 WL 4443085 (9th Cir., July 27, 2009).

[16] *Fernandez v. K-M Industries Holding Co., Inc.*, 2009 WL 2579643 (N.D. Cal., August 21, 2009).

even expanded on the idea that the use of assets of a company to indemnify a fiduciary was tantamount to using plan assets, where the company was owned in part by an ESOP.

¶ 903.3 Duty to Monitor Board of Directors

A. DOL Interpretive Bulletin 94-2

In 1994,[17] the DOL made clear its position that ERISA fiduciaries who own stock in a company have a duty to monitor the board of directors of the company on issues such as executive compensation, mergers & acquisition strategies, and the like if the plan owns enough stock to have an impact. Obviously, an ESOP will often have sufficient stock ownership. For that reason, a trustee of an ESOP should adopt a procedure for documenting its careful monitoring of the major actions taken by the board of a company whose stock it owns. The duty to monitor has been raised in virtually all of the significant stock drop cases brought against fiduciaries in the last several years.

B. Amsted Industries

The decision in the Amsted Industries case[18] involved, in part, an allegation that the trustee of the Amsted Industries ESOP failed to monitor the Board of Directors in connection with the Board's approval of a major leveraged purchase of another company. While the facts of the case appear to show that the trustee in fact did monitor, the opinion in the case would seem to say that trustee was safe in relying on the Board's judgment. While this case creates a mixed message for fiduciaries, clearly monitoring board activities should be on any trustee's best practices list.

¶ 904 ESOP Benefit Distributions and Repurchase Liability

ESOPs are subject to the benefit distribution rules generally applicable to defined contribution plans. In addition, IRC Section 409 creates some additional ESOP-specific requirements.

¶ 904.1 Special Timing and Form Rules for ESOPs.

A. Accelerated Timing Rules

IRC Section 409(o) requires ESOPs to make distributions sooner than other defined contribution plans. For a participant who terminates prior to retirement, death, or disability, his distribution must commence by the sixth plan year following the year of his termination of employment. The distributions can be in a lump sum or in annual installments over a five-year period (which can be extended an additional five years for larger accounts). In addition, distributions of leveraged shares can generally be deferred until the ESOP repays in full the loan it incurred to purchase such shares.

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[17] Department of Labor Interpretive Bulletin, 29 C.F.R. Section 2509.94-2.

[18] *Armstrong v. LaSalle Bank*, 446 F.3d 728 (2006 7th Cir.).

B. Distributions in the Form of Employer Stock

IRC Section 409(h) gives participants the right to receive their distributions in the form of employer stock. Two important exceptions exit: First, an ESOP sponsored by an S-corporation need not provide distributions in stock. Second, an employer that restricts ownership of its stock to employees and qualified retirement plans may make distributions in cash without offering stock. These qualifying sponsors have the option of distributing in shares with a mandatory buyback by the plan sponsor. IRC Section 409(h) provides that if stock (that is not publicly traded) is distributed to an employee from the ESOP, the company must provide a "put option" allowing the employee to immediately sell the shares to the company at the most recent appraised value. It is also possible for the company to issue a promissory note to pay the purchase price if it meets the adequate security and reasonable interest rate standards of IRC Section 409(h)(5).

C. Modifying Distribution Policy

While pension plans are generally not permitted to modify benefit distribution rules, IRC Section 411(d)(6)(C) provides an exception for ESOPs. The Code permits the modification to be made in any manner, so long as it does not discriminate in favor of highly compensated employees. The IRS has taken a much narrower view of the options available. The IRS regulations generally only permit an ESOP to switch between lump sum and installment distributions. In practice, many ESOPs also change the number of years an employee must wait to commence distribution (within the IRC Section 409(o) parameters). In addition, many plans switch from cash to stock distributions or stock to cash.

¶ 904.2 Repurchase Liability

Repurchase liability is the term used to describe the company's obligation to buy back to stock from terminating employees in the future. Many ESOP companies have retained professionals to assist in projecting the future cash needs associated with these purchases. Some companies that have failed to adequately plan for the liability have found themselves in a liquidity squeeze that could lead to expensive capital transactions or possibly the sale of the company. Although planning for this corporate liability has generally been considered a corporate finance function, recent case law developments have raised adequate repurchase liability planning as an ERISA fiduciary responsibility as well.

The flexibility noted above in the timing and form of benefit distributions can be valuable in developing a repurchase liability strategy. For example, an employer may find that for some periods it is important to defer the expense of repurchases as long as possible. At other times, when the stock value is rising and cash is available, it may be best to may distributions out more quickly.

¶ 905 Section 409(p) and S Corporation ESOPs

¶ 905.1 Anti-Abuse Purpose and Mechanics

IRC Section 409(p) was designed to prevent abusive tax structures associated with the enormous tax benefit of combining an ESOP shareholder with an S corporation. A violation of this anti-abuse rule results in a tax to the employer equal to 50% of the value of shares accruing for the benefit of disqualified persons, and an income tax to the disqualified person calculated by treating him as if he received a taxable distribution of the prohibited allocation of shares.

A. Determination of Disqualified Person and Non Allocation Year

A violation of 409(p) occurs if employer securities accrue or are allocated directly or indirectly for the benefit of a "disqualified person" (a "DQP") during a "non-allocation year" (a "NAY").

B. Testing

A DQP is a person who has allocated to him "deemed owned shares" equal to or exceeding the total number of deemed owned shares of the company. Deemed own shares includes the shares allocated to the person in the ESOP and the additional shares that would be allocated to him if all shares then remaining in the ESOP suspense account were released and allocated to participants. In addition, "synthetic equity" which includes stock options, stock appreciation rights, warrants and similar instruments that are not treated as shares for S corporation purposes are deemed owned shares. Finally, the present value of a nonqualified deferred compensation arrangement can be treated as deemed owned shares, determined by converting such present value into a number of shares with an equivalent fair market value.

A NAY occurs and triggers the tax consequences if one or more DQPs own at least 50% of the outstanding stock of the company (including deemed owned shares in the ESOP) or at least 50% of the sum of the outstanding stock of the company (including deemed owned shares in the ESOP plus the synthetic equity owned by DQPs.

Family group rules and other attribution rules apply as well in determining the existence of a DQP and an NAY.

¶ 905.2 Planning Considerations

A. Role in Planning Equity Compensation for Management

Many S corporation ESOPs have gone to 100% stock ownership by the ESOP to completely avoid taxation and any need for cash distributions for non-ESOP shareholders to pay taxes. To avoid any possibility of other ownership, these companies often use either SARs or phantom stock, rather than real stock or stock options to compensate employees. Programs established for employees may need to contain forfeiture provisions under which the employee agrees to a forfeiture in the event necessary to ensure continued 409(p) compliance.

B. Synthetic Equity for Investors

In order to accomplish a 100% leveraged buyout of a company, it is often necessary to use subordinated debt. These investors often demand some upside equity potential in the form of warrants. Even though the investor is not an employee or an ESOP participant, the warrant is still counted as synthetic equity. In planning a transaction, the 409(p) planning would often include a consideration of (i) the size of the warrants demanded by the investors, (ii) the equity incentives the Board and ESOP trustee would like to give to senior management, (iii) any non-qualified deferred compensation plans, and (iv) any ESOP participants who may either be projected to have a high concentration of ESOP shares in their ESOP accounts or at least enough when coupled with other benefits to be a concern.

¶ 906 KSOPs

¶ 906.1 Use of Salary Deferral Contributions to Acquire Stock

ESOPs are most often funded through employer contributions and employees usually do not contribute their own money to purchase employer stock. However, it is possible to design an ESOP to include a 401(k) feature that allows employees to choose to invest some or all of their salary deferral contributions into a company stock fund. These arrangements are often referred to as “KSOPs.” Such an arrangement is common at companies whose stocks are publicly traded. However, for a closely held company, compliance with federal and state securities laws can be a challenge. Because of the transaction costs involved, a company would probably want to be comfortable it could raise one million or more through the offering.

A. Securities Law Considerations

Offering company stock to employees in the KSOP is an “offering” of a security under Section 5 of the Securities Act of 1933 (the “33 Act”). Generally, an offering must be registered with the Securities and Exchange Commission (“SEC”), an extremely costly project. Private offering exemptions exit that can be useful in avoiding registration. In particular, SEC Rule 701 exempts from registration an offering to employees through a compensatory benefit plan.[19] Rule 701 contains the following dollar limitations:

> “The aggregate sales price or amount of securities sold in reliance on this section during any consecutive 12-month period must not exceed the greatest of the following:
>
> (i) $1,000,000;
>
> (ii) 15% of the total assets of the issuer (or of the issuer's parent if the issuer is a wholly-owned subsidiary and the securities represent obligations that the parent fully and unconditionally guarantees), measured at the issuer's most recent balance sheet date (if no older than its last fiscal year end); or
>
> (iii) 15% of the outstanding amount of the class of securities being offered and sold in reliance on this section, measured at the issuer's most recent balance sheet date (if no older than its last fiscal year end).”

[19] See 17 CFR Sect. 230.701.

Rule 701 is not intended to exempt from registration capital raising programs, but rather, employee benefit programs. In addition, Rule 701 does not provide an exemption from the anti-fraud fraud provisions. For that reason, a sponsor of a KSOP must make a determination of the level of financial disclosure that will be provided to KSOP participants in order for them to make the investment decision to purchase company stock. Some securities law counsel advise KSOP clients that the only safe disclosure document is one that includes substantially all of the information that would be included in a "going public" transaction. Other advisers counsel that a brief description of the company, its business and a copy of recent financial statements are sufficient.

B. Uses of KSOPs

Two situations in which closely held companies have used KSOPs are described below:

1. Acquisition Strategy

A company that proposes a 100% buyout of shareholders in a single transaction using an ESOP will face a challenge in raising all of the capital needed. Traditionally, companies have first secured as much inexpensive senior secured debt as possible, followed by more expensive unsecured, mezzanine debt. Any remaining funds needed could come from equity investors. To create a 100% ESOP owned company, the equity would need to come from within the ESOP. In this case, the company would amend its 401(k) plan to permit participants to make a one-time transfer of accumulated salary deferral contributions to purchase company stock. The funds raised from the employees, together with the senior and mezzanine debt, would be used to purchase the company.

2. Repurchase Liability Strategy

An ESOP company is faced with the challenge of having to repurchase shares of stock from departing employees on a somewhat regular basis. One way to finance these repurchases is through a KSOP feature added to the ESOP. As employees' salary deferral contributions are added to the KSOP's company stock fund, the cash is available to the ESOP trustee to "purchase" within the KSOP the stock of departing employees. In this way, the cash from salary deferral contributions goes to the departing employee, and his or her shares of stock go the KSOP accounting of the employee who has elected to purchase the shares. Such a KSOP provides a benefit to the company in the form of reduced capital requirements while funding an employee benefit investment for the electing participant.

C. Valuation of Stock

For a KSOP that is regularly collecting salary deferral contributions and converting the amounts to company stock, it is important to devise a fair method for regularly valuing company stock. One approach is to have the KSOP collect salary deferral contributions throughout the year, maintain the cash in an interest bearing account, and then sue the accumulated cash to make a purchase of company stock only once per year at the time the annual valuation is complete.

Other KSOPs provide for quarterly valuations and conversions in order to avoid having employees' contributions remain in a short-term cash account for the year.

¶ 906.2 Use of Matching Contributions to Acquire Stock

A. Leveraged and Non-Leveraged ESOPs

An ESOP may provide that a contribution will be made as a matching contribution based on the employee's contributions to the company's 401(k) plan. Under SEC guidance from 1980 and 1981,[20] the use of the matching contribution to acquire stock for employees would not constitute an "offering" of a security, and therefore, the registration and disclosure issues raised above would not be a concern. Often, an ESOP will provide for two types of contributions, one a match based on the 401(k) and the other a discretionary contribution that is allocated to employees based on their relative compensation. In a leveraged KSOP, the company will find that the dollars contributed as a match do "double duty." First, the matching dollars satisfy the company's obligation to make a matching contribution each year. Second, the KSOP uses the dollars to make loan payments that would have required company contributions in any event.

B. Valuation Issues

In a leveraged ESOP, the dollar amount of the matching contribution for an employee may be higher or lower than the fair market value of the shares released from the ESOP suspense account for the year from loan payments. Many KSOPs provide that the employee will get a match based on the fair market value of the shares released and allocated to him, regardless of how large or small the dollar contribution needed to release the target number of shares. Other KSOPs provide that the employee will get a target match that is the greater of the dollar amount promised or the fair market value of the shares released. If the shares have increased in value, the participants would get the extra benefit of the share appreciation.

¶ 906.3 Compliance with 401(k) Requirements

A. Nondiscrimination Testing

The salary deferral contributions to the KSOP are subject to the regular discrimination testing rules applicable to 401(k) plans. However, the regulations require separate testing of the deferrals that are directed to the company stock fund and those that are directed to the other available investment funds.

B. Restrictions on In-Service Distributions

Shares of stock in the KSOP are subject to the hardship withdrawal and other in-service benefit distribution limitations of IRC Section 401(k). ERISA Section 404(c) fiduciary protection is not available for closely held stock in a KSOP.

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[20] SEC Release Nos. 33-6188 (2/1/80) and 33-6281 (1/15/81).