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WINDING DOWN EMPLOYEE STOCK OWNERSHIP PLANS

The decision to terminate or wind down an employee stock ownership plan requires consideration of a variety of significant tax and ERISA issues. Employers and their counsel must understand the applicable rules and potential legal pitfalls to determine the best approach.

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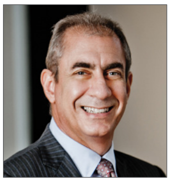

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Employee stock ownership plans (ESOPs) are tax-qualified retirement plans that are uniquely positioned to play dual roles of providing retirement benefits to employees and serving as a corporate finance vehicle. The dual nature of an ESOP can lead to significant issues when an employer wishes to terminate the ESOP. Because of an ESOP's unique status as a financing tool and the requirement that it be primarily invested in "qualifying employer securities" (referred to, for simplicity, as employer stock), terminating an ESOP requires a plan sponsor to navigate complex provisions of the Internal Revenue Code of 1986 (Code) and the Employee Retirement Income Security Act of 1974 (ERISA) that are not generally applicable to other types of tax-qualified plans. It is particularly important that plan sponsors and other plan fiduciaries be aware of how the termination of an ESOP implicates ERISA's fiduciary duties.

There are many circumstances that may lead a plan sponsor to terminate an ESOP. For example, a plan sponsor may decide to terminate an ESOP because:

- The ESOP ceases to be desirable as a design matter, for example, because an employer determines that its employees' retirement assets should not be significantly concentrated in employer stock. In this case, it is not uncommon to transform the ESOP into a profit sharing plan.
- The plan sponsor's stock ceases to exist as a result of a corporate transaction, for example:
  - the employer stock is sold for cash; or
  - all of the assets of the plan sponsor are sold and the employees are transferred to the buyer.
- The buyer in a corporate transaction decides that an ESOP does not fit into its overall employee benefit program, even if the ESOP and employer stock survive the transaction, such as in a merger in which the original sponsor's stock is converted into the stock of the acquirer and the ESOP is assumed by operation of law.
- A leveraged ESOP has paid off its employer stock acquisition loan and lost its usefulness as a corporate finance tool, and the employer has an otherwise robust retirement program for its employees.
- The plan sponsor wishes to restructure its debt, eliminate leverage, or reconfigure its corporate structure, with the result that a leveraged ESOP, with its employer stock acquisition loan, no longer fits into its capitalization structure.

Other factors that can affect the approach to terminating or converting an ESOP include:

- The structure of the ESOP.
- Whether there is an unpaid stock acquisition loan.
- The percentage of the employer owned by the ESOP.
- The number of ESOP participants.
- A pending or anticipated corporate transaction.
- Other circumstances of the plan sponsor at the time of plan termination, including how these factors impact the potential for fiduciary liability.

This article discusses:

- The decision to terminate an ESOP and when fiduciary obligations arise.
- Code rules that are applicable to terminating tax-qualified plans generally.
- Code rules that are applicable to terminating ESOPs.
- ERISA rules that are applicable to terminating ESOPs.
- Scenarios involving termination of an ESOP outside of a corporate transaction.

This article assumes a basic familiarity with the rules governing ESOPs.

Search Employee Stock Ownership Plans (ESOPs) for an overview of ESOPS, including the rules governing ESOPs.

DECIDING TO TERMINATE AN ESOP

Fiduciary duties under ERISA, and the liability that flows from them, are of critical concern to employers that sponsor ESOPs and to other ESOP fiduciaries. Fiduciary decisions are those that relate to:

- Exercising discretionary authority or discretionary control over:
  - the management of the plan; or
  - the management or disposition of plan assets.
- Rendering investment advice to the plan for a fee.
- Administering the plan.

(29 U.S.C. § 1002(3), (21)(A).)

Although ERISA considers a broad spectrum of activity to be fiduciary in nature, the decision to maintain or terminate an ESOP is a settlor function that is not considered a fiduciary act under ERISA. Therefore, ERISA's fiduciary rules do not govern the actual decision to terminate an ESOP (see, for example, *Lockheed Corp. v. Spink*, 517 U.S. 882 (1996)). However, once that decision is made, subsequent decisions and actions of the plan sponsor and other plan fiduciaries which flow from the termination decision will invariably implicate various fiduciary obligations under ERISA.

Search ERISA Fiduciary Duties: Overview for more on settlor duties.

CODE RULES APPLICABLE TO THE TERMINATION OF TAX-QUALIFIED PLANS

ESOPs fall within the broader category of tax-qualified plans, and therefore the termination of an ESOP must comply with the requirements generally applicable to the termination of any tax-qualified plan. These requirements include:

- Full vesting of all unvested account balances upon the termination of the plan (26 U.S.C. § 411(d)(3); see below *Code Rules Applicable to ESOP Terminations*).
- Protection for accrued benefits under Code Section 411(d)(6) (see below *Anti-Cutback Rules: Code Section 411(d)(6)*).

The acceleration applied to unvested account balances could be of significant economic concern to ESOPs in which employer stock allocated to employee accounts on account of employer contributions is initially unvested. In such a case, terminating the ESOP will cause a windfall not contemplated by the design of the ESOP to employees who would have not met the applicable vesting service requirements before the plan's termination.

There are also certain administrative tasks that must be completed to effect a plan termination, including:

- Amending the plan document to comply with the laws in effect at the time of the termination.
- Notifying plan participants and beneficiaries with remaining account balances of their rights and any elections available to them.
- Distributing plan assets.
- Filing a final Form 5500.
- Adopting resolutions (by the plan sponsor's board of directors or other authorized body) terminating the plan that provide for, among other things:
  - the effective date of the termination; and
  - the acceleration of participants' unvested account balances, if not otherwise provided for in the plan document.

The plan sponsor may also wish to submit a Form 5310 to the Internal Revenue Service (IRS) to seek affirmation of the tax-qualified status of the ESOP on its termination.

Search Retirement Plan Determination Letters Toolkit for resources to assist employers in applying for an IRS determination letter for their qualified retirement plans.

CODE RULES APPLICABLE TO ESOP TERMINATIONS

Issues covered by the Code rules applicable to ESOP terminations include:

- The prohibition on reducing, or "cutting back," ESOP participants' accrued benefits.
- Requirements relating to pass-through voting or tender rights regarding employer stock allocated to ESOP participants' accounts.
- Limitations on allocating proceeds from a sale of employer stock to ESOP participants' accounts.
- Excise tax on early dispositions of employer stock.

ANTI-CUTBACK RULES: CODE SECTION 411(d)(6)

In an ESOP termination, as well as in other circumstances, the plan sponsor may wish to eliminate the right of employees to invest retirement assets in, or receive distributions in the form of, employer stock. This may be done by a regular plan amendment or by converting the ESOP to a profit sharing or money purchase plan (see below *Converting an ESOP into a Different Type of Tax-Qualified Plan*). However, there may be some concern regarding whether eliminating participants' right to receive distributions in employer stock from an ESOP violates the anti-cutback rules of Code Section 411(d)(6) and ERISA Section 204(g).

Under the anti-cutback rules, the sponsor of a tax-qualified plan is generally prohibited from amending the plan to eliminate an optional form of benefit (26 U.S.C. § 411(d)(6); 29 U.S.C. § 1054(g)). However, the regulations make clear that an ESOP may be amended to eliminate a plan provision that requires ESOP participants to be provided with the right to receive a distribution in the form of employer stock in certain circumstances (Treas. Reg. § 1.411(d)-4, Q&A-2(b)(2)(iii)(A), Q&A-2(d)(2)(ii)). Specifically, an employer sponsoring an ESOP may substitute cash distributions for distributions of employer stock if:

- The employer becomes substantially employee-owned.
- The employer is an S-Corporation.
- Employer stock:
  - becomes readily tradable;
  - ceases to be readily tradable; or
  - continues to be readily tradable, but there is a sale of substantially all of the stock or substantially all of the assets of the employer and, in either situation, the purchasing employer continues to maintain the plan.

(Treas. Reg. § 1.411(d)-4, Q&A-2(d)(1).) For the last exception, the employer may also substitute distributions of securities of a predecessor entity for distributions of securities of the purchasing or successor employer.

These exceptions to the anti-cutback rules are available only if the nondiscrimination rules of Code Section 401(a)(4) are satisfied and if the employer stock has been held by the ESOP for the lesser of:

- Five years.
- The entire period of the ESOP's existence.

(Treas. Reg. § 1.411(d)-4, Q&A-2(d)(2).)

Eliminating the right of participants to receive ESOP distributions in the form of employer stock outside of the circumstances specified above could raise special issues. Issues can arise, for example, under Code Section 411(d)(6), the tax-qualification rules governing stock bonus plans, and possibly under the regulations governing leveraged ESOPs. There is some authority addressing the elimination of a stock distribution right in certain limited circumstances (see, for example, IRS Response to Technical Assistance Request #4 (Feb. 23, 2010) (allowing ESOPs to "reshuffle" employer stock among ESOP participants so that certain participants would lose their right to receive distributions in employer stock); *Hoffman v. Tharaldson Motels, Inc. Emp. Stock Ownership Plan*, 2010 WL 749788 (D.N.D. Feb. 26, 2010)). However, in the authors' experience:

- Practitioners commonly take the position that, with amendments to the plan document and other proper structuring, it is possible permissibly to eliminate the ESOP participants' stock distribution right.
- The IRS consistently approves applications for a favorable determination on plan termination in situations in which the stock distribution right is eliminated.

When eliminating the stock distribution right is pursued in connection with an ESOP termination, plan fiduciaries and practitioners should pay careful attention to any applicable anti-cutback issues.

Search Protected Benefits Under Code Section 411(d)(6) for more on the anti-cutback rules.

PASS-THROUGH VOTING OR TENDER RIGHTS: CODE SECTION 409(e)

The unwinding of an ESOP commonly occurs in connection with a corporate transaction, such as a merger or sale of assets, or an offer to purchase all of the plan sponsor's stock, such as in a tender offer. An ESOP termination in connection with these types of transactions implicates the fiduciary duty provisions of ERISA (see below *Pass-Through Voting or Tender Rights: ERISA Fiduciary Duties*) and the Code provisions governing a plan's eligibility as an ESOP, specifically regarding:

- The shareholder rights of participants relating to employer stock allocated to their ESOP accounts.
- The responsibilities of an ESOP trustee regarding the employer stock allocated to participants' ESOP accounts and unallocated employer stock held in a suspense account.

Code Section 409(e) requires certain voting rights to be passed through to ESOP participants regarding employer stock allocated to their accounts. For a public company, Code Section 409(e) requires the ESOP to allow participants to vote shares allocated to their accounts regarding any matter on which those shares are entitled to vote. For a privately held company (generally defined as one without a class of securities required to be registered under Section 12 of the Securities Exchange Act of 1934), Code Section 409(e) requires the plan to allow participants to vote shares allocated to their accounts regarding any matter that involves the approval or disapproval of, among other transactions:

- Any corporate merger or consolidation.
- A sale of substantially all of the assets of the trade or business.

However, a vote to elect members to a board of directors of a privately held company is not required to be passed through to participants.

Search Employee Stock Ownership Plans (ESOPs) for more on voting rights that must be passed through to ESOP participants.

If the underlying transaction is structured in a way that does not require shareholders to vote on the transaction, such as in a stock sale, the ESOP trustee may (but is not required to) pass through the decision to participants regardless of whether the company is public or private. Therefore, in the case of a tender offer, an ESOP may (but is not required to) provide that the trustee retains discretion to tender, or not to tender, the plan's shares.

PASS-THROUGH VOTING OR TENDER RIGHTS: ERISA FIDUCIARY DUTIES

The trustee's conduct regarding any vote or tender is subject to ERISA's fiduciary duty of prudence and the exclusive benefit rule. As a result, even if the plan document does not require passing through voting rights or tender decisions, the ESOP trustee may choose to pass through voting rights or tender decisions to the participants as a strategy to mitigate potential fiduciary liability with regard to its decision to vote or tender shares. If the ESOP passes through voting rights or tender decisions, the ESOP trustee must ensure that participants' voting or tender instructions are:

- Made without the employer's coercion or undue influence.
- Consistent with:
  - the terms of the plan; and
  - ERISA.

If those requirements are met and the plan document requires the trustee to follow participants' directions regarding allocated shares, then the participants are effectively considered named fiduciaries over the shares of employer stock allocated to them and the trustee is obligated to follow their directions (see, for example, Letter from Dep't of Labor to Ian D. Lanoff (Sept. 28, 1995) (regarding pass-through voting provisions in collectively bargained ESOPs)). To attain greater protection in this scenario, the ESOP trustee should, at a minimum, provide participants with a detailed explanation of the proposed transaction and a confidential platform through which they may submit their voting or tender instructions.

If passing through voting rights or tender decisions is not required by the plan document, the ESOP trustee should consider whether the potential benefit of mitigating fiduciary liability by passing through voting rights or tender decisions is outweighed by:

- The administrative burden of implementing the pass-through voting procedures.
- The risk that pass-through voting rights or tender decisions might interrupt the expedient closing of an underlying corporate transaction.

If these concerns arise and the plan document requires passing through of voting rights or tender decisions, it may be advisable to amend the plan document to eliminate any passing through provisions not required by Code Section 409(e) and allow the trustee alone to make voting and tender decisions. Considerations that weigh in favor of pass-through voting rights or tender decisions include:

- The legally incorrect, but common, assumption by ESOP participants that the stock allocated to their accounts is owned by them, rather than by the trustee.
- The human relations issues in surprising and possibly disappointing ESOP participants by not passing through voting rights or tender decisions.

If voting rights or tender decisions are passed through to participants but no instruction is received regarding the shares allocated to a participant's account, the plan document generally provides instructions regarding how to treat the shares. This is also the case regarding shares of employer stock that are not yet allocated to participants' accounts. A typical provision in a plan document will either:

- Give the trustee the sole discretion to decide the manner in which the shares are voted or tendered.
- Affirmatively direct the trustee to vote or tender the shares in the same proportion as the shares for which the trustee receives instructions.

Additionally, in a tender offer, the plan may provide that the lack of an instruction is an affirmative election not to tender (*Herman v. NationsBank Tr. Co.*, 126 F.3d 1354, 1368-69 (11th Cir. 1997), reh'g denied, 135 F.3d 1409 (11th Cir.), *cert.* denied, 525 U.S. 816 (1998)).

Although passing through voting rights or tender decisions may help mitigate the trustee's fiduciary liability in connection with the decision to vote or tender shares, legal ownership of the shares resides with the trustee, as does the ultimate responsibility for voting or tendering them. Therefore, regardless of any plan provision governing the voting or tender of shares of employer stock, the ESOP trustee should make an affirmative decision consistent with ERISA's fiduciary duties regarding the voting or tender of the allocated shares for which no participant instruction is received and the unallocated shares held in a suspense account, particularly because:

- Plan provisions are generally deemed invalid to the extent they are inconsistent with ERISA (29 U.S.C. § 1104(a)(1)(D)).
- There is conflicting authority regarding whether ESOP participants can be "named fiduciaries" over shares other than those allocated to their accounts.

This is true even where the plan document mandates that specific action be taken regarding unallocated shares (for example, where the plan document provides that unallocated shares be voted or tendered in proportion to allocated shares for which participant instructions are actually received). As a result, the ESOP trustee may disregard any applicable plan provision that it believes is inconsistent with ERISA (see, for example, Letter from Dep't of Labor to Citizens & Southern Trust Co. (Feb. 23, 1989); Letter from Dep't of Labor to Ian D. Lanoff (Sept. 28, 1995)). In one leading case, a court granted an ESOP trustee's motion for declaratory judgment in connection with the trustee's decision to ignore the plan's pass-through voting requirements where:

- Approximately 40% of the ESOP's shares were held by company insiders opposing the transaction for the purpose of maintaining control of the company.
- The terms of the transaction otherwise yielded substantial value to the ESOP participants.

The court found that, under these circumstances, passing through the vote was contrary to ERISA because it would not be in the best economic interests of ESOP participants (*Cent. Tr. Co. v. Am. Avents Corp.*, 771 F. Supp. 871 (S.D. Ohio 1989)). However, in the common case where the trustee finds that the decision to vote or tender is not contrary to ERISA's fiduciary standards, the trustee is obligated to follow the ESOP's voting provision because a plan provision may be overruled by a trustee only if it is affirmatively inconsistent with ERISA (29 U.S.C. § 1104(a)(1)(D)).

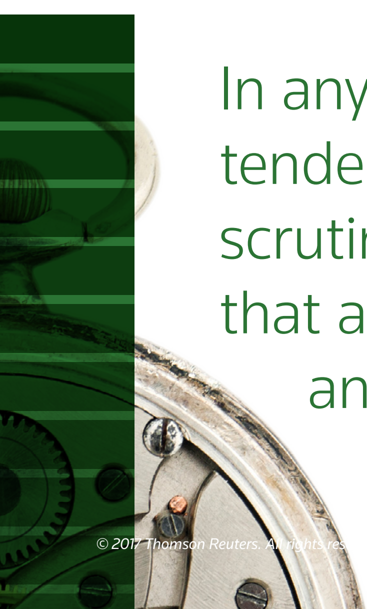
In any ESOP termination in which a vote or tender decision is implicated, the trustee should scrutinize the relevant plan provisions and ensure that any action ultimately taken is documented and done with the goal of minimizing the potential for fiduciary liability.

CODE SECTION 415 LIMITATIONS

If unallocated suspense account shares are sold in connection with the termination of an ESOP and any proceeds of the sale are allocated to participant accounts, practitioners should consider whether these allocations may be made without violating Code Section 415(c). Code Section 415 generally limits the amount of annual additions that may be allocated for the benefit of a participant under defined contribution plans sponsored by an employer in any given year to the lesser of:

- 100% of the participant's compensation.
- A stated dollar amount, indexed for inflation (for 2017, this amount is $54,000).

The IRS previously took the position that excess proceeds constitute annual additions under Code Section 415 (Treas. Reg. § 1.415-6(b)(2)(i); see, for example, IRS Priv. Ltr. Ruls. 9507031 (Feb. 17, 1995), 9426048 (July 1, 1994), 9417033 (Apr. 29, 1994), 9417032 (Apr. 29, 1994)). Depending on the amount of the excess proceeds, this position could have made it impracticable to cash out a leveraged ESOP. The IRS subsequently reversed its position and agreed that all proceeds from a sale of unallocated shares constitute earnings and, therefore, the proceeds are not subject to Code Section 415 limitations, so long as ERISA's primary benefit requirement is met in connection with the sale of the ESOP's stock (see below *Primary Benefit Rule: Paying Back the ESOP Loan*; May 18, 1998 memorandum from Carol Gold, Director Employee Plans, Subject: Technical Advice Request Concerning Annual



In any ESOP termination in which a vote or tender decision is implicated, the trustee should scrutinize the relevant plan provisions and ensure that any action ultimately taken is documented and done with the goal of minimizing the potential for fiduciary liability.

Additions under Section 415 of the Internal Revenue Code; see also, for example, IRS Priv. Ltr. Ruls. 200514026 (Apr. 8, 2005), 200321020 (May 23, 2003), 200147056 (Nov. 23, 2001), 200034039 (Aug. 25, 2000)).

If the proceeds of the sale of unallocated suspense account shares are insufficient to repay the outstanding loan balance, then the lender may forgive the remaining debt. In this case, the IRS has ruled that the amount forgiven does not constitute an annual addition for purposes of Code Section 415 (see, for example, IRS Priv. Ltr. Rul. 9640027 (Oct. 4, 1996)).

EXCISE TAX ON EARLY DISPOSITIONS OF EMPLOYER STOCK

In the case of a Code Section 1042 transaction, which can allow shareholders of privately held companies to sell stock to an ESOP and defer capital gains tax, there may be excise taxes on early dispositions of employer stock. Where there has been a prior Code Section 1042 transaction, these rules should be reviewed carefully.

Search Employee Stock Ownership Plans: Winding Down an ESOP for more on excise taxes on early dispositions.

ERISA RULES APPLICABLE TO ESOP TERMINATIONS

Several ERISA provisions are implicated when a plan sponsor terminates an ESOP, including:

- Fiduciary standards of conduct.
- Prohibited transaction rules governing sales to a party in interest.
- The primary benefit rule relating to ESOP loans.

PRUDENCE AND EXCLUSIVE BENEFIT RULES

In the context of an ESOP termination and the related sale of employer stock, the fiduciaries' decisions in connection with the sale, including acceptance of the sale price, must comply with ERISA's duty of prudence (29 U.S.C. § 1104(a)(1)(B)). Generally, the duty of prudence is not altered, and fiduciary liability cannot be mitigated, by any provision in the plan's governing documents that gives preference to the purchase or holding of employer stock. Any plan provisions that are inconsistent with ERISA's fiduciary duties will give way to the applicable fiduciary standard (*Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014); *Amgen Inc. v. Harris*, 136 S. Ct. 758 (2016)).

In making decisions relating to the sale of employer stock, the fiduciary must act in a manner that is solely in the interest of, and for the exclusive purpose of providing benefits to, the ESOP participants (29 U.S.C. § 1104(a)(1)). The case law addressing whether fiduciaries acted prudently and for the exclusive benefit of the ESOP participants highlights the importance of engaging an independent appraiser or financial advisor to support a fiduciary's decision to sell employer stock and the related sale price.

For example, in *Donovan v. Cunningham*, a seminal case on valuation, the court stated that a plan fiduciary is not expected to be a valuation expert so long as it hires qualified advisors and otherwise relies on a valuation that is current at the time of the stock purchase (716 F.2d 1455 (5th Cir. 1983), *cert.* denied, 467 U.S. 1251 (1984)). In several cases, courts have held that an ESOP trustee's decision regarding whether it should tender employer stock was prudent where the trustee relied on an independent valuation (see, for example, *Cent. Tr. Co.*, 771 F. Supp. at 876).

While ERISA Section 408(c)(3) expressly recognizes that a plan fiduciary may be an insider of the plan sponsor (29 U.S.C. § 1108(c)(3)), plan sponsors should consider that it may be difficult for an insider trustee to demonstrate that its decision to sell employer stock (and the price at which shares are sold) is prudent and solely in the interest of the ESOP participants. In *Donovan v. Bierwirth*, a seminal case on the application of ERISA's exclusive benefit rule, the court held that when the plan sponsor was faced with a corporate takeover and the plan trustees, as officers of the plan sponsor, had a potential conflict of interest, the plan trustees should have:

- Appointed an independent trustee.
- Employed independent legal and investment counsel for advice.

(680 F.2d 263 (2d Cir.), *cert.* denied, 459 U.S. 1069 (1982); see also *In re Fairchild Indus., Inc.*, 835 F. Supp. 603 (N.D. Fla. 1993); *In re NationsBank of Tex.*, 50 F.3d 1036 (11th Cir. 1995); *Danaher Corp. v. Chi. Pneumatic Tool Co.*, 635 F. Supp. 246 (S.D.N.Y. 1986).)

In order to mitigate fiduciary liability, strong consideration should be given to appointing an independent third-party trustee or other fiduciary to make all decisions affecting an ESOP in connection with a proposed sale of employer stock or other corporate transaction.

ADEQUATE CONSIDERATION REQUIREMENT

In addition to the fiduciary duties to act prudently and for the exclusive benefit of plan participants, if the assets of a plan are sold to a party in interest, such as the plan sponsor, ERISA Section 408(e)(1) includes an express requirement that the sale may not be for less than adequate consideration (29 U.S.C. § 1108(e)(1)). If employer stock is traded on a national securities exchange, then the prevailing trading price constitutes adequate consideration (29 U.S.C. § 1002(18)(A)). If employer stock is not publicly traded, adequate consideration means fair market value as determined in good faith by the trustee or the named fiduciary (29 U.S.C. § 1002(18)(B)).

A proposed regulation issued by the Department of Labor (DOL), if finalized, would require the determination of fair market value to be conducted by an independent appraiser or an independent fiduciary (Proposed Regulation Relating to the Definition of Adequate Consideration, 53 Fed. Reg. 17,632 (proposed May 17, 1988) (to be codified at 29 C.F.R. pt. 2510)). While this regulation was proposed many years ago and has not been the subject of recent administrative re-examination, it is typically followed closely in private company sale transactions involving employer stock.

In addition to these requirements, the Code generally requires that, in the case of an ESOP, all valuations of employer stock that is not readily tradable on a public market be made by an independent appraiser (26 U.S.C. § 401(a)(28)(C)).

Numerous cases explore the topic of adequate consideration in the context of ESOP transactions involving employer stock. In the *Cunningham* case, the court found that ESOP trustees improperly relied on an independent advisor's valuation of employer stock. In *Cunningham*, the independent advisor based its valuation on the assumption that revenues would increase approximately 50% in one year (based on the value of new agreements entered into by the plan sponsor) and that a similar growth rate would continue indefinitely. Although the employer's revenues stayed flat, the ESOP trustees continued to rely on the valuation and made several purchases of employer stock based on this valuation report. The court concluded that a prudent fiduciary would have questioned whether continued reliance on the prior appraisal was warranted. (716 F.2d at 1468-71.)

Reviewing the extensive case law regarding valuations of employer stock reveals a number of imprudent practices and insight into transactions gone awry. However, the DOL has recently provided guidance regarding best practices for ESOP transactions involving employer stock. In connection with the $5.25 million settlement in June 2014 in the case of *Perez v. GreatBanc Trust Co.*, the DOL and GreatBanc agreed to public disclosure of future restrictions imposed on GreatBanc when acting as a trustee.

In allegations broadly similar to those in *Cunningham*, the DOL alleged that GreatBanc failed to adequately inquire into an appraisal that presented overly optimistic and unrealistic projections of the plan sponsor's financials, including the trustee's failure to investigate the credibility of the assumptions, factual bases, and adjustments to financial statements that formed the basis for the appraisal. (News Release, Emp. Benefits Sec. Admin., US Labor Department Reaches $5.25M Settlement with GreatBanc Trust (June 3, 2014), available at 2014 WL 2466292.)

The safeguards enumerated in the *GreatBanc* settlement require GreatBanc to:

- Make an affirmative determination, before entering into a transaction involving employer stock, that it can rely on the valuation advisor. GreatBanc is required to investigate the advisor's qualifications and is prohibited from engaging an advisor that has ever previously performed work for:
  - the plan sponsor;
  - any other counterparty to the ESOP in the transaction; or
  - any investment bank or consultant involved in structuring the transaction.
- Retain responsibility for overseeing the valuation process and ensuring that the valuation advisor documents certain required items. Either GreatBanc or the advisor must provide a detailed written opinion about the reasonableness of any projections.
- Ensure that the plan sponsor provides audited unqualified financial statements prepared by a certified professional accountant for the preceding five fiscal years, or otherwise carefully consider proceeding with the transaction if these statements are not available.
- Document the process and substance of the valuation analysis. It may only rely on the appraiser's valuation report contingent on taking certain steps and providing certain requisite documentation.
- Consider requesting a clawback arrangement or other purchase price adjustment to protect the ESOP against the possibility of adverse consequences from significant corporate events or changed circumstances, and retain written documentation of these considerations.

(Notice of Settlement, Exhibit 1, at 13-22, *Perez v. GreatBanc Tr. Co.*, No. 12-01648 (C.D. Cal. June 2, 2014).)

The *GreatBanc* settlement does not create any new substantive legal requirements for ESOP trustees (other than GreatBanc itself), and in fact several aspects of the settlement are likely to be problematic in real-world transactions. For example, if a major investment bank has structured the transaction, the most qualified ESOP valuation firms may have previously been engaged by that bank and therefore would be prohibited under the *GreatBanc* settlement terms from assisting the trustee. Trustees should consider the settlement conditions, but use reasonable business judgment in implementing them, while always focusing on being able to defend against a claim by participants or the DOL of a breach of ERISA's fiduciary rules.

Search ERISA Litigation: Causes of Action Under ERISA Section 502 for more on claims of breach of fiduciary duty.

PRIMARY BENEFIT RULE: PAYING BACK THE ESOP LOAN

A common form of ESOP is a leveraged ESOP in which the ESOP's purchase of a block of shares of employer stock is financed by a loan from the plan sponsor or a third party. The shares of employer stock are placed in a suspense account and, over time, as the loan is paid down with employer contributions to the ESOP, shares are released from the suspense account and allocated to the participants' individual accounts. A loan to an ESOP must be primarily for the benefit of participants and beneficiaries of the ESOP in order to be exempt from the prohibited transaction provisions of ERISA and the Code (29 U.S.C. § 1108(b)(3); 26 U.S.C. § 4975(d)(3)). There are other requirements for an ESOP loan to be exempt, including limitations on the types of assets that may be used to repay the loan (Treas. Reg. § 54.4975-7(b)(5); 29 C.F.R. § 2550.408b-3(e)).

Under the applicable ERISA and Code regulations, loan payments made under an ESOP loan in any plan year cannot exceed an amount equal to the sum of:

- Contributions (other than contributions of employer stock).
- Earnings attributable to loan collateral held by the ESOP for the current year and all prior years, less all loan payments made in prior years.

(Treas. Reg. § 54.4975-7(b)(5).)

For a period, it was widely believed that proceeds from the sale of the unallocated employer stock held as loan collateral were deemed to be earnings that could be used to repay the ESOP loan. However, this view was called into question by the IRS (IRS Priv. Ltr. Rul. 8828009 (July 15, 1988); IRS Gen. Couns. Mem. 39747 (Aug. 3, 1988)). In Private Letter Ruling (PLR) 8828009, the terms of the ESOP provided that the loan could be repaid with the proceeds of the sale of the unallocated suspense account stock. This ruling reasoned that, because the repayment provision could operate to reduce the amount of employer stock that would ultimately be allocated to ESOP participants:

- It did not satisfy the primary benefit requirement.
- The loan constituted a non-exempt loan that would be subject to applicable excise taxes under Code Section 4975.

The IRS asserted that the employer had the primary responsibility for repayment of the loan through its contributions to the ESOP. This ruling was bolstered by the IRS's finding, in General Counsel Memorandum (GCM) 39747, that the regulations do not contemplate, for purposes of loan repayment, the sale of employer stock previously acquired by contribution or purchase. This ruling effectively prohibits any sale in which the proceeds from employer stock are used to repay the ESOP loan, even if the employer stock is sold for adequate consideration. This may result in an unintended windfall to participants in the termination of an ESOP that holds unallocated employer stock in a suspense account, because the plan sponsor is required to immediately allocate the stock (or the proceeds of its sale) to participant accounts.

Practitioners have asserted various arguments for interpreting PLR 8828009 and GCM 39747 so as not to prohibit the repayment of the ESOP loan with the proceeds of the sale of suspense account stock in connection with a corporate transaction. In subsequent guidance, the IRS has significantly backed off of its previous position by applying the primary benefit requirement in circumstances where the suspense account stock is used to repay an ESOP loan. More recently, the IRS has indicated that the primary benefit requirement is met, and proceeds from the sale of suspense account stock can be used to repay an ESOP loan, if:

- At the time the ESOP loan was made, the plan sponsor intended to continue the ESOP through the loan's due date and make contributions to the ESOP sufficient to allow the ESOP to repay the loan.
- A transaction or ESOP termination has a legitimate business purpose, such as:
  - the sale of the stock or assets of the plan sponsor; or
  - a significant contraction of the plan sponsor's operations.

(See IRS Priv. Ltr. Ruls. 201419025 (May 9, 2014) (negotiated sale of all of the plan sponsor's assets), 200716027 (Apr. 20, 2007) (change in economic circumstances and drastic decline in plan participation), 200536031 (Sept. 9, 2005) (substantial business challenges), 200536028 (Sept. 9, 2005) (substantial business challenges), 200514026 (Apr. 8, 2005) (sale of all of the plan sponsor's stock), 200504040 (Jan. 28, 2005) (contraction of plan sponsor's business), 9416043 (Apr. 22, 1994) (sale of employer stock into an unsolicited tender offer).)

However, the IRS continues to assert that an ESOP may not include a provision requiring a loan to be repaid using the proceeds of suspense account stock, and that the satisfaction of the primary benefit requirement will be determined based on the prevailing circumstances at the time that the loan is repaid (see IRM 4.72.4.4.7).

NON-TRANSACTIONAL ESOP TERMINATION SCENARIOS

Outside of a corporate transaction, plan sponsors may consider either distributing to ESOP participants the employer stock allocated to their accounts or converting the ESOP to a different type of tax-qualified plan.

DISTRIBUTING EMPLOYER STOCK TO ESOP PARTICIPANTS

One possible exit strategy for terminating an ESOP is simply to distribute to ESOP participants the employer stock allocated to their accounts. The default ESOP distribution rule is that a participant entitled to a distribution must be given the right to demand payment in the form of employer stock (26 U.S.C. §§ 409(h)(1)(A), 4975(e)(7)). If employer stock is distributed, the net unrealized appreciation (NUA), which generally refers to the appreciation in the value of the employer stock after it is contributed to or purchased by the ESOP, may be excludable from the income of the distributee upon distribution under certain circumstances (26 U.S.C. § 402(e)(4)).

If NUA treatment is available, the NUA becomes taxable at long-term capital gains rates when the distributee ultimately sells the stock. Long-term capital gains rates are currently significantly lower than the ordinary income rates generally applicable to tax-qualified plan distributions. NUA treatment is not available if the distribution is rolled over into an individual retirement account (IRA). However, if the distribution is properly and timely rolled over into an IRA or another tax-qualified vehicle, the distribution will not be a taxable event to the participant (26 U.S.C. § 72(q)(1), (2)(E)).

Search Locating Missing Participants in Terminating Plans for more on distribution options and IRA rollovers.

Although the simplicity of distributing employer stock may seem attractive, a privately held company distributing employer stock from its ESOP may encounter a number of challenges, including that:

- Distributing employer stock to participants may result in a large number of minority shareholders, if the stock is not repurchased by the company.
- It may be difficult to identify an IRA custodian that is willing to hold stock of a privately held company at a reasonable cost.

The benefits of distributing employer stock (as opposed to cash) in terminating ESOPs of privately held companies include the ability to mitigate:

- The fiduciary liability that attaches to a sale of employer stock to the plan sponsor while it is held by the ESOP.
- The liquidity burden to the plan sponsor related to repurchasing the stock.

Even if distributions are made in the form of employer stock, the concern regarding liquidity cannot be entirely mitigated because, under Code Section 409(h)(1)(B), participants in a private company ESOP may require the plan sponsor to repurchase distributed stock under a fair valuation formula (26 U.S.C. § 409(h)(1)(B)). This is often referred to as the ESOP "put option." Because of the complexities associated with employees (and former employees) holding stock of a privately held company, as well as the liquidity issues implicated by the ESOP put option, many private company ESOPs either:

- Give participants the right to elect to receive distributions in the form of either stock or cash, with the assumption that most will elect cash (26 U.S.C. § 409(h)(2)(A)).
- Mandate that distributions be made only in cash using the proceeds of periodic sales of stock from the ESOP to the plan sponsor. This option is allowable only if:
  - the plan sponsor is an S-Corporation; or
  - the plan sponsor's charter limits the ownership of employer stock to employees and tax-qualified plans.

  (26 U.S.C. § 409(h)(2)(B).)

If the plan sponsor decides to distribute cash rather than stock, the plan sponsor must repurchase all of the ESOP's shares and then the ESOP can distribute the resulting cash to employees.

A fiduciary that is independent of the plan sponsor should make the decision on behalf of the ESOP about whether, and on what terms (particularly at what price), the ESOP sells its stock back to the plan sponsor. Additionally, the plan document may need to be amended to remove the participants' right to receive distributions in the form of employer stock. One way to accomplish this is by converting the ESOP into a different type of tax-qualified plan that is not required under the Code to make distributions in the form of employer stock.

Search Prohibited Transactions and Exemptions Under ERISA and the Code for more on independent decision-making, ERISA Section 406(b), and self-dealing prohibited transactions.

CONVERTING AN ESOP INTO A DIFFERENT TYPE OF TAX-QUALIFIED PLAN

If the employer would like to maintain a tax-qualified retirement plan other than an ESOP, converting an ESOP into a profit sharing plan (or a money purchase plan) may be preferable to a plan termination. If the ESOP is merely being converted and not terminated:

- Employer contributions to the plan need not become fully vested upon the conversion, but instead would continue to vest over the prescribed schedule.
- The plan sponsor:
  - avoids the administrative burden of rolling over participants' account balances to avoid the negative tax consequences to participants; and
  - preserves NUA treatment on the ultimate distribution of employer stock.

For a privately held company, this type of conversion can also be accompanied with a repurchase of the ESOP's employer stock by the plan sponsor, preventing the company from potentially having a large number of minority shareholders. However, the plan sponsor should also consider the other business consequences of the immediate cash outlay required to repurchase a large amount of employer stock. Liquidity concerns may render this approach impractical. In any event, because an ESOP is the only type of tax-qualified plan which has a stock distribution requirement, the conversion will eliminate participants' ability to demand distributions in the form of employer stock.

Search Requirements for Qualified Retirement Plans for more on defined contribution plans, including profit sharing plans and money purchase plans.

PRACTICAL IMPLICATIONS

According to a recent study by the National Center for Employee Ownership of Form 5500 filings, as of November 2016 there were 6,717 ESOPs in existence, covering 14.1 million participants and holding $270 billion of employer securities. Over time, it is inevitable that many of those ESOPs will be terminated, converted into other types of plans or otherwise resolved, whether through ordinary course distributions of employer securities or other means. In addition to compliance with all of the rules applicable to the termination of tax-qualified plans generally, practitioners and plan fiduciaries must pay close attention to the specific Code and ERISA rules unique to ESOPs to ensure a smooth path to winding down an ESOP.

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