No. 19-2485

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

SHARON LEE, on behalf of herself individually, and on behalf of all others similarly situated,

Plaintiff-Appellant,

v.

ARGENT TRUST COMPANY, CHOATE CONSTRUCTION COMPANY ESOP COMMITTEE, CHOATE CONSTRUCTION COMPANY BOARD OF DIRECTORS,

Defendants-Appellees.

Appeal from the United States District Court
for the Eastern District of North Carolina
No. 5:19-cv-00156-BO

CORRECTED BRIEF OF *AMICUS CURIAE* AMERICAN SOCIETY OF APPRAISERS IN SUPPORT OF DEFENDANTS-APPELLEES

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UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

DISCLOSURE STATEMENT

- In civil, agency, bankruptcy, and mandamus cases, a disclosure statement must be filed by **all** parties, with the following exceptions: (1) the United States is not required to file a disclosure statement; (2) an indigent party is not required to file a disclosure statement; and (3) a state or local government is not required to file a disclosure statement in pro se cases. (All parties to the action in the district court are considered parties to a mandamus case.)
- In criminal and post-conviction cases, a corporate defendant must file a disclosure statement.
- In criminal cases, the United States must file a disclosure statement if there was an organizational victim of the alleged criminal activity. (See question 7.)
- Any corporate amicus curiae must file a disclosure statement.
- Counsel has a continuing duty to update the disclosure statement.

No. 19-2485 Caption: Sharon Lee v. Argent Trust Company, et al.

Pursuant to FRAP 26.1 and Local Rule 26.1,

American Society of Appraisers
(name of party/amicus)

who is Amicus, makes the following disclosure:
(appellant/appellee/petitioner/respondent/amicus/intervenor)

1. Is party/amicus a publicly held corporation or other publicly held entity? ☐ YES ☑ NO

2. Does party/amicus have any parent corporations? ☐ YES ☑ NO
If yes, identify all parent corporations, including all generations of parent corporations:

3. Is 10% or more of the stock of a party/amicus owned by a publicly held corporation or other publicly held entity? ☐ YES ☑ NO
If yes, identify all such owners:

4. Is there any other publicly held corporation or other publicly held entity that has a direct financial interest in the outcome of the litigation? ☐YES ☑NO
If yes, identify entity and nature of interest:

5. Is party a trade association? (amici curiae do not complete this question) ☐YES ☐NO
If yes, identify any publicly held member whose stock or equity value could be affected substantially by the outcome of the proceeding or whose claims the trade association is pursuing in a representative capacity, or state that there is no such member:

6. Does this case arise out of a bankruptcy proceeding? ☐YES ☑NO
If yes, the debtor, the trustee, or the appellant (if neither the debtor nor the trustee is a party) must list (1) the members of any creditors' committee, (2) each debtor (if not in the caption), and (3) if a debtor is a corporation, the parent corporation and any publicly held corporation that owns 10% or more of the stock of the debtor.

7. Is this a criminal case in which there was an organizational victim? ☐YES ☑NO
If yes, the United States, absent good cause shown, must list (1) each organizational victim of the criminal activity and (2) if an organizational victim is a corporation, the parent corporation and any publicly held corporation that owns 10% or more of the stock of victim, to the extent that information can be obtained through due diligence.

Signature: /s/ Theodore M. Becker Date: 06/10/2020

Counsel for: American Society of Appraisers

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STATEMENT OF THE IDENTITY AND INTEREST OF THE AMICUS CURIAE[1, 2]

The American Society of Appraisers (ASA) is the largest multi-disciplinary organization devoted to the appraisal and valuation profession. The ASA is a non-profit, professional organization that teaches, tests, and credentials highly-qualified appraisers of businesses and assets. The ASA's mission is to foster public trust of members and the appraisal profession through the highest levels of ethical and professional standards. The ASA fosters professional excellence through education, accreditation, publication, and other services with an emphasis on professional ethics to protect the public. The ASA is a founding member of The Appraisal Foundation, authorized by Congress as the organization responsible for setting The Uniform Standards of Professional Appraisal Practice for the valuation profession. The ASA's world-renowned education programs are taught by leading appraisal experts. Additional information about the ASA is available at http://www.appraisers.org.

The instant appeal involves important questions about fundamental principles of ERISA, employee stock ownership plans ("ESOP") and the valuation standard of value

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[1] Pursuant to Fed. R. App. P. 29(a)(4)(E), no party's counsel authored this brief in whole or in part; no party or party's counsel contributed money that was intended to fund the preparation and submission of this brief; and no person—other than the amicus curiae, its members, or its counsel—contributed money that was intended to fund the preparation and submission of this brief.

[2] Pursuant to Rule 29(a)(2), all parties have consented to the filing of this brief.

known as "fair market value" ("FMV").[3] Congress intended for ESOPs to be a method of corporate finance and form of defined-contribution plan primarily to encourage employee ownership. In an ESOP, a trust purchases stock of the sponsoring employer (or qualified affiliate) and holds the stock for allocation to, and the beneficial ownership of, eligible employees. In order for an ESOP stock purchase to be exempt from ERISA's prohibited-transactions provisions, trustees must assess the company's stock using the FMV standard, as distinguished from other "standards of value" for valuation assessments.

Members of the ASA regularly advise ESOP trustees on the FMV of employer stock for purposes of ESOP transactions, annual ESOP valuations, and other ERISA matters involving FMV appraisals, and are experts on standards of value and generally accepted valuation principles. The ASA has a strong interest, on behalf of its members who advise ESOP trustees and perform FMV assessments, in the issues in this appeal.

[3] As set forth in Section III(b), FMV is a standard that requires the appraiser to assume, among other things, a hypothetical buyer and hypothetical seller, in the general market, who both seek to maximize their returns.

I. Introduction.

In recent years, ESOP trustees have been sued for approving an ESOP's purchase of stock at a value that allegedly exceeded the FMV. Such lawsuits premise their claims on the notion that ESOP trustees should, but do not, act like supposed "real-world" buyers of companies such as private-equity ("PE") buyers. Some courts have been misled into error and have accepted that there should be no difference between ERISA standards for an ESOP trustee's evaluation of an ESOP transaction and the prevailing practices of PE buyers that purchase companies.

The brief of amicus curiae Pension Rights Center ("PRC")[4] advocates this position[5] and attempts to find support in this Court's decision in *Brundle v. Wilmington Tr., N.A.*, 919 F.3d 763, 769 (4th Cir. 2019). PRC misreads *Brundle* and improperly attributes to this Court many incorrect notions about ESOPs and the standards for an ESOP trustee's evaluation of a transaction. Whatever the facts of *Brundle* or any other cases, this case is distinct. *Brundle* did not hold as a matter of law that ESOP trustees are governed by practices of PE buyers.

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[4] The abbreviation "PRC" in a citation refers to the Brief of Amicus Curiae Pension Rights Center, ECF No. 23; the abbreviation "Pl." refers to the Brief of Plaintiff-Appellant, ECF No. 20.

[5] PRC uses the term "real-world" buyer. PRC refers to a private-equity buyer; in other cases, plaintiffs equated a real-world buyer with a private equity buyer and have used private-equity experts to critique ESOP transactions. *See, e.g., Blackwell v. Bankers Tr. Co. of S. Dakota*, No. 3:18-CV-141-CWR-FKB, 2019 WL 1433769, at *4 (S.D. Miss. Mar. 29, 2019); *Perez v. First Bankers Tr. Servs., Inc.*, No. CV124450MASDEA, 2017 WL 1232527, at *60 (D.N.J. Mar. 31, 2017); *Acosta v. Vinoskey*, 310 F. Supp. 3d 662, 672 (W.D. Va. 2018); *Casey v. Reliance Trust Co.*, 2019 WL 8359021 (E.D. Tex., Dec. 6, 2019)(plaintiffs offered expert "private equity buyer").

Practices of PE buyers are incompatible with ERISA's requirements and fundamental valuation principles. In order to correct Plaintiff's and PRC's many misapprehensions about ESOPs, the ASA is presenting extensive Congressional materials and valuation authority, which have not been part of the records in other ESOP cases. These materials confirm that Plaintiff's claims lack merit, and the standards advocated by PRC are contrary to Congress' intent for ESOPs and standards of ESOP trustee conduct. *See Massachusetts Mut. Life Ins. Co. v. Russell*, 473 U.S. 134, 146, 105 S. Ct. 3085, 3092, 87 L. Ed. 2d 96 (1985)(reviewing the "voluminous legislative history of" ERISA); *Nachman Corp. v. Pension Ben. Guar. Corp.*, 446 U.S. 359, 381, 100 S. Ct. 1723, 1736, 64 L. Ed. 2d 354 (1980)("There is not a word in the statute or legislative history suggesting that Congress ever intended to" adopt positions advocated by Petitioner).

What is more, Congress considered many of the alleged ESOP 'abuses' that Plaintiff and PRC complain about to be *features* of ESOPs. Notably, PRC's brief cites two publications that critique ESOPs and conclude by proposing legislative changes to ERISA. (PRC, p. 2, at fn. 2, p. 5.) Plaintiff, PRC, and others are entitled to their opinions on what ERISA *should* require for ESOPs, but that is an issue for Congress to consider, not courts.

II. Plaintiff's and PRC's Analysis is Flawed at the Outset.

Plaintiff and PRC implicitly argue that Plaintiff's complaint states a claim merely because it alleges a "prohibited transaction under 29 U.S.C. § 1106(a)," because

prohibited-transactions exemptions "are affirmative defenses" that defendants must prove. (PRC, pp. 4, 14; Pl., pp. 25-27.) But ERISA § 406 does not create a cause of action. It appears in Part 4 of Subtitle B, entitled "Fiduciary Responsibility." *See* 29 U.S.C. Subtitle B, Part 4. This section creates the fiduciary obligation not to cause a prohibited transaction "[e]xcept as provided in section [408]." 29 U.S.C. §§ 1106(a), 1108.

Whether Plaintiff can plead a cognizable claim for an allegedly improper prohibited transaction is a different matter. ERISA § 502(a), in ERISA's "Administration and Enforcement" section, contains the only causes of action authorized by ERISA. 9 U.S.C. Subtitle B, Part 5; *see Varity Corp. v. Howe*, 516 U.S. 489, 519, 116 S. Ct. 1065, 1080, 134 L. Ed. 2d 130 (1996)(ERISA § 502(a) contains the "exclusive" private causes of action); *Russell*, 473 U.S. at 146 (same); *Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 56, 107 S.Ct. 1549, 1557–1558, 95 L.Ed.2d 39 (1987)(same). ERISA § 502(a) "represents a careful balancing of the need for prompt and fair claims settlement procedures against the public interest in encouraging the formation of employee benefit plans." *Pilot Life*, 481 U.S. at 54. ERISA "resolved innumerable disputes between powerful competing interests," and its provisions are "not all in favor of potential plaintiffs." *Mertens v. Hewitt Assocs.,* 508 U.S. 248, 262, 113 S. Ct. 2063, 2071, 124 L. Ed. 2d 161 (1993).

ERISA 502(a) claims have elements and impose burdens of pleading and proof on Plaintiff. An ERISA § 502(a)(2) claim requires a plaintiff to plead and prove a breach

of a fiduciary duty, losses to an ERISA plan, and at least a prima facie case for causation. 29 U.S.C. §§ 1132, 1109; *Tatum v. RJR Pension Inv. Comm.*, 761 F.3d 346, 362-63 (4th Cir. 2014), *cert. denied*, —— U.S. ——, 135 S. Ct. 2887, 192 L.Ed.2d 924 (2015)(plaintiff must prove breach and loss, then the burden of persuasion shifts). An ERISA § 502(a)(3) claim requires a plaintiff to plead and prove: (1) the defendant was a fiduciary when it engaged in the alleged conduct; (2) breach of fiduciary duty; and (3) appropriate equitable relief tied to the alleged violation. *In re DeRogatis*, 904 F.3d 174, 190 (2d Cir. 2018). A plaintiff assumes additional burdens depending on the remedy sought and theory of damages. *See CIGNA Corp. v. Amara*, 563 U.S. 421, 443, 131 S. Ct. 1866, 1881, 179 L. Ed. 2d 843 (2011)(an ERISA § 502(a)(3) claim for estoppel requires a showing of detrimental reliance).

A claim for breach of an ESOP trustee's fiduciary duty also must survive the Rule 12(b)(6) inquiry mandated by the Supreme Court in *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 425, 134 S. Ct. 2459, 2470, 189 L. Ed. 2d 457 (2014). A complaint alleging ESOP fiduciary misconduct requires "careful judicial consideration of whether the complaint states a claim that the defendant has acted imprudently." *Id.* Because the "duty of prudence turns on 'the circumstances . . . prevailing' at the time of the fiduciary acts," an assessment of a complaint "will necessarily be context specific." *Id.* at 425. In evaluating a complaint, courts must consider that "Congress sought to encourage the creation of ESOPs," and courts must not unfairly favor plaintiffs and expose employers to "heightened" risks of litigation. *Id.* at 423.

Plaintiff cannot avoid ERISA § 502(a)(2) or requisite context-specific inquiry, and PRC's attacks on ESOPs are not substitutes for Plaintiff's obligation to plead an ERISA § 502(a) claim.

III. ERISA Does Not Require ESOP Trustees to Act Like PE Buyers.

PRC advocates for this Court to reverse the district court largely on the basis of concerns with the alleged failure of ESOP trustees to engage in the due-diligence and valuation practices of supposed "real-world" PE buyers. There are, however, legislative mandates in ERISA that establish standards that differ from practices of PE buyers. For an ESOP purchase of stock, those standards are found in ERISA §§ 404(a)(1) and 408(e). 29 U.S.C. §§ 1104(a)(1), 1108(e). ERISA § 404(a)(1) requires fiduciaries to act:

> . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent [person] 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.***

29 U.S.C. § 1104(a)(1)(B)(emphasis added). The emphasized language – ignored by Plaintiff and PRC – is extremely important. It reflects Congress' expectation that "courts will interpret this prudent man rule (and other fiduciary standards) bearing in mind the special nature and purpose of employee benefit plans." H.R. Rep. No. 93-1280 at *5083, 1974 U.S.C.C.A.N. at 5083; Private Pension Plan Reform, Subcomm. on Private Pension Plans of the Comm. on Finance, Part 1 (May 21, 22, and 23, 1973), Part A, at Page 445. This standard requires trustees and courts to consider "***the***

particular plan and decision at issue." *DeFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 420 (4th Cir. 2007)(emphasis added).

ERISA § 408(e) provides the standard for ESOP purchases of company stock. An ESOP purchase of stock is exempt if for "***no more***" than "adequate consideration," which ERISA defines as the "fair market value of the asset as determined in good faith by the trustee . . ." 29 U.S.C. §§ 1108(e)(1) (emphasis added), 1002(18)(B). The "good faith" required by § 408(e) is measured by the standards of ERISA § 404(a)(1)(B), which means that an ESOP trustee's evaluation of an ESOP stock purchase must consider the character and aims of the particular plan. *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983); *Chao v. Hall Holding Co., Inc.*, 285 F.3d 415, 437 (6th Cir. 2002)("good faith. . . must be read in light of the overriding duties of Section 404"); *Perez v. Commodity Control Corp.*, 16-cv-20245, 2017 WL 1293619, *10 (S.D. Fla., March 7, 2017)(same).

a. Plaintiff and PRC Fundamentally Misunderstand ESOPs, Including Their Benefits, Character, and Aims.

PRC's brief suggests that this Court should permit Plaintiff's conclusory pleading because an ESOP is a "retirement" plan, and because it is not diversified, courts must apply heightened standards of prudence to ESOP trustees. (PRC, pp. 3, 5, 8.) This is wrong for two reasons. First, the character and aims of an ESOP are not principally as a retirement plan – the case PRC relied upon traces back to a misreading of legislative history. *See Chao v. Hall Holding Co.,* 285 F.3d 415, 425 (6th Cir. 2002). *Chao* cited *Martin v. Feilen*, 965 F.2d 660, 664 (8th Cir. 1992), which cited 129 Cong. Rec. S16629, at S16636.

The page cited does not discuss the purpose of ESOPs. The next page, S16637, does, and states: "ESOP's primary purpose, however, is not to serve as a retirement vehicle but, rather, to serve as an incentive for corporations to structure their financing in such a way that employees can gain an ownership stake in the company for which they work." 129 Cong. Rec. S16629, 16637.

Congressional materials are in accord. In May 1972, at House Committee on Ways and Means hearings, Louis O. Kelso explained "corporate financing techniques" then-called "Employee Stock Ownership (ESO) financing." ERISA-LH 30-C, 1972 WL 136948 (A.&P.L.H.), 104, 107. The ESOP was designed to provide financing, make employees "beneficial" owners of stock, and "link[] the day-to-day performance of work by employees and the day-to-day growth and operation of business enterprise." *Id.* at 105. ESOPs were a corporate investment in workers who, through their "labor power," could grow the company and participate in that growth. *Id.* at 106. The ESOP pays no more than FMV, and long-term gains come from paying the loan "within a reasonable period of years" and working hard to grow the company over time. *Id.* at 109.

After ERISA's enactment, the Senate Finance Committee issued two Committee Prints that further explain ESOPs. *See* attached Addendum ("ADD."), ESOPs: An Explanation for Employees (1978) ("Employee Handbook," ADD. 1); *see also* Employee Stock Ownership Plans: An Employer Handbook (1980) ("Employer

Handbook," ADD. 13). The Employee Handbook[6] explained that in an ESOP, employees do not invest their own money. The employee's "investment is the time and effort he puts into his job to make his employer profitable." Employee Handbook, *see* ADD. 4, p. 1. In an ESOP, the employee's "work performance directly affects the financial success" of ESOP accounts. *Id.*, p. 9. This differs from a retirement plan in which employees invest their own money and seek rates of return over long periods.

The Employer Handbook explained that "[p]roviding retirement benefits for employees has always been a secondary purpose for the establishment of a stock bonus plan," because "as an employee benefit plan," Congress' principal goal was to "give the employee-participants an interest in the ownership and growth of the employer's business." Employer Handbook, ADD. 39-40, p. 23, 24 (because ESOPs may borrow to acquire stock, that "further demonstrates Congressional intent that an ESOP is not primarily a retirement plan, but rather has as its primary objective the providing of stock ownership interests for employees."); *see also* 132 Cong. Rec. S7934-01, 1986 WL 776250 at 776250; *Moench v. Robertson,* 62 F.3d 553, 568 (3d Cir. 1995)("ESOPs, unlike pension plans, are not intended to guarantee retirement benefits . . ."), *abrogated by Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 134 S. Ct. 2459, 189 L. Ed. 2d 457 (2014); 129 Cong. Rec. S16629 at S16637, 132 Cong. Rec. S7934-01, 1986 WL 776250 (Senator Long, the "father of the ESOP," explaining that "ESOP's primary purpose, however,

[6] ERISA was amended after the Employee Handbook was published, and some information in this document that has no bearing on the instant appeal is no longer accurate.

is not to serve as a retirement vehicle," but "an incentive for corporations to structure their financing in such a way that employees can gain an ownership stake in the company for which they work.," and "[p]roviding retirement benefits for employees has always been a secondary purpose for the establishment of a stock bonus plan.").

With respect to an ESOP trustee's fiduciary obligations, Congress explained that the trustee's goal is not to protect a retirement plan. The Employer Handbook states that when interpreting the trustee's fiduciary standards, "it is important to understand the purposes of an ESOP as an employee benefit plan," which is principally not to "[p]rovid[e] retirement benefits." Employer Handbook, ADD. 39, at p. 23 (quoting Rev. Rul. 69-65, 1969-1 C.B. 114 (1969)). The "special purpose" of the ESOP "requires" that ESOP trustee fiduciary standards "must be based upon the ESOP objective of providing stock ownership for employees." Employer Handbook, ADD. 40, at p. 24. Indeed, the ESOP trustee appropriately acts in the exclusive interests of participants when the goal is to promote stock ownership. *Id.*, ADD. 43, at p. 27.

ERISA also exempts ESOP trustees from the obligation to seek a "fair return" on the investment and the investment-diversification requirements. *Id.*, ADD. 42-43, p. 26, 27; *see also* 32 Cong. Rec. S7934-01, 1986 WL 776250. ESOPs are not retirement plans that require special oversight or fiduciaries to act like PE buyers who buy low hoping to sell high. As Senator Long explained, ESOPs are for workers willing to tie future benefit to company performance, who through hard work are "willing to sacrifice now in order to have a brighter future." 129 Cong. Rec. S16549, at S16637 (1983). The

ESOP gains when the loan is paid down and if the company grows. *See* Kelso, ERISA-LH 30-C, 1972 WL 136948 (A.&P.L.H.), 105.

b. The FMV Standard Required by ERISA § 1002(18) Precludes the Valuation Standards that Plaintiff and PRC Propose.

PRC fails to cite ERISA provisions to support its argument that an ESOP stock transaction is unlawful unless the ESOP trustee pursued the "lowest price possible for the ESOP" that a PE buyer might pay. (PRC, p. 3) This is not the standard. The adequate-consideration exemption applies if the ESOP pays "***no more***" than "adequate consideration," defined as the "fair market value" as determined in "good faith" by the trustee. 29 U.S.C. §§ 1108(e)(emphasis added), § 1002(18). This is the valuation standard required *specifically* for ESOP transactions, and in response to demands for a prohibited-transactions exemption specifically to allow ESOPs. *See* ERISA-LH 22-B, 1973 WL 173119 (A.&P.L.H.), 3 (public comment); ERISA-LH 22-C, 1973 WL 173120 (A.&P.L.H.), 170-71 (same); ERISA-LH 23, 1973 WL 173121 (A.&P.L.H.), 4-5 (same); ERISA-LH 23, 1973 WL 173121 (A.&P.L.H.), 66 (same); ERISA-LH 71 at *108 (1974) (Administration's recommendation); *id.* at *110-11 (conferee recommendation).

FMV is a "standard of value" in valuation parlance. A standard of value, which may be defined by statute, regulation, private contract, or other document,[7] [8]

[7] INTERNATIONAL VALUATION STANDARDS (2017), at IVS 104, § 10.2; BUSINESS VALUATION, § 2.01 (2010) (emphasis added).

[8] *Id.*, at IVS 101, § 20.1.

"describe[s] the fundamental premises on which the reported values will be based"[9] and is "critical," because it "may influence or dictate a valuer's selection of methods, inputs and assumptions, and the ultimate opinion of value."[10] "It is possible, indeed likely, that the same business interest could have different values, depending on which standard of value we use."[11]

FMV is the same standard of value ERISA requires for annual ESOP valuations, reporting purposes, and distributions. *See Mertens v. Hewitt Assocs.*, 508 U.S. 248, 260, 113 S. Ct. 2063, 2070, 124 L. Ed. 2d 161 (1993) (We certainly agree with petitioners that language used in one portion of a statute . . . should be deemed to have the same meaning as the same language used elsewhere in the statute . . . ."). It has a well-accepted meaning, which is set forth in a 1988 proposed DOL regulation on "adequate consideration":

> …the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset.[12]

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9 *Id.*, at IVS 104, § 10.1.

10 Laro and Pratt, BUSINESS VALUATION AND TAXES: PROCEDURE, LAW, AND PERSPECTIVE (2005), p. 7.

11 *Id.*, p. 3.

12 *See also* Pratt, THE OPINION OF THE COLLEGE ON DEFINING STANDARDS OF VALUE, 34 Valuation 2, at 6 (1989), available at http://www.appraisers.org/docs/default-source/college-of-fellows-articles/defining-standards-of-value.pdf.

29 C.F.R. Part 2510, 1988 WL 269847. This is the same standard used throughout the Tax Code and regulations, the Bankruptcy Code, and statutes ranging from the Social Security Act to the Fishery Conservation and Management Act of 1976. *See, e.g,* 26 C.F.R. § 20.2031-1; Rev. Rul. 59-60, 1959-1 C.B. 237 (1959); *see also Almota Farmers Elevator & Warehouse Co. v. United States*, 409 U.S. 470, 474, 93 S. Ct. 791, 794, 35 L. Ed. 2d 1 (1973)(takings clause requires FMV, which is "what willing buyer would pay in cash to a willing seller").

FMV is not the lowest possible price a PE buyer might pay. FMV is an *objective* assessment of market forces, and it accounts for competing forces of *sellers as well as buyers*, both of whom seek to maximize gain.[13] FMV assumes hypothetical buyers, not any particular individual or category of buyers.[14] FMV does not consider specific financing arrangements, investment goals, return requirements, business pressures, or other characteristics or requirements of a particular buyer.[15] *See, e.g., Buckley v. Comm'r*, 68 T.C.M. (CCH) 754 (T.C. 1994)("The applicable standard is objective, using a hypothetical willing buyer and seller. It is not a personalized standard that focuses on a particular buyer or seller."); *see Holman v. Comm'r*, 601 F.3d 763, 775 (8th Cir. 2010)(FMV must consider motivations of both buyer and seller, who both want to

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13 *Id.*, at 8.

14 *Supra*, note 7, at IVS 104, § 30.7.

15 *Supra*, note 7, at IVS 104, § 30.2 (FMV is "impersonal and detached" and excludes "special terms or circumstances such as atypical financing, sale, leaseback arrangements, special considerations or concessions granted by anyone associated with the sale, or any element of value available only to a specific owner or purchaser.").

maximize returns); *Estate of Watts v. Comm'r*, 823 F.2d 483, 486 (11th Cir. 1987)(same); *Simonson v. County of Hennepin*, No. TC-24818, 1997 WL 45311, at *3 (Minn. Tax Feb 3, 1997)(same); *Fairy-Mart v. Marathon Petroleum Co., LP*, No. 17-cv-1195, 2017 WL 5140514 at *13 (D. Conn., Nov. 6, 2017)(distinguishing FMV; investment value considers factors "such as whether a transaction will yield economies of scale for the buyer").

PE buyers, in contrast, do not perform FMV appraisals; they assess a standard known as "investment value," which is a subjective estimate of what a particular buyer or "class of investors"[16] would pay "based on subjective, personal parameters." *Simonson*, 1997 WL 45311 at *3. It is the price a particular buyer would pay[17] primarily based on the particular return that investor seeks.[18] "There is virtually universal consensus that the term *investment value* means a value based on expected earnings or monetary return to an investor."[19] *See also Maryville Properties, L.P.,* 83 S.W.3d 608, 617 (Mo. Ct. App. 2002)(investment value is the "value of a property to a particular investor," affected by "particular circumstances" and "needs" of the buyer.)

Unlike FMV, investment value does not consider contrary pressure by a seller seeking the *highest* price.[20] The "two amounts together constitute[] the fair market

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16 *See* Pratt, VALUING A BUSINESS (5th Ed. 2008), p. 43.

17 *Supra*, note 7, at IVS 104, § 60.2 (also explaining that investment value "does not involve a presumed exchange").

18 *Supra*, note 7, at § IVS 104, § 60.2.

19 *Supra*, note 12, at 8.

20 *Supra*, note 7, at IVS 104, §§ 30.2(e), 60.2.

value." *Judge v. Comm'r*, 35 T.C.M. (CCH) 1264 (T.C. 1976); *Chapman Glen Ltd. v. Comm'r*, 140 T.C. 294, 325 (2013)(value only from reference of buyer is not FMV); *Buckley v. Comm'r,* 68 T.C.M. (CCH) 754 (T.C. 1994)("focusing too much on the view of one of these persons, to the neglect of the view of the other, is contrary to a determination of fair market value."); *Black v. Comm'r*, 36 T.C.M. (CCH) 1347 (T.C. 1977)(expert improperly did not consider what a willing seller would accept); *Estate of Bright v. United States*, 619 F.2d 407, 411 (5th Cir. 1980), *on reh'g*, 658 F.2d 999 (5th Cir. 1981)("The price at which a willing buyer but not a willing seller would have traded does not determine fair market value."); *Hans v. Tharaldson*, No. 3:05-CV-115, 2011 WL 6937598, at *1 (D.N.D. Dec. 23, 2011)(valuation from the perspective of "hypothetical prudent hotel investor," who is "naturally looking for enhanced returns and maximum gains" and "seeks to drive the sharpest bargain possible maximizing the potential for a windfall" is "not helpful to the determination of the fair market value"); *Mirant Mid-Atlantic, LLC v. Supervisor of Assessments of Charles Cty,* No. 09-RP-CH-0261, et al., 2012 WL 273160 (Md. Tax Ct., Jan. 25, 2012) (FMV must consider hypothetical "willing seller," and value to buyer that wants to pay the lowest price is not FMV).

c. Plaintiff and PRC Ignore Standards for a Good Faith Assessment of an Asset's FMV.

The standards of ESOP trustee conduct proposed by Plaintiff and PRC would require ESOP trustees to reject an independent appraiser's estimate of FMV. The exemption for "adequate consideration" requires the trustee to determine FMV in

"good faith." 29 U.S.C. § 1002(18). The Employer Handbook explained that a trustee assesses FMV in good faith ordinarily where "the person making the valuation is not a disqualified person and is both competent to make the valuation and is not in a position to derive an economic benefit from the value utilized," and "the method utilized in the valuation is a generally accepted method for valuing for purposes of arm's length business transactions where valuation is a significant factor." *Employer Handbook*, ADD. 43, p. 27. This is the standard Treasury regulations require for a good-faith assessment of FMV. 26 C.F.R. § 53.4941(e)-1, Treas. Reg 53.4941(e)-1, 2003 WL 1125349; 26 C.F.R. § 1.1361-1; 26 C.F.R. § 1.46-8, Treas. Reg. § 1.46-8; 26 C.F.R. § 54.4975-11; 26 C.F.R. § 1.422-2; *see also* Prop Regs.2/7/1984, Fed. Reg. Vol. 49, No. 26, p. 4504, 2002 WL 413544.

Qualified appraisers perform FMV estimates countless times, for a variety of purposes. A FMV estimate is not meant to consider the goals of PE buyers, who seek rates of returns, *year-over-year*, of 15% or more.[21] The due diligence a PE buyer performs is not for the purpose of determining FMV, it is for the purpose of the PE buyer's goals of obtaining such high returns within 4-7 years after acquiring a company.[22] The FMV appraisal does not reduce the 'price' to account for the management fee a PE commonly takes. *See, e.g.* Adam H. Isenberg (FN1) & Monique Bair DiSabatino (FN1), *Private-*

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[21] Private Equity Funds—Private Equity Fund Structures, 1 Real Estate Transactions: Structure and Analysis with Forms § 4:85.

[22] *See* What is an Equity Firm?, available at https://corporatefinanceinstitute.com/resources/careers/companies/equity-firm/

Equity Funds Beware How You Could Be Exposed to Pension Liability After Sun Capital, Am. Bankr. Inst. J., October 2013, at 20, 20. PE buyers reduce the preferred 'price' in view of changes PE buyers implement to management, operations, units or divisions, worker employment, and the legal organization of entity.

A PE buyer's goals may justify the investigative efforts that can cost millions of dollars. But a FMV appraiser adheres to valuation principles. An ESOP trustee's good-faith obligation to assess FMV does not require the trustee to reject a FMV appraisal performed in accordance with valuation principles.

IV. Plaintiff's and PRC's Other Attacks on ESOPs Also are Misplaced.

Plaintiff's and PRC's additional assertions about ESOPs, which are designed to color this Court's views of ESOPs, are false.

a. Incorrect Assertion 1: 'The Post-Transaction Valuation is Evidence of Pre-Transaction Overpayment'.

The district court's house analogy correctly explained the difference between the pre-transaction FMV of a company, which the ESOP trustee determines in connection with the transaction, and the post-transaction equity value of the ESOP stock. Under ERISA, the trustee's obligation in a proposed ESOP purchase of company stock is to assess the FMV of the company stock. 29 U.S.C. §§ 1108(e), 1002(18). The annual, post-transaction valuation that Plaintiff and PRC reference is a valuation of a different asset – it is the annual valuation of the FMV of the value of the *ESOP's stock* after the leverage. 29 U.S.C. § 1023(b)(3)(A); § 1025(a)(2)(B)(i). The

FMV of the ESOP's stock, post-transaction, is going to be less than the FMV of the company's equity pre-transaction if the company obtains financing, just as the district court explained. The pre-transaction FMV of a company, and post-transaction annual valuation of the ESOP's stock, are an apples-to-oranges comparison. *See, e.g., Scott v. Evins*, 802 F. Supp. 411, 416 (N.D. Ala. 1992)("The common stock of Evins exists independently of the debt used to leverage the purchase"), *aff'd*, 998 F.2d 1022 (11th Cir. 1993), *and aff'd*, 998 F.2d 1022 (11th Cir. 1993).

b. Incorrect Assertion 2: 'A Sponsor Company's Stock Value is Reduced by Warrants, Which Dilute Ownership Interest and Reduce the ESOP's Ownership.'

Plaintiff and PRC argue that warrants should give rise to an inference of fiduciary imprudence, because the ESOP must pay less if the selling shareholders received warrants, and warrants allow sellers to "retain a significant amount of control." (PRC, p. 11.) An allegation that an ESOP transaction involved warrants is not evidence that an ESOP paid more than FMV. Warrants are a financing mechanism in lieu of higher interest rates on subordinate notes issued to sellers. Whether an ESOP trustee may have a fiduciary obligation to assess warrants as part of the assessment of the ESOP transaction, the FMV of a company is not affected by financing, including warrants. FMV assumes a transaction "in cash" on the date of the transaction and is not affected by financing. *Almota Farmers Elevator & Warehouse Co. v. United States*, 409 U.S. 470, 474, 93 S. Ct. 791, 794, 35 L. Ed. 2d 1 (1973); *Scott*, 802 at 416. Just as the FMV of your

house is not affected by the magnitude of one buyer's down-payment, or another buyer's mortgage interest-rate, or a third buyer's intent to obtain a home-equity line of credit, the FMV of a company is not affected by warrants as a means of financing.

Second, warrants are widely used to finance many kinds of transactions, not just ESOP transactions.[23] A warrant is like a "long-term call option"[24] whereby sellers accept a lower interest rate in exchange for the option to purchase shares at a future date, at a negotiated, predetermined strike price. Warrants do not guarantee returns. If the share value goes up, then on the exercise date, the warrant holder can obtain a return. Treasury Secretary Steven Mnuchin recently told executives of major airlines that airlines would have to provide "warrants" in exchange for low-interest loans by Treasury.[25]

Warrants benefit the ESOP. Selling shareholders commonly get unsecured, last-position, subordinated, unsecured notes, which bear market interest rates of 13-15%. In lieu of such interest rates, sellers get warrants, and the interest rate is reduced significantly, typically to 5% or below. Later, if the stock value increases, the warrant holder *commonly does not receive stock* upon exercise of the warrant right. Warrants require or permit the company to pay an amount that accounts for the increase in the value of

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[23] Steiker, WARRANTS IN ESOP TRANSACTIONS, The Journal of Employee Ownership Law and Finance, Vol. 20/2.

[24] Pratt, COST OF CAPITAL ESTIMATION AND APPLICATIONS (2002), p. 42.

[25] https://money.usnews.com/investing/news/articles/2020-04-10/us-treasury-wants-major-airlines-to-repay-part-of-grants-give-up-warrants-sources

the stock. The warrant holder gets the one-time payment and no additional stock option rights. Warrants preserve company cash flow by reducing interest rates and create flexibility for the company. Outside lenders consider warrants more favorable on creditworthiness than loans with high interest rates. The warrant holders assume risk that the warrants may become worthless if the company's value does not increase, and they are incentivized to ensure the company's success.

An allegation of the use of warrants, without facts to plausibly allege *misuse*, is not evidence of fiduciary impropriety.

c. Incorrect Assertion 3: 'A Discount for Lack of Control is Required when Warrants are Issued.'

In addition to their misapprehensions about warrants, Plaintiff and PRC misstate when a "discount for lack of control" or a "controlling interest" valuation adjustment is permissible. (PRC, pp. 11, 16; P., pp. 18, 19.)

Preliminarily, the suggestion that this Court should be concerned with an ESOP transaction that does not transfer unfettered governance or operational control to the ESOP is misplaced. Congress thoroughly considered the measure of control that ESOPs should obtain. With the Revenue Act of 1978, Congress provided pass-through voting to participants on mergers, consolidations, recapitalizations, reclassifications, liquidation, dissolution, sale of substantially all the assets, or similar transactions as the Secretary prescribes. H.R. CONF. REP. 95-1800, 208-09, 1978 U.S.C.C.A.N. 7198, 7214. During hearings, Congress considered the supposed 'abusive' ESOP control

arrangements that Plaintiff and PRC raise in their briefs. Congress received results from a poll of ESOP sponsors in which sponsors identified the ability of the "principal owners of a business" to "divest themselves of their holdings *while retaining control of their business*" as one of the most favorable *characteristics* of ESOPs. *See* Hearing of the Committee on Finance, July 19 and 20, 1978, at pp. 314-315 (emphasis added). Congress was aware that trustees may be "accountable to the board of directors of the company rather than to the employees," and "the principal stock holder in a closely held company can retain control over the company without actually holding a 'controlling interest.'" *Id.* As the Assistant Secretary of the Treasury explained to Congress:

> Actually, the way the current law reads, the stock remains in a trust, and the trust is administered by a committee. That committee is appointed by the board of directors. So under the present law, as it now stands, there would be no change in the control of the company.

(*Id.*, p. 116.) In his words, ESOP ownership is not the same as "real ownership." *Id.* In 1985 and 1988, Congress rejected changes to prerogatives of control in ESOP companies. 131 Cong. Rec. E3774-01, 1985 WL 725073, 2 (ERISA "permits ESOP trustees who are also management officials"); 134 Cong. Rec. S1071-04, 1988 WL 1082667 (management has "broad rights to severely limit the authority of participants in determining the future of the company."). There is nothing wrong with an ESOP buying 100% of the stock but not obtaining unfettered management and operational

control. The only control Congress required for ESOPs are the pass-through voting rights.

With respect to the FMV estimate of the value of control, Plaintiff's and PRC's argument that a discount for lack of control is required when warrants have been issued is flatly incorrect. According to FMV principles, if a buyer of a block of stock obtains certain "indicia of control" rights beyond those of a true minority shareholders, and a hypothetical buyer *and a hypothetical seller* would agree to increase the price to account for those rights, then some measure of control adjustment is permissible.[26] The appropriate *measure* of control adjustment must, of course, be reasonable in view of the particular control rights the buyer obtains.

By law, ESOPs obtain some "more common" elements of control, which true minority shareholders do not obtain, and that are recognized in the valuation field as having value.[27] These are: (1) the paramount right to vote shares to prevent or approve any sale of the company, merger, or recapitalization; (2) other pass-through voting rights; and (3) the right of the ESOP trustee to reject any direction from the supposed "corporate insiders" on shareholder actions if the trustee believes it is not in the best interests of the ESOP.

Consider two offers to a buyer. One offer permits the rights referenced above, and the second offer does not. A hypothetical seller would demand greater value for

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26 Fishman and Pratt, PPC'S GUIDE TO BUSINESS VALUATIONS (15th ed.) (2005).

27 *Supra*, note 25, at p. 154.

the first offer, and a hypothetical buyer would pay more. A discount for lack of control would not be appropriate pursuant to FMV standards of valuation.

d. Incorrect Assertion 4: 'ESOPs are Improper If Sellers Use Them Because They Cannot Find a Private Buyer for Their Stock'.

PRC urges this Court to presume fiduciary misconduct if sellers may have used an ESOP to create an exit strategy or market, even after an unsuccessful attempt to sell the company. (PRC, p. 6.) The use of an ESOP to create a market, even in the absence of another buyer, is a *feature* of an ESOP. The Employer Handbook explains that ESOPs provide shareholders with a "limited market for their stock," "in many cases it is the only market for such stock," and "a market for stock in a closely-held corporation . . . to attract investors who might otherwise not purchase the stock because they normally would encounter difficulty in reselling it." (Employer Handbook, ADD. 17, 20; pp. 1, 4, § I(F).) It also states that a "benefit to the employer is that the ESOP provides its shareholders with a buyer for their stock if they wish to sell," and this is a "tremendous advantage" because it could assist in "attracting additional investors." (Employee Handbook, ADD. 12, p. 9.)

e. Incorrect Assertion 5: 'ESOPs should not be Used to Benefit the Sellers or Company.'

PRC urges close court scrutiny of ESOP transactions by vilifying sellers and companies that use an ESOP to benefit themselves. (PRC, p. 6.) An independent, qualified, and diligent ESOP trustee is not concerned if the sellers or company use the

ESOP to obtain financing or create a market. Congress intended for ESOPs to be used this way. The Employer Handbook explains that "Congress has clearly recognized ESOP as a corporate financing vehicle," the ESOP is "a technique of corporate finance" for "the employer to finance its capital growth," and "ESOP financing provides an alternative for raising capital" for "closely-held corporations which are unable or unwilling to raise capital through a public offering of stock." (Employer Handbook, ADD. 32-33, 38, pp. 16-17, 22; *see also* 132 Cong. Rec. S7934-01, 1986 WL 776250 ("ESOPs were intended by the Congress as a technique of finance to acquire the stock of an employer"); Tax Reform Act of 1976, § 803(h), 90 Stat. 1590 ("Congress, in seeking to permit and promote ESOPs," was concerned with "securing capital funds for necessary capital growth.")).

f. Incorrect Assertion 6: 'ESOPs are Tainted with Self-Dealing that can Only be Remedied by Lawsuits and Heighted Fiduciary Standards'.

PRC degradingly calls selling shareholders and executives who appoint the independent trustee the "corporate insiders." (PRC, pp. 3, 5.) ESOPs are optional benefit plans, and by their nature they must buy stock from parties in interest. Congress wanted to form ties between the company and the employees. The supposed "corporate insiders" also are the ones ERISA requires to appoint the fiduciaries and the trustee. ERISA's default fiduciary is the company and the board of directors. 29 U.S.C. § 1003(16)(A)(ii). Congress addressed potential abuse with fiduciary standards and the "good faith" obligation to assess FMV, not by encouraging litigation.

V. Conclusion.

In evaluating Plaintiff's and PRC's arguments, this Court has the opportunity to correct misimpressions that have been subjecting ESOPs to unjustified attack. The Supreme Court in *Dudenhoeffer* summed up the core problem with Plaintiff's and PRC's approach to ESOP fiduciary issues in this quote:

> Intent of Congress Concerning Employee Stock Ownership Plans.—The Congress, in a series of laws [including ERISA] has made clear its interest in encouraging [ESOPs] as a bold and innovative method of strengthening the free private enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees. The Congress is deeply concerned that the objectives sought by this series of laws will be made unattainable by regulations and rulings which treat [ESOPs] as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans.

Tax Reform Act of 1976, § 803(h), 90 Stat. 1590, *quoted in Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 416, 134 S. Ct. 2459, 2465–66, 189 L. Ed. 2d 457 (2014).

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Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

Pursuant to Fed. R. App. P. 32(g), I certify the following:

This brief complies with the type-volume limitations of Fed. R. App. P. 32(a)(7)(B) and Fourth Circuit Rule 32(b), because this brief contains 6,294 words as determined by the Microsoft Word word-processing system used to prepare the brief, excluding the parts of the brief exempted by Fed. R. App. P. 32(f).

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type-style requirements of Fed R. App. P. 32(a)(6) because it has been prepared in a proportionally spaced typeface using Microsoft Word word-processing system in a 14-point Garamond font.

/s/ THEODORE M. BECKER
Theodore M. Becker

CERTIFICATE OF SERVICE

I certify that on June 10, 2020, I electronically filed the foregoing **CORRECTED *Amicus Curiae* Brief** of the American Society of Appraisers with the Clerk of this Court using the Court's CM/ECF system, which will send a notice of such filing to the registered ECF users.

/s/ THEODORE M. BECKER
Theodore M. Becker

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ADDENDUM

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95th Congress
2d Session } COMMITTEE PRINT

ESOPs

An Explanation for Employees

Prepared by the Staff of the

COMMITTEE ON FINANCE
UNITED STATES SENATE

RUSSELL B. LONG, *Chairman*

(II)

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(II)

CONTENTS

ESOPs—An Explanation for Employees

Introduction

An Employee Stock Ownership Plan, or "ESOP" as it is usually called, is designed to give employees the chance to acquire a stock ownership in their company. More importantly, the ESOP usually does this without requiring the employee to spend any of his own money; his investment is the time and effort he puts into his job to make his employer profitable. Although some ESOPs permit or require employees to put money into the ESOP, most provide that the employer will make all necessary ESOP payments.

What Is An ESOP?

An ESOP is an employee benefit plan which is "qualified" under the Internal Revenue Code. That is, it has been written in such a way that it satisfies the requirements of the Internal Revenue Code. As a qualified plan, the ESOP is required to be operated for the "exclusive benefit" of participating employees (and their beneficiaries).

How Does an ESOP Work?

The ESOP is designed to acquire stock of an employer for the benefit of employees. To do so, the ESOP may borrow money from a bank or other lender (including the employer). The stock is bought directly from the employer or from shareholders. When the ESOP borrows money, the employer guarantees to the lender that the ESOP will repay the loan. Employees are never required to assume any obligation for the repayment of the money borrowed by the ESOP. The employer is required to make annual payments to the ESOP in an amount at least equal to the amount the ESOP must pay on the money it borrowed. These amounts are then paid by the ESOP to the lender each year.

The employer is also permitted to make additional payments of cash or stock to the ESOP each year. The amount of these additional payments is usually decided by the board of directors of the employer. Because the ESOP is "qualified," the employer gets a tax deduction for all payments to the ESOP, up to a maximum limitation established by the Internal Revenue Code. This tax deduction is available for the required employer payments and any additional payments, and its effect is to reduce the annual cost of the ESOP to the employer. Cash put into the ESOP by the employer will be used primarily to purchase employer stock. In addition, this cash may be invested temporarily in savings accounts or certain other permitted investments.

What Do Employees Get as Part of the ESOP?

Each year, all amounts of cash and employer stock paid by the employer to the ESOP, and employer stock bought with cash held in the ESOP, are allocated among the accounts of employees who are participating in the ESOP. This allocation is usually done on a formula related to each employee's salary or wages as compared to the salaries or wages of all other participating employees. Take as an example an employee who earns $10,000 per year from a company where the total salaries of all participating employees equal $500,000. That employee's salary or wages is 2 percent of the total, and so his share of allocations of cash and employer stock under the ESOP for that year would be 2 percent. If the employer contributed $100,000 to the ESOP during the year, the employee's share would be $2,000.

A trust will be established (under the ESOP) to hold the cash and employer stock paid to the ESOP for the benefit of employees (and their beneficiaries). It is created by a separate written trust agreement and will be administered by a trustee. This is done to assure that each employee's interest in ESOP assets will be protected.

What Do I Own in the ESOP?

An ESOP, like most employee benefit plans, is designed to benefit employees who remain with the employer the longest and contribute most to the employer's success. Therefore, an employee's ownership interest in cash and employer stock held in the ESOP is usually based on his number of years of employment with the employer. The employee's ownership interest in the ESOP is called his "vested interest," and the language in the ESOP which determines his vested interest is called a "vesting schedule." Although there are many vesting schedules which may be used by an ESOP, most vesting schedules are set up so that the longer an employee stays with the employer, the greater his vested interest becomes.

If an employee terminates employment with the employer for any reason other than his retirement, or, in some cases his death, his vested interest will be determined by looking at the vesting schedule and measuring how many years he has worked for the employer. All cash and employer stock in which he does not have a vested interest because he has not worked for the employer for enough years will be treated as a "forfeiture," to which the former

employee will not be entitled. Forfeitures are usually allocated among the ESOP accounts of the remaining employees on the same basis as employer payments to the ESOP are allocated.

The vesting schedule applies only where an employee does not end his employment because of retirement or, in some cases death. If an employee retires, or, in some cases if he dies, he will immediately have a 100-percent vested interest in all ESOP assets held for him.

When Do I Receive What I Own From the ESOP?

Even though employer stock and cash are usually put into the ESOP for an employee each year, and put into a special account under his name, he will normally not be able to actually get any employer stock and cash from the ESOP until after his employment with the employer terminates and he ceases to be a participant in the ESOP.

After an employee's participation in the ESOP ends, he (or his beneficiary) will be eligible to receive a payment of his vested interest. There are many permissible times and methods for making the payment to him from the ESOP. For example, an ESOP may provide that payment will be made as soon as possible after an employee's termination of employment. On the other hand, the ESOP may require that any payment be deferred until some later time, such as the normal retirement date set forth in the ESOP or the employee's death. However, payment of a former employee's vested benefit under the ESOP must start soon after his death or attainment of age 65. Payment may be made to a former employee (or his beneficiary) in a lump sum, or it may be made in installments.

Payment of an employee's vested interest from an ESOP must normally be made in as many whole shares of employer stock as possible, with the value of any fractional share being paid in cash. Occasionally, depending upon how the ESOP is set up, the ESOP may pay a portion of an employee's vested interest in cash. However, this is not the usual case.

What Can I Do With My Shares of Employer Stock From the ESOP?

Once a former employee (or his beneficiary) gets his shares of employer stock from the ESOP, they are his property and he can do what he wants with them. He can vote the shares of employer stock at shareholders' meetings, receive any dividends paid on the stock by the employer, and he may keep the stock as long as he wishes.

However, if he wishes to sell or otherwise transfer ownership of the stock to a third party, he may be required by the terms of the ESOP to first offer to sell the stock to the employer and the ESOP. This requirement is called a "right of first refusal" for the employer and the ESOP; they can exercise this right and purchase the employer stock at its fair market value. Generally, the price offered by the prospective buyer would establish the fair market value for the stock. However, if an independent party hired by the employer decides that the fair market value is higher than the offering price, then that would be the fair market value of the stock when it is sold to the employer or the ESOP. The purpose of this right of first refusal is to protect the employees of a closely held employer by preventing the stock from being acquired by outside parties who have no interest in the employer or the ESOP and to protect the employer from violating any Federal law as a result of having its stock sold when it does not no satisfy certain Government rules.

In addition, at the time the former employee (or his beneficiary) receives his employer stock from the ESOP, he may be given a "put option," the right to demand that the employer buy his shares of employer stock at their fair market value. In such a case, the ESOP may provide that the ESOP may buy the employer stock, although the ESOP may not be required to buy the stock under the put option. The purpose for including a put option in the ESOP is to assure that each former employee (or his beneficiary) will have someone available to buy his shares of employer stock if he wishes to sell.

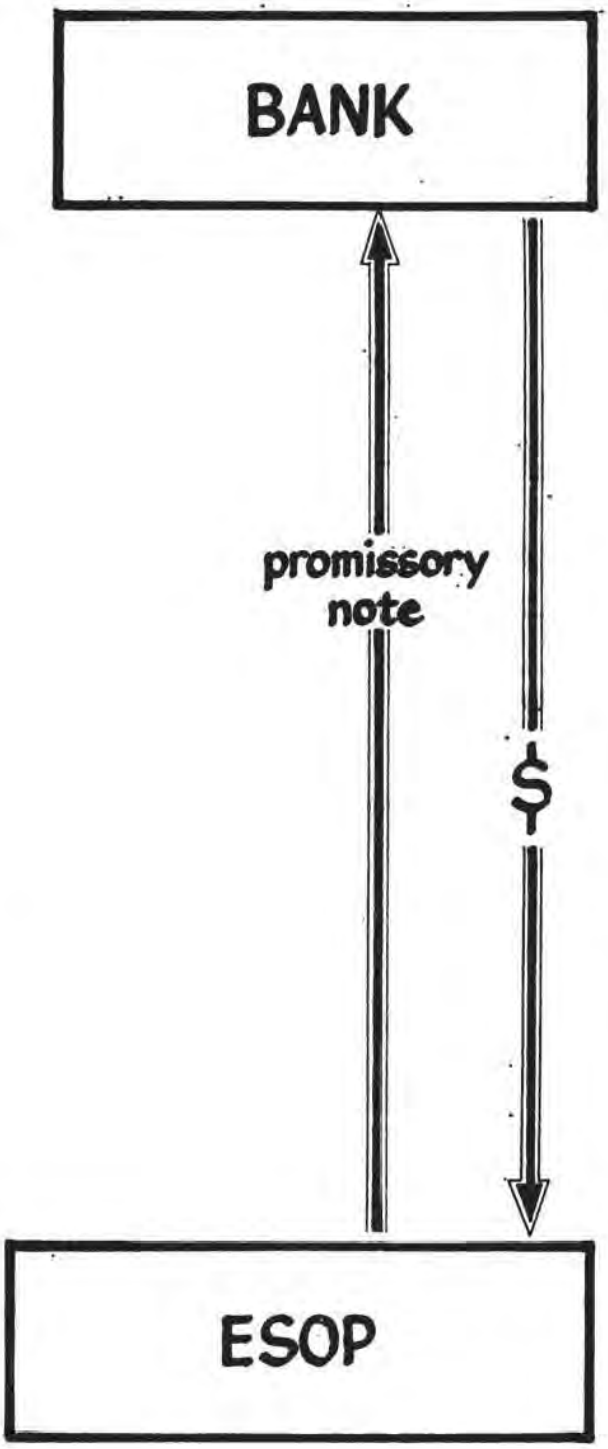
How Does the ESOP Help My Employer?

The employer benefits primarily from the favorable tax treatment it receives for all payments made to the ESOP. This is very important when the employer uses the ESOP as a means of borrowing money. In order to understand how the use of the ESOP to raise money benefits the employer, a comparison must be made with the usual method of borrowing money.

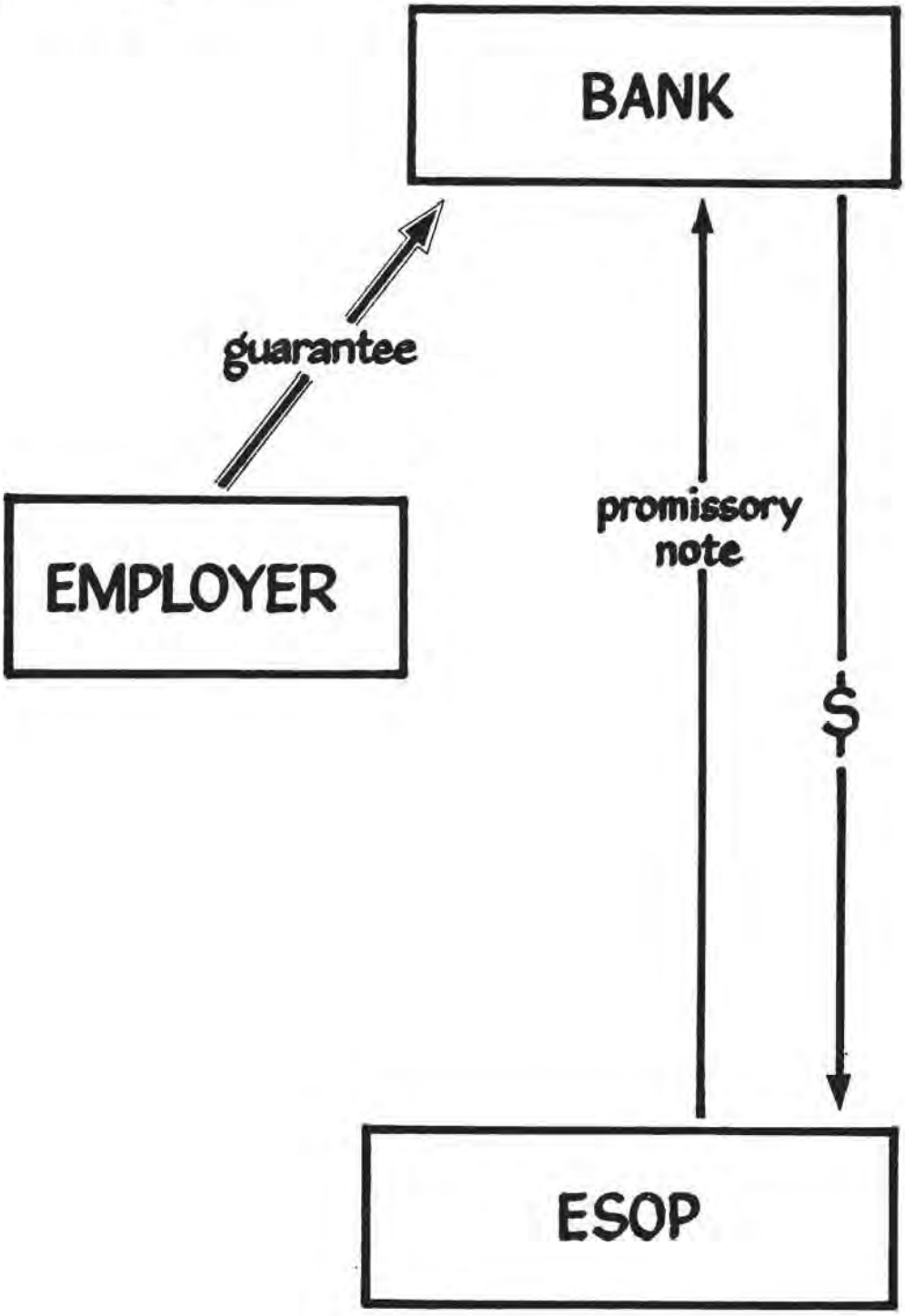
If an employer which does not have an ESOP wishes to borrow money to build a new building, expand production, or for any other reason, the employer would go to a bank to borrow money. When the employer repays the loan, it will also pay interest on the loan, just like an individual person would do with a charge account. Although the interest payments would be tax deductible, the principal payments on the loan would not. This means that the employer would first figure its taxable income, then pay its income taxes, and then make its payment on the loan.

The use of an ESOP for this purpose greatly helps the employer because of the effect it has on the employer's taxes.

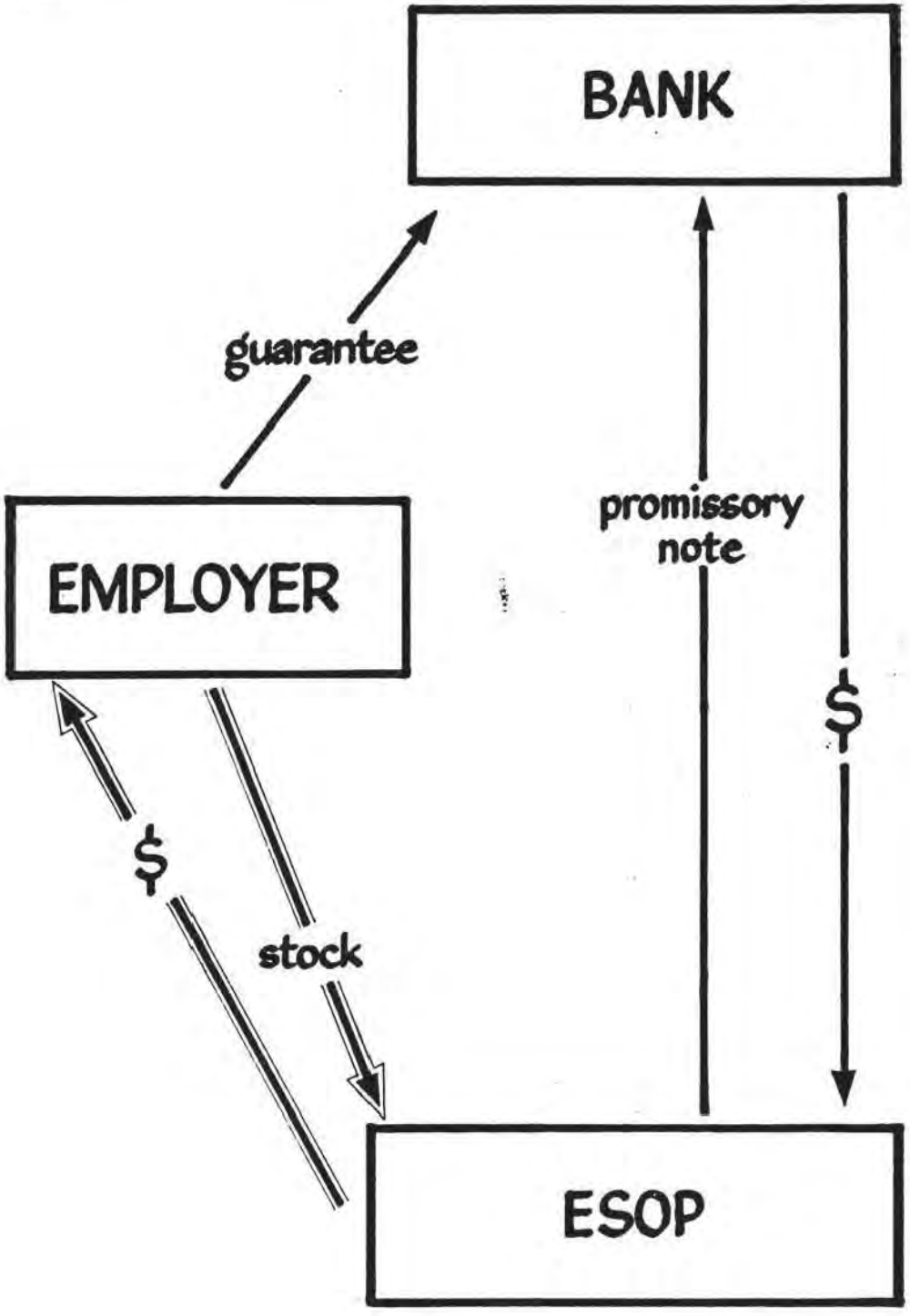
In this situation, the ESOP borrows the money from a bank, and signs a promissory note for the money:



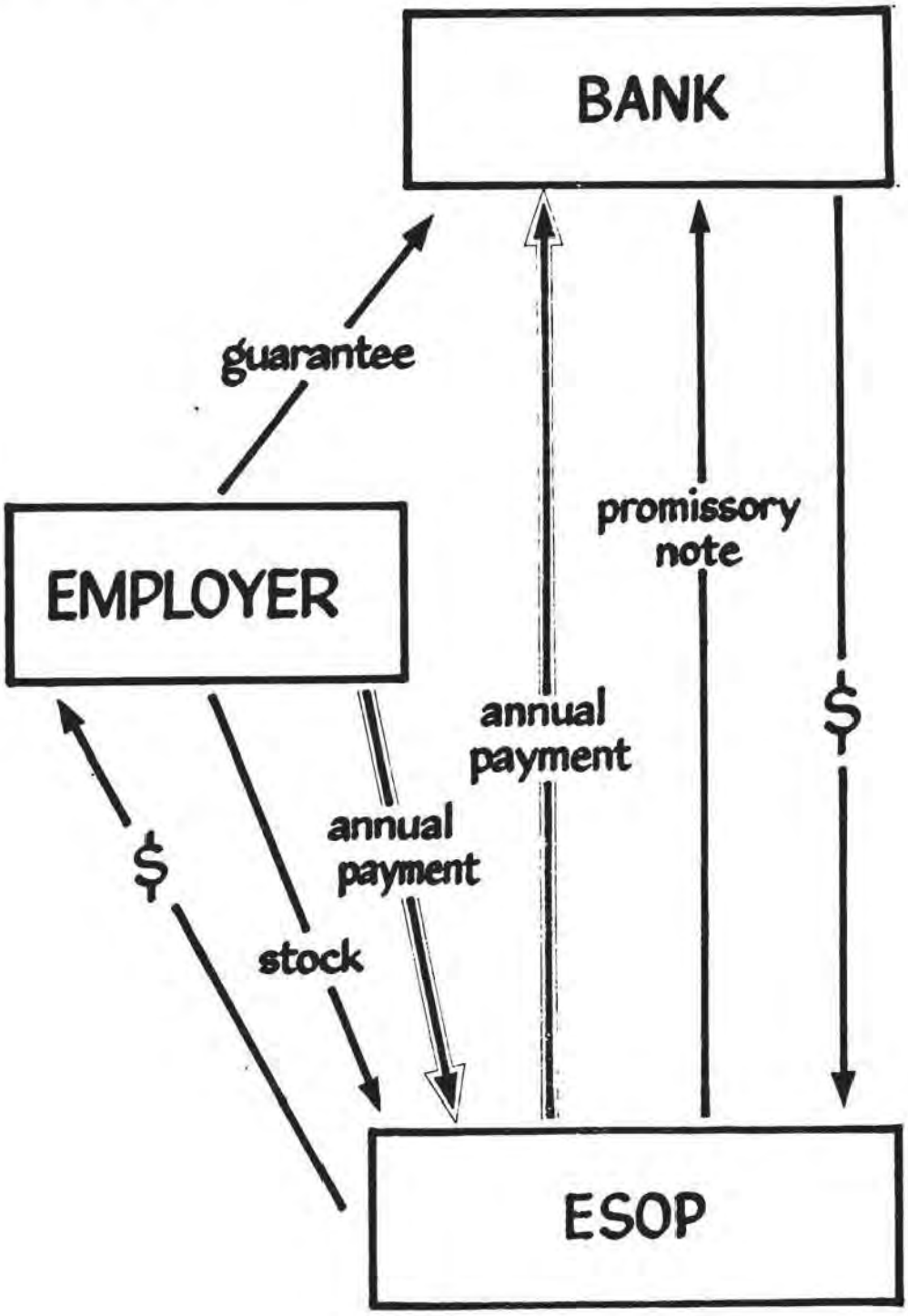
As part of the ESOP loan, the employer gives a written guarantee to the bank, promising that the ESOP will repay the loan and that each year the employer will pay to the ESOP enough money to permit the ESOP to make its annual repayment of the loan:



The ESOP then uses the money from the loan to buy stock from the employer:



Each year, the employer makes a tax-deductible payment to the ESOP, sufficient to let the ESOP make its annual debt repayment to the bank:



The effect of this transaction is to allow the employer to borrow money from a lender and repay the loan with tax-deductible dollars. Since the principal and interest repayments are deducted before the employer's taxable income is determined, the taxable income is lower than through regular borrowing and the employer's taxes are reduced.

Since the major portion of the ESOP assets are used to buy employer stock, the value of each employee's ESOP benefit is directly tied to the financial success of the employer. Also, the employer, as a result of the use of an ESOP, benefits because employees understand that their work performance directly affects the financial success of the employer and the value of ESOP assets. After all, they now own part of the company.

Another benefit to the employer is that the ESOP provides its shareholders with a buyer for their stock if they wish to sell. For stockholders of a small employer, this is a tremendous advantage, and it could also assist the employer in attracting additional investors.

Summary

The adoption of an ESOP provides benefits for the employer, its shareholders and its employees. Our tax laws encourage the establishment and use of ESOPs. Congress has passed five laws in the past 5 years to encourage employers to consider ESOP. Will it continue? Senator Russell B. Long, chairman of the Senate Finance Committee, has repeatedly stated: "Just as in 1862, when Congress passed a law to allow Americans who had very little money to own and develop up to 160 acres of land, we should now give Americans the opportunity to become owners of our growing frontier of new capital (stock). The way to do this is through laws which encourage the development of programs like ESOP."

○

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2d Session

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An Employer Handbook

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EMPLOYEE STOCK OWNERSHIP PLANS

An Employer Handbook

I. INTRODUCTION

This committee publication is intended to serve as a general explanation of employee stock ownership plans for employers, their financial advisors and their attorneys. The term employee stock ownership plan would include both an "ESOP," the employee stock ownership plan described in section 4975(e)(7) of the Internal Revenue Code, and a Tax Credit Employee Stock Ownership Plan (generally referred to as a TRASOP) described in section 409A of the Internal Revenue Code.

An ESOP is an employee benefit plan which also provides indirect benefits for employers and their shareholders. Employees are able to acquire a stock ownership in their employer without the need to invest their own money. In addition, because the ESOP is also a method of corporate finance, the employer is able to generate additional capital through the ESOP for expansion, repaying any indebtedness incurred thereby with tax deductible dollars. Finally, shareholders of closely-held corporations may be provided with a limited market for their stock.

A. What Is An ESOP?

An ESOP is an employee benefit plan which is "qualified" under the Internal Revenue Code. That is, it has been designed to operate in such a way that it satisfies the requirements of the Internal Revenue Code and the income tax regulations. This is important in that employer contributions to a qualified employee benefit plan, such as an ESOP, are tax-deductible to the employer within the limits established by the Internal Revenue Code.

The ESOP is designed to invest primarily in employer stock, and may borrow the funds necessary to purchase employer stock from the employer or its shareholders. Stock purchased by the ESOP is held in trust for employees of the employer, and is distributed to them after their employment with the employer ends and they cease to participate in the ESOP. This means that assets acquired by the ESOP can never be returned to the employer.

B. What Is A TRASOP?

A TRASOP is a form of employee stock ownership plan which was initially created by the Tax Reduction Act of 1975 and the Tax Reform Act of 1976. This is why it was initially referred to as a "TRASOP." In the Revenue Act of 1978, the name was changed to "ESOP." However, this created a great deal of confusion in that the traditional employee stock ownership plan has been referred to as an ESOP. Accordingly, in the Technical Corrections Act of 1979, the name was changed to a "tax credit employee stock ownership plan." However, the Committee recognizes that this type of plan will continue to be known as a TRASOP. An employer adopting a TRASOP receives an additional investment tax credit for contributions to the plan. The

purpose of a TRASOP, building stock ownership into employees, is the same as an ESOP. A TRASOP is subject to the same restrictions and requirements imposed by the Internal Revenue Code on ESOPs and other qualified plans. In addition, the TRASOP is required to satisfy the requirements initially set forth in the Tax Reduction Act of 1975, revised in the Tax Reform Act of 1976, and incorporated into section 409A of the Internal Revenue Code by the Revenue Act of 1978.

C. How Does An ESOP Work?

The ESOP is designed to acquire stock of an employer for the benefit of employees. To do so, the ESOP often borrows money from a bank or other lender (including the employer). The stock is purchased directly from the employer or from shareholders. When the ESOP borrows money, the employer generally guarantees to the lender that the ESOP will repay the loan and that the employer will make annual payments to the ESOP sufficient in amount to permit the ESOP to make its annual payments on the indebtedness.

Because the ESOP is qualified, these annual contributions by the employer are generally tax-deductible. The employer is also permitted to make additional contributions of cash or stock to the ESOP each year, as determined by its board of directors. These contributions would also be tax-deductible, provided they do not exceed the limitations imposed by section 404 of the Code. The ESOP uses the proceeds of the loan to purchase stock of the employer.

D. How Does A TRASOP Work?

A TRASOP is also designed to provide stock ownership for employees; however, it is not designed to borrow money to purchase employer stock. To encourage an employer to transfer its stock to the plan, the Congress has provided an additional 1½ percent investment tax credit for employers which do so, beyond the normal 10 percent investment tax credit for which each employer is eligible. Since the employer receives a tax credit for its TRASOP contributions, they are not also tax-deductible.

E. What Do Employees Receive From An ESOP Or A TRASOP?

All cash and employer stock contributed to the ESOP or TRASOP, and employer stock purchased with cash borrowed by the ESOP or contributed by the employer, is allocated each year to the accounts of all employees who are participating in the ESOP or TRASOP. This allocation is done on the basis of an allocation formula to be explained in this handbook under *Allocation to Employees' ESOP and TRASOP Accounts*. All amounts allocated are held for employees in a trust under the plan. The trust is established under a written trust agreement, and is administered by a trustee who is responsible for protecting the interests of employees (and their beneficiaries).

An ESOP, like most employee benefit plans, is designed to benefit employees who remain with the employer the longest and contribute most to the employer's success. Therefore, an employee's ownership interest in cash and employer stock held in the ESOP is usually based

on his number of years of employment with the employer. The employee's ownership interest in the ESOP is called his "vested benefit," and the provisions in the ESOP which determine his vested benefit are called the "vesting schedule." Although there are many vesting schedules which may be used by an ESOP, most vesting schedules are set up so that the longer an employee stays with the employer, the greater his vested benefit becomes. On the other hand, each employee who participates in a TRASOP is automatically 100 percent vested in all amounts held in the plan for his benefit.

If an employee terminates employment with the employer for any reason other than his retirement, or in some cases his death, his vested benefit under the ESOP will be determined by referring to the vesting schedule and determined by how many years he has worked for the employer. All cash and employer stock in which the employee does not have a vested benefit because he has not worked for the employer for enough years will be treated as a "forfeiture." Forfeitures are usually allocated among the ESOP accounts of the remaining employees on the same basis as employer contribution to the ESOP are allocated. This allocation method is explained later in this handbook under *Allocation to Employees' ESOP and TRASOP Accounts.*

If an employee retires, or in some cases if he dies, his vested benefit in cash and employer stock held for him in the ESOP will be determined without reference to the vesting schedule. Instead, he will have a 100 percent vested benefit in all ESOP assets held for him.

Even though employer stock and cash are usually put into the ESOP or TRASOP for an employee each year, and held in a special account under his name, he will normally not be able to actually receive a distribution of employer stock and cash from the plan until after his employment with the employer terminates and he ceases to be a participant in the plan.

After an employee's participation in the ESOP or TRASOP ends, he (or his beneficiary) will be eligible to receive a distribution of his vested benefit. There are many permissible times and methods for making the distribution to him. For example, an ESOP or TRASOP may provide that distribution will be made as soon as possible after an employee's termination of employment. On the other hand, the plan may require that any distribution be deferred until some later time, such as the normal retirement date set forth in the plan or the employee's death. However, distribution of a former employee's vested benefit under the ESOP or TRASOP must start soon after his death or attainment of age 65. Payment may be made to a former employee (or his beneficiary) in a lump sum, or it may be made in installments.

Distribution of an employee's vested benefit from an ESOP or TRASOP must normally be made in cash or shares of employer stock as determined by the administrator of the plan, subject to the distributee's right to demand a distribution of his or her benefit in stock. This is explained later in this handbook under *Distribution of ESOP and TRASOP Benefits and Stock Repurchases.*

Once a former employee (or his beneficiary) receives a distribution of his shares of employer stock from the plan, they are his property and he can do what he wants with them. He can vote the shares of employer stock at shareholders' meetings, receive any dividends paid on the stock by the employer, and he may keep the stock as long as he wishes.

However, if the stock is closely-held and he wishes to sell or otherwise transfer ownership of the stock to a third party, he *may* be required by the terms of the plan to first offer to sell the stock to the employer and the ESOP or TRASOP. This requirement is called a "right of first refusal." The employer and the ESOP (or TRASOP) can exercise this right and purchase the employer stock at its fair market value before the participant (or his beneficiary) may sell it to a third party. Generally, the price offered by the prospective buyer would establish the fair market value for the stock. The purpose of this right of first refusal is to protect a closely-held employer by preventing the stock from being acquired by outside parties who have no continuing interest in the employer or the ESOP or TRASOP and to protect the employer from violating any Federal law as a result of having its stock sold when it does not satisfy certain government rules. (These rules are explained later in this handbook under *ESOP and TRASOP Problem Areas*).

In addition, at the time the former employee (or his beneficiary) receives closely-held employer stock from the ESOP or TRASOP, he generally must be given a "put" option, the right to demand that the employer buy his shares of employer stock at their fair market value. In such a case, the provisions in the ESOP or TRASOP may provide that the plan may substitute for the employer and exercise a right to buy the employer stock. However, the plan may not be required by its terms to buy the stock under the put option. The purpose for requiring a put option for employer stock in the ESOP or TRASOP is to assure that each former employee (or his beneficiary) will have some available market for his shares of closely-held employer stock if he wishes to sell.

F. How Does An ESOP Or A TRASOP Benefit Shareholders?

Shareholders of closely-held corporations may not have a market for their stock if they wish to sell. This would also be true for the estate of a deceased shareholder. If the shareholder wishes to sell his stock, or if his estate needs to sell his stock to pay estate taxes, the only market for the stock (assuming that the employer had not adopted an ESOP or TRASOP) would be the employer, other shareholders, or some outside party. The problem for the estate could become critical as the time for paying estate taxes approaches. If the other shareholders lack the necessary cash to purchase the stock, the shareholder or his estate would have to sell the stock to the employer. However, a sale of less than all the stock to the employer could create serious problems for the seller unless the "stock redemption" rules of the Internal Revenue Code are satisfied. This is because the proceeds of the sale could be taxed as a dividend (that is, at ordinary income rates) if the stock redemption rules are not met. In addition, the employer might not have the necessary cash to purchase the stock. A repurchase of stock by the employer would have to be made with after-tax dollars and could seriously impede its operations. In such a situation, the stock might have to be sold to an outside party whose interests and objectives might not be consistent with those of the other shareholders and the employees of the company.

The ESOP or TRASOP may resolve these problems. The plan may act as a purchaser for this stock and the ESOP may borrow money to acquire it. Because the ESOP or TRASOP is a legal entity which is

separate from the employer, sales of employer stock to the plan may be made without concern about the Internal Revenue Code s stock redemption rules, provided that the sale is properly structured. This means that the proceeds of the sale in excess of the seller's basis in this stock would be taxed to the seller at capital gains rates rather than as ordinary income. However, it must be pointed out that the selling shareholder or his estate would only be able to sell stock to the ESOP or TRASOP at its "fair market value"; this value is usually determined by an independent evaluation, and might not be as high as the shareholder or his estate think it is. (To sell stock to an ESOP or TRASOP at a price in excess of its fair market value may be treated as a "prohibited transaction" under the Code and the Employee Retirement Income Security Act of 1974, giving rise to excise tax penalties on the proceeds of the sale. It could also result in a determination that the plan is not being operated for the "exclusive benefit" of participants; this could potentially lead to disqualification of the plan under the Internal Revenue Code.) However, within the above limitations, the ESOP or TRASOP does provide a viable market for stock of a closely-held corporation, and in many cases it is the only market for such stock.

G. How Does an ESOP or a TRASOP Benefit Employers?

As a method of corporate finance, the ESOP provides extensive benefits for employers. Its existence as a market for stock in a closely-held corporation could enable the corporation to attract investors who might otherwise not purchase the stock because they normally would encounter difficulty in reselling it. However, it is important to note that the plan may not be obligated in advance to purchase employer stock. In addition, the employer might find that the ESOP or TRASOP serve as strong motivational tools for employees who recognize that they are acquiring an ownership interest in the company. Also, as explained more fully in this handbook under *The* TRASOP. Congress has provided an additional investment tax credit for employers who adopt certain forms of TRASOPs and contribute cash or stock to them. Finally, an ESOP permits the employer to raise capital in a way which carries with it beneficial tax treatment for the principal portion of any debt repayments.

Although it has not been effectively measured, many employers who have adopted an ESOP or TRASOP, and people who have been interested in these plans' motivational effects, feel that the realization by an employee that he has acquired an ownership interest in the company gives him a greater incentive toward his employer. Eventually, data will be developed to measure this phenomenon, but at this time the question of the ESOP's or the TRASOP's motivational value is mostly speculative. However, it has been somewhat documented in recent studies published by the U.S. Department of Commerce and the Department of Labor.

II. THE MECHANICS OF ESOP

A. Qualification Under the Internal Revenue Code

Like all other "qualified" plans, an ESOP must satisfy the requirements of the Internal Revenue Code and the income tax regulations.

That is, the ESOP must be operated under rules regarding eligibility, vesting, and other aspects of the plan which comply with the provisions of the Internal Revenue Code and the requirements of ERISA. In adopting an ESOP, an employer should consult with a professional who is experienced in establishing qualified plans so that the qualification of the ESOP will be assured.

B. Employer and Employee Contributions

1. Employer Contributions

Generally, an employer contribution to an ESOP is entirely within the sole discretion of its Board of Directors. That is, the employer's board of directors must determine the amount of its contribution (by dollar amount, formula or other means) and must notify participants of the amount of the contribution. In addition, the contribution to the plan must be made by the due date for the filing of the employer's Federal income tax return. The contribution may be in cash, company stock, or a combination of both.

However, in the event that the ESOP has borrowed money from a lender and the employer has guaranteed repayment of the loan to the ESOP, the employer's annual contribution to the ESOP generally should not be less than the ESOP's annual debt amortization of the loan (after taking into account dividends on employer stock in the ESOP). Annual dividends on company stock held by the ESOP may be used to pay a portion of the debt, thereby permitting a reduced annual contribution; however, because there can be no assurance as to the amount of the dividend, or even that a dividend will be declared each year, in considering the adoption of an ESOP an employer would be best advised to project an annual contribution to the ESOP in an amount at least equal to the annual ESOP debt payment.

Employer contributions to qualified employee benefit plans, including an ESOP, are tax deductible to the employer within the limitations imposed by section 404 of the Internal Revenue Code, as amended by ERISA.

Section 404(a)(3)(A) of the Internal Revenue Code provides that an employer may contribute to a stock bonus plan ESOP, and claim as a tax deduction, an amount equal to 15 percent of the compensation of participants under the plan for that plan year. In addition, if for any year the employer makes a contribution in an amount less than 15 percent of the compensation of participants under the ESOP, the Code permits the unused deductible amount to be carried forward to succeeding taxable years and to be added to the tax-deductible contribution for those succeeding years so that the employer may contribute, and deduct, an amount not in excess of 25 percent of the compensation of ESOP participants for that taxable year. This carryforward of unused tax-deductible contributions may be done until the unused amount is exhausted.

If the employer maintains an ESOP which consists of a stock bonus plan and a money purchase plan, or if the employer maintains a stock bonus plan ESOP and a separate pension plan, the employer is permitted by Code section 404(a)(7) to contribute, and deduct, up to 25 percent of the covered compensation under the ESOP and pension plan. However, these limitations apply only with regard to employer deductions, and have nothing to do with the limitations on annual allocations to participants' accounts also imposed by the Internal Revenue Code.

Since the ESOP is a qualified defined contribution plan, the employer maintaining the ESOP is subject to the limitations imposed by the Code on the amount which may be allocated to participants' accounts in any year. As stated above, the deduction limitations set forth in the Code may have the effect of imposing an indirect limitation on an employer's annual contribution by establishing a ceiling on the amount of the contribution which may be deducted each year for such a contribution.

The enactment of section 415 of the Code by ERISA imposed a major restriction on the amount of the annual contributions which an employer may make to a qualified plan or plans in any year. The Code now provides that the "annual addition" which may be allocated to the account of a plan participant each year may not exceed the lesser of 25 percent of his covered compensation or $25,000 (adjusted annually for cost-of-living increases). It is important to note that in determining the "annual addition" allocations to a participant's account for a year, the following items must be included: (1) employer contributions to all defined contribution plans in which the employee is a participant, (2) forfeitures and (3) the lesser of (a) one-half of the employee's contributions to the plan or (b) all of the employee's contributions to the plan in excess of 6 percent of his compensation. For example, if an employee earning $100,000 contributed $6,000 to the plan for the year, none of his contributions would be included in the "annual addition." However, if he contributed $10,000 to the plan for the year, $4,000 would be included in the "annual addition" since $4,000 is the lesser of (a) one-half of his contribution ($10,000 divided by 2=$5,000) and (b) his contributions in excess of 6 percent of his compensation ($4,000).

If the employer simultaneously maintains a defined benefit pension plan and a defined contribution plan (including an ESOP or a TRASOP), the section 415(e) limitation still applies. To determine whether the annual allocation to a participant's account is acceptable, section 415(e) applies a formula which adds a defined benefit fraction to a defined contribution (ESOP) fraction, the sum of which cannot exceed 1.4. The defined benefit fraction is: The participant's projected benefit at year end divided by the maximum benefit permitted by ERISA at year end.

This fraction assumes that the participant's compensation for all future years will remain constant. For example, if a participant's projected benefit at year end is $75,000 and the maximum benefit permitted for that employee is $75,000, the defined benefit fraction would be 1.0.

The defined contribution fraction is: The total annual additions to a participant's account through year end divided by the maximum annual additions which could have been made under ERISA.

The defined benefit fraction and defined contribution fraction are added together, and if their total exceeds 1.4, one or more of the employer's plans will be disqualified. It is critical to note that in applying these limitations, all defined contribution plans maintained by an employer are aggregated together, as are all defined benefit plans.

The limiting effect of section 415 of the Code must be recognized. Even though the provisions relating to deductability of employer contributions have the effect of limiting the amount of employer contributions, this is done indirectly. Section 404 only imposes a maximum on the amount of the contribution which may be taken as a tax deduction by the employer in any year; the employer would be free to contribute any additional amounts to the plan which it desired, provided it was not concerned with deducting these additional contributions from its corporate income tax.

In spite of the "chilling effect" the provisions of section 404 would have on the making of additional, nondeductible contributions, the ability to make these contributions continues to exist. However, the section 415 limitations on annual additions specifically preclude the allocation of any employer contributions to a participant's account which, when combined with reallocated forfeitures and in some cases a certain portion of employee contributions in any year, would exceed the maximum limitations established by the Code. This is, of course, extremely important to an employer which is using the ESOP as a financing vehicle and which wishes to borrow the maximum possible amount. If the loan amortization requires an annual ESOP contribution equal to 25 percent of the total covered compensation of all participants (which would be deductible under section 404), the employer might find that, as a result of unexpected forfeitures in a particular year, its contribution might have to be reduced to remain within the limitations on annual additions imposed by the Internal Revenue Code. This might result in an inability of the ESOP to make its full loan amortization in that year. For this reason, when an ESOP is being used as a financing vehicle, the employer might be well advised to project a maximum loan amortization rate, and annual contribution, of no more than 20 percent 22 percent of covered payroll, with the rest of the annual allocation among participants being made up of reallocated forfeitures. In this way, a default in the loan provisions would be unlikely to occur as a result of section 415.

It is important to note that Code section 415(c)(6) permits higher allocation to participants' accounts in ESOPs and TRASOPs, provided that certain requirements imposed by that section are satisfied by the plan.

2. Employee Contributions

In general, the maximum permissible employee contribution to a qualified defined contribution plan under IRS guidelines, including an ESOP, is 6 percent (mandatory) and 10 percent (voluntary) of that

employee's covered compensation. However, the use of employee contributions to acquire company stock in an ESOP raises significant securities law issues which an employer adopting an ESOP should consider in deciding whether to require or permit employee contributions thereto. These are explained more fully in this handbook under *ESOP and TRASOP Problem Areas*. It should also be recognized that employee contributions to ESOPs or TRASOPs are not tax-deductible to the employee.

C. Allocations to Employees' ESOP and TRASOP Accounts

Although a stock bonus plan ESOP is not required to set forth a definite employer contribution formula, it must contain a definite formula for the allocation of employer contributions and forfeitures to participants in the plan. Forfeitures result when a participant terminates service without having a 100 percent nonforfeitable interest in all amounts allocated to his account. An employer has the option of adopting different formulae for the allocation of these amounts, provided that there is no discrimination in favor of officers, shareholders or highly compensated employees (the "prohibited group").

The most prevalent allocation formula, and the one required for TRASOPs, is based upon the relative compensation of each participant for the year. That is, if a participant's compensation is $10,000 and the total compensation of all participating employees is $1,000,000, his account would be credited with 1 percent of all employer contributions (plus forfeitures).

For example, his proportionate allocation of a $100,000 annual employer contribution and a forfeiture reallocation of $50,000 would be $1,000 and $500 respectively. Clearly, this formula results in greater dollar allocations for the more highly compensated participants. However, since it is applied equally to each participant, giving equal credit for each dollar of each individual's annual compensation, this formula is deemed not to be discriminatory. Although other factors may be involved which will produce a discriminatory situation, Code section 401(a)(5) specifically states that "Neither shall a plan be discriminatory . . . merely because the contributions or benefits of or on behalf of the employees under the plan bear a uniform relationship to the total compensation, or basic or regular rate of compensation, of such employees . . . ."

An alternative formula for allocating employer contributions and forfeitures, and the most basic, would be to provide an equal amount for each participant. However, this would not recognize that employee benefit programs, like salaries, are intended to reward the more productive employees.

A major problem arises, however, when the annual addition of contributions and forfeitures to the account of a particular participant in a year exceeds the limitations imposed by section 415 of the Code. In such a case, the allocations to this participant's account must be reduced to the extent necessary to conform to the Code restrictions, with the excess being reallocated among the accounts of the remaining participants pursuant to the allocation formula. If the total allocation of contributions and forfeitures is so large that each participant's proportionate share exceeds the Code limitations, ESOP allocations

for that year must be reduced or the ESOP may be disqualified. It is also possible for forfeitures to be held in a suspense account for as long as one year to avoid exceeding these limitations.

As stated above, the allocation of TRASOP contributions is based upon each participating employee's relative compensation. However, compensation of an employee in excess of $100,000 may not be taken into account for purposes of determining the allocation of employer contributions.

D. Distribution of ESOP and TRASOP Benefits and Stock Repurchases

A participant's rights as to the timing of his distribution will be set forth in the ESOP or TRASOP. For example, the employer may feel it desirable to distribute a participant's benefits as quickly as possible after his termination of service. Generally, this distribution would be delayed until the close of the plan year in which the employee terminated service.

On the other hand, the employer may wish to defer any such distribution. Deferral of distributions is limited by the Code, which requires that, unless the participant elects otherwise, a plan must pay vested benefits to a participant commencing not later than the 60th day after the latest of the close of the plan year (a) in which the participant attains the earlier of age 65 or the plan's specified normal retirement age, (b) of the 10th anniversary of the year in which the participant commenced participation in the plan, or (c) in which the participant terminates service with the employer.

Even though an employer may defer the distribution of benefits to a terminated participant until the latest of the above dates, the employer may well wish to make distribution at the earliest date. This is because the plan administrator will be required to maintain a constant record of the location of a terminated participant and comply with ERISA reporting and disclosure requirements in order to make distribution of the participant's vested interest at the deferred date. It is no longer permissible for a participant's vested interest to be deemed forfeited merely because he cannot be located. For this reason, the employer may decide to avoid the time and expense required on the part of the plan administrator to maintain these records. In determining when to permit distribution of benefits after a participant terminates service with his employer, the employer must balance a desire to reduce these recordkeeping requirements with a desire to prevent having an employee leave in order to receive a distribution of his benefits.

In addition, an employer may be required to provide a market for any closely held stock distributed to a participant; it may also be desired that the plan actually make the repurchase. However, if all employer contributions are currently being used by the plan to amortize any indebtedness incurred to acquire employer stock, there may not be sufficient cash flow for the employer or the plan to repurchase distributed stock. Accordingly, it may be desirable to defer distributions from the plan.

The way in which a participant's vested benefit may be distributed to him from an ESOP depends upon the form of ESOP which the employer has adopted. If the plan has been designated as an ESOP and meets the requirements of the Treasury regulations, or if the

ESOP has been leveraged, or if the employer maintains a TRASOP, the participant's benefit may be distributed to him (or his beneficiary) in cash or employer stock, as determined by the terms of the plan. However, this is subject to the right of the distributee to demand that the distribution be in shares of employer stock. This right to demand a distribution of employer stock instead of cash must be communicated in writing to the participant (or his beneficiary) before the plan may elect to distribute cash. If the ESOP which the employer has adopted merely consists of a stock bonus plan, which is not intended to be leveraged and which is not an ESOP within the meaning of the Treasury regulations, the participant's benefit distribution may be subject to the rules which have traditionally been applicable to stock bonus plans. That is, the benefit must be distributable in as many whole shares of employer stock as possible, with the value of any fractional shares being distributable in cash.

Any distributee of a benefit consisting of closely-held employer stock from an ESOP or a TRASOP generally must be given a "put option" on the shares of employer stock distributed to him. That is, he must have the right to demand that these shares of employer stock be repurchased from him. The Treasury regulations on leveraged ESOPs and TRASOPs require that if the employer is precluded by law from repurchasing its own shares of stock (for example, a bank), the put option must be to a third party. The Senate Committee on Finance Report on the Revenue Act of 1978 specifically established the following terms which are applicable to any such put option:

1. Upon receipt of the employer stock, the distributee must have up to six months to require that the employer repurchase this stock, at its then fair market value. Although the obligation to repurchase stock under the put option would apply to the employer, not the ESOP or the TRASOP, it is permissible for the ESOP or TRASOP to actually make the purchase in lieu of the employer. If the distributee does not exercise the put option within the six-month period, the option will temporarily lapse.

2. After the close of the employer's taxable year in which the temporary lapse of a distributee's put option occurs, and following a determination of the value of the employer stock (determined in accordance with Treasury regulations) as of the end of that taxable year, the employer will notify each distributee who did not exercise the initial put option in the preceding year of the value of the employer stock. Each such distributee will then have up to three months to require that the employer repurchase his or her shares of employer stock. If the distributee does not exercise this put option, then the employer stock will not be subject to a put option in the future.

3. At the option of the party repurchasing employer stock under the put option, such stock may be repurchased on an installment basis over a period of five years. If the distributee agrees, the repurchase period may be extended to a period of ten years. As security for the installment repurchase, the seller must at least be given a promissory note, the full payment of which could be required by the seller if the repurchaser defaults in the payments of a scheduled installment payment. In addition, if the term of the installment obligation exceeds five years, the employee must be given adequate security for the outstanding amount of the note.

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4. Because a distributee might wish to transfer the ESOP or TRASOP distribution to an IRA in a "tax-free" rollover and because the rollover would have to be made before the expiration of the first six-month put option period, the IRA trustee must be able to exercise the same put option as the actual distributee.

A participant may receive his ESOP or TRASOP benefit in a lump-sum distribution during a single taxable year or in several annual installments. In addition, the TRASOP is subject to an additional restriction in that except in the case of death, retirement, or termination of service, no participant may receive a distribution of any amounts earlier than 84 months following the date it was contributed to the plan. An additional exception to the 84-month limitation would be for dividends paid on employer stock in the TRASOP; these dividends may be distributed to participants in the year they are received by the TRASOP. The major effect of these distribution methods will be discussed later in this handbook under *Taxation of ESOP and TRASOP Benefits.*

E. Voting Rights on ESOPs and TRASOPs

Prior to the enactment of the Revenue Act of 1978, only a TRASOP was required to provide voting rights for employees on employer stock held by the plan. However, the 1978 Act greatly modified this situation.

The Act continued the rule that, for all publicly-traded employer stock acquired by a TRASOP, employees must be entitled to direct the trustee as to the voting of this employer stock on all corporate issues. In addition, the Revenue Act (as revised by the Technical Corrections Act of 1979) specified that this rule would be applicable for publicly-traded employer stock acquired by a leveraged ESOP for taxable years beginning after December 31, 1979.

It was with regard to voting rights on closely-held employer stock held by qualified plans, however, that the Revenue Act of 1978 made its most significant changes. For all closely-held employer stock acquired after December 31, 1979 by a qualified defined contribution plan (ESOP, stock bonus plan, money purchase pension plan, profit sharing plan) which invests more than 10 percent of its assets in such stock, employees must be entitled to direct the trustee as to the voting of such stock on all corporate issues on which State law (or corporate charter) requires *more* than a majority vote.

These same rules are applicable for closely-held employer stock acquired by a TRASOP for taxable years beginning after December 31, 1978.

In the Committee on Finance report on the Revenue Act of 1978, it was mandated that the Treasury Department, working with the Department of Labor, congressional staffs and representatives of private business, conduct a study on voting rights and financial disclosure on employer stock and report to the Congress. Until the study is completed and reviewed by Congress, it is likely that the entire issue of voting rights will be in transition.

F. Use of Dividends On Employer Stock

If an employer which adopts an ESOP or TRASOP pays dividends on its stock, then the shares of stock held in the plan must likewise receive dividends. Rather than being a burden, however, this may prove

a strong motivational effect to employees; the receipt by participants of dividends each year on the employer stock in the ESOP or TRASOP provides an annual reminder of their ownership in the employer. For this reason, an employer which has not paid dividends on its stock in the past may decide to do so in the future. Clearly, the ESOP or TRASOP will best benefit the employer and employee if they recognize their commonality of purpose.

Dividends paid on ESOP or TRASOP stock may be used in several ways. These amounts may be allocated to each participant's account, based on the number of shares held in the account. On the other hand, dividends on stock acquired with indebtedness may be used by the ESOP as additional amounts to amortize that indebtedness. Of course, since a TRASOP may not borrow funds to acquire employer stock, dividends on stock held in such a plan would not be used to repay any indebtedness; rather, they would be distributed to participants or allocated to their accounts. Finally, as provided in the Tax Reform Act of 1976, dividends paid on employer stock to an ESOP or TRASOP may be "passed through" the plan and paid to participants, based upon the number of shares of employer stock held in their accounts.

If the dividends are allocated to each participant's account in the ESOP or TRASOP and retained there, the participant will have no current tax liability. The amounts will simply be held and distributed to him along with his other ESOP or TRASOP benefits; at that time the participant will incur an income tax liability as explained later in this handbook under *Taxation of ESOP and TRASOP benefits.*

If dividends are used to amortize ESOP indebtedness, a proportionate amount of employer stock will be allocated to each participant's account, again based upon the number of shares in his account. The tax effect for the participant of the use of dividends in this way will be the same as if the dividends were retained in the ESOP and allocated to participants' accounts.

A participant will be taxed currently at ordinary income rates on any dividends which are "passed through" the ESOP or TRASOP and paid directly to him. In effect, these amounts will constitute extra remuneration to him each year; theoretically, these should make the participant more aware of his ownership in the employer and in the success of the company, since the size of the dividend will be a direct reflection of the employer's profitability.

G. Taxation of ESOP And TRASOP Benefits

When a terminated participant, or his beneficiary, receives a distribution of ESOP or TRASOP benefits, various Federal income tax results may occur. Section 402(a)(1) of the Code provides that, with certain exceptions, a distributee from a qualified employee benefit plan is taxable on the total distribution to him in the year when it is made. However, it is important to recognize that a participant will not be taxed on any distributed amounts which constitute his contributions to the plan. In addition, Code sections 402(a)(2), 402(e), and 2039(f) create cer ain exceptions for lump-sum distributions from qualified plans.

The actual determination of a participant's tax liability as a result of his distribution from an ESOP, TRASOP, or other qualified plan,

is done as a series of factual and mathematical determinations, the first of which is to determine whether it qualifies as a lump-sum distribution and to determine which portion of the distribution is taxable. Pursuant to section 402(e) of the Internal Revenue Code, as amended by ERISA, if a terminated participant receives a distribution of his total ESOP or TRASOP benefits in a single taxable year, as a result of his death, disability, termination of service or attainment of age 59½, it will generally be treated as a lump-sum distribution; his Federal income tax liability on the shares of employer stock distributed to him by the ESOP or TRASOP will be based upon the original cost of the shares to the plan (or their market value at the time of distribution, if lower). That is, the amount of the distribution which is subject to Federal income tax will not include any increase in the value of employer stock while held by the plan. In addition, it will not include the value of any employee contributions to the ESOP or TRASOP.

The balance of the distribution will be taxable to the terminated participant (or his beneficiary). However, a portion of that distribution may be taxable at capital gains rates. This is determined by multiplying the amount of the taxable distribution by a fraction, the numerator of which is the participant's total number of calendar years of participation in the ESOP (or a plan which was amended into the ESOP) prior to 1974 and the denominator of which is his total years of plan participation. This portion will be taxable to the participant as long term capital gain. However, the participant may elect to treat the entire distribution as if it represented post-1973 employer contributions.

Although the remainder of the taxable distribution will be treated as ordinary income, the participant may be eligible for a special ten-year averaging method on this income. This averaging is permitted only for a lump-sum distribution following death or after the individual has been an ESOP or TRASOP participant (including participation in a plan which was amended into the ESOP) for at least five years prior to the distribution year. The election for the special ten-year averaging method is made by filing IRS Form 4972 with the participant's federal income tax return, for the year in which the distribution is made.

If the participant receives his ESOP or TRASOP distribution in more than a single taxable year or if it otherwise fails to qualify as a lump-sum distribution under section 402(e) of the Internal Revenue Code, the entire distribution will be taxed entirely at ordinary income rates, based upon the market value of the shares of employer stock at the time of distribution, and will not be eligible for the special ten-year averaging method.

The participant whose distribution qualifies for lump-sum treatment under section 402(e) will not recognize any taxable gain on the unrealized appreciation in value of his shares of employer stock until he sells the shares, either to the ESOP or TRASOP or the company pursuant to their "right of first refusal" or his "put" option, or to a third party. At that time, all appreciation in the value of the shares while in the ESOP or TRASOP will be taxable to him at long-term capital gain rates. Any appreciation in the value of the shares while they are in his possession will be taxable to him at capital gain rates, but the issue of whether the gain will be long or short term is based

solely upon whether he holds the shares for a long enough period following distribution.

If a participant dies and his ESOP or TRASOP benefits are distributed to his designated beneficiary or his estate, $5,000 of the distribution may be excluded from the recipient's gross income, pursuant to section 101(b) of the Internal Revenue Code. In addition, if the entire distribution is paid to a participant's beneficiary in a single year and the distributee agrees in writing not to treat the distribution as a lump-sum distribution, the amount of the distribution will be excluded from the participant's taxable estate under section 2039(c) of the Internal Revenue Code. Finally, the participant may elect to roll over a part or all of his ESOP or TRASOP benefit to an individual retirement account (IRA), thereby deferring any taxability on the amount rolled over to the IRA until it is ultimately distributed to the participant (or beneficiary).

III. THE TRASOP

In the Tax Reduction Act of 1975, Congress created a new form of employee stock ownership plan, the "TRASOP." The Act provided that an employer which adopted a TRASOP and contributed to it an equivalent amount of stock, or cash used to acquire stock, would be eligible for an additional investment tax credit equal to 1 percent of its qualified capital investment each year. In the Tax Reform Act of 1976, Congress increased this additional investment tax credit to 1½ percent and extended its life through 1980, provided that the employer makes a TRASOP contribution equal to the additional ½ percent credit amount and provided that the employees contribute an additional amount equal to the ½ percent credit. By adopting and fully funding a TRASOP, an employer would be eligible for an 11½ percent investment tax credit instead of 10 percent. In the Revenue Act of 1978, the provision for the 1½ percent additional investment tax credit was made a part of the Internal Revenue Code (formerly it was only contained in the Tax Reduction Act of 1975, as amended by the Tax Reform Act of 1976) and its life was extended through 1983. Also, in the Revenue Act of 1978, the Congress also provided that this additional investment tax credit is not subject to any minimum tax. In addition, as explained earlier in this handbook, the Revenue Act of 1978 changed the name of the TRASOP, causing a great deal of confusion. The Technical Corrections Act of 1979 changed the name, hopefully for the last time, to "Tax Credit Employee Stock Ownership Plan."

As a result of the changes made by the Revenue Act of 1978, a TRASOP is required to be a "qualified" plan; this means that it must satisfy the Internal Revenue Code requirements which are applicable to all qualified plans. In addition, it must meet other tests which were set forth in the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the Revenue Act of 1978 (which are now contained in sections 409A and 48 of the Internal Revenue Code). Some of these additional requirements, such as employee voting rights on employer stock, have been explained elsewhere in this handbook. However, for ease of reference, they will be discussed in this section as well.

As stated above, the Revenue Act of 1978 mandated that the TRASOP be a qualified plan. However, because of the unique relationship between the plan and the investment tax credit, these plans are exempted from the traditional requirement that they be established by the last day of the employer's taxable year to be qualified for that first year. Because an employer may not know the actual amount of its investment tax credit for as long as eight and one-half months following the close of its taxable year, Congress felt that it would be a hardship to require that the plan be established for such a long period prior to its funding date. Accordingly, section 409A of the Internal Revenue Code specifically states that a TRASOP will be qualified for its initial year provided that it is established by the due date (including extensions) for the filing of the employer's Federal income tax return for that year.

Unlike other qualified plans, which may adopt various vesting schedules to determine when a participant has a 100 percent nonforfeitable interest in all amounts held in the plan for him, the TRASOP must provide each participant with an immediate, 100 percent nonforfeitable interest in his account. For employer stock acquired by a TRASOP for taxable years prior to December 31, 1978, this vested benefit may be reduced if the employer recaptures any portion of its investment tax credit. However, the Revenue Act of 1978 provided that for employer stock acquired for future taxable years, no withdrawal of prior contributions is permitted; this means that each employee will always be 100 percent vested in his account in the plan. As in the past, an employer will be able to take a tax deduction for any recaptured investment tax credit (for which no withdrawal from the plan is permitted) or reduce future plan contributions by the amount of the recapture.

Prior to the passage of the Revenue Act of 1978, each employee participating in the TRASOP was required to receive an allocation of the employer's contribution each year, irrespective of whether the employee was employed on the last day of the plan year. Congress recognized that this created an administrative problem for the employer since many employees would leave during the year and still be eligible for a share of the employer's contribution. Accordingly, by making these plans qualified, Congress deleted this problem, allowing these plans to establish the same participation requirements as other qualified plans, such as the requirement that a participant actually be an employee as of the last day of the plan year in order to receive an allocation of the employer's contribution. Any such allocations would be based upon the employee's compensation while he was actually employed, rather than while he was actually participating in the TRASOP, in any year. Of course, like other qualified plans, the TRASOP must satisfy the eligibility, nondiscrimination and coverage tests set forth in the Internal Revenue Code.

The Revenue Act of 1978 expanded the availability of TRASOPs to subsidiary corporations. Prior to its passage, a parent had to own 80 percent of a subsidiary before the subsidiary's employee could be covered under the parent's plan and receive an allocation of the parent's stock. The Revenue Act reduced this ownership requirement to 50 percent for first tier subsidiaries (it remains 80 percent for second

tier and lower tier subsidiaries). In addition, the Act guaranteed that a subsidiary (including a 50 percent first tier subsidiary) will not recognize gain from the contribution of its parent corporation's stock to the plan for its employees. It is important to note, however, that the 80 percent standard will continue to be applied for all other purposes of determining the plan's qualified status or possible discrimination.

All TRASOP participants are required to be able to direct the trustee to certain degrees regarding the voting of employer stock held for them in the plan. As explained in this handbook under *Voting Rights On ESOP and TRASOP Stock*, if an employer sponsoring the TRASOP is publicly-traded, participants must be permitted to vote stock held in the plan on all corporate issues. However, if the employer stock is closely-held, the participants must be entitled to vote employer stock acquired for taxable years after December 31, 1979 (December 31, 1978 in the case of a *TRASOP*), on all corporate issues which, by State law or corporate charter, require the affirmative vote of more than a majority of outstanding shares. Traditionally, these would be issues such as corporate mergers, acquisitions, or disposal of substantially all of the employer's assets. As yet, the mechanics for the pass-through of this vote have not been determined.

A major problem area for TRASOPs has been the lack of guidelines regarding the timing of employer and employee contributions for the additional ½ percent investment tax credit. (Employer contributions for the 1 percent additional investment tax credit were required to be made by the filing date for the employer's Federal income tax return for a particular year.) This lack of guidance has presented a major impediment to the use of the additional ½ percent investment tax credit by employers.

The Revenue Act of 1978, as amended by the Technical Corrections Act of 1979, resolved that problem by providing that employees may have up to two years following the close of an employer's taxable year to make their ½ percent tax credit amount contributions to the plan and that the employer's matching contributions will be made as the employees make theirs. In this way, the problem which resulted when employees failed to make the full ½ percent contribution and the employer had to withdraw an already-contributed one-half percent amount (or portion thereof) from the plan because the additional tax credit was deemed to be recaptured is resolved. This change was also necessary because Congress removed the ability of the employer to withdraw prior contributions from the plan if a portion of the investment tax credit is recaptured.

Unlike most qualified plans, a TRASOP may not be integrated with Social Security. This means that participants' benefits may not be reduced by the amount of any Social Security taxes paid by the employer.

A TRASOP is subject to the same rules as an ESOP regarding distribution of benefits to participants (or beneficiaries), with the single difference that, except in the case of dividends or a participant's death, retirement or termination of service, no distribution of benefits may be made by the *TRASOP* prior to 84 months following the date of contribution by the employer. These rules are explained earlier in this handbook under *Distribution of ESOP and TRASOP Benefits and Stock Repurchases*. Like an ESOP, a TRASOP may at times dis-

tribute a participant's interest in cash instead of employer stock and, if the employer stock is closely-held, it will be subject to a "put option" by the participant (or beneficiary) and may be subject to a right of first refusal on the part of the plan or the employer. Publicly-traded employer stock, however, is not subject to a "put option" or right of first refusal. Finally, the tax results of a TRASOP distribution for the participant (or beneficiary) are the same as an ESOP distribution, as explained earlier in this handbook under *Taxation of ESOP and TRASOP Benefits.*

IV. ESOP AS A FINANCING TECHNIQUE

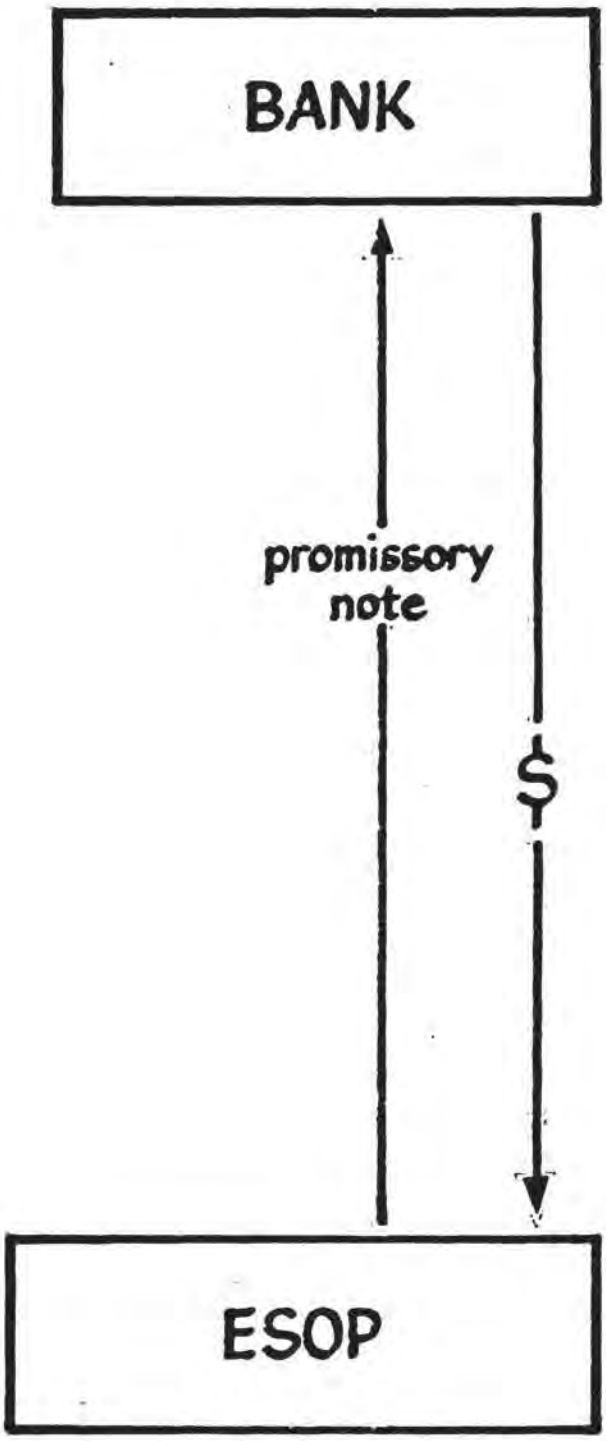
A. Basic ESOP Financing Model

Congress has clearly recognized ESOP as a corporate financing vehicle, in addition to its status as an employee benefit plan. Also, in ERISA Congress provided that an ESOP is the only qualified employee plan which may debt finance its acquisitions of employer stock through an extension of credit by a party in interest. The primary purpose for defining ESOP, under ERISA section 407(d)(6) and Code section 4975(e)(7), was to provide ESOPs with the special debt financing exemption from the general prohibited transaction rules under ERISA section 406 and Code section 4975.

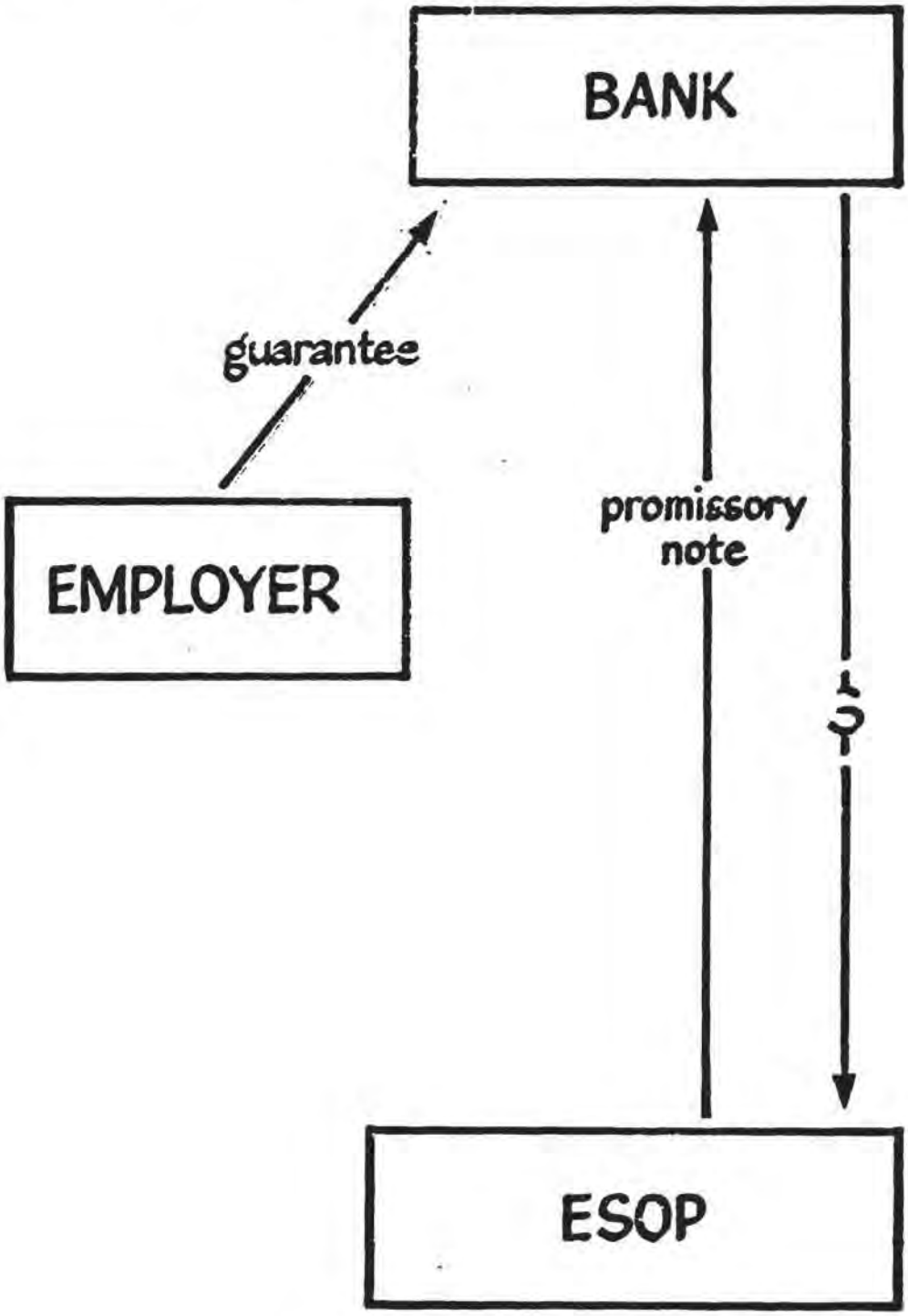
Under the Trade Act of 1974 and the Tax Reduction Act of 1975, the Senate Finance Committee specifically defined ESOP as a technique of corporate finance, utilizing a stock bonus plan (which may be combined with a money purchase pension plan) qualified under Code section 401(a), designed to invest primarily in qualifying employer securities, and further designed: (i) to meet general financing requirements of the corporation, including capital growth and transfers in the ownership of corporate stock; (ii) to build into employees beneficial ownership of stock of their employer or its affiliated corporations, substantially in proportion to their relative incomes, without requiring any cash outlay, any reduction in pay or other employee benefits, or the surrender of any other rights on the part of such employees; and (iii) to receive loans or other forms of credit to acquire stock of the employer corporation or its affiliated corporations, with such loans and credit secured primarily by a legally binding commitment from the employer to make future payments to the trust in amounts sufficient to enable such loans to be repaid.

As a technique of corporate finance, an ESOP may utilize the credit of the employer corporation for the purpose of debt financing its acquisitions of employer stock, thereby allowing the employer to finance its capital growth and transfers in the ownership of its stock with pre-tax corporate dollars, while building ownership interests into its employees. The use of ESOP financing of new capital generally involves a loan from an outside lender to finance corporate expansion The typical transaction is often structured as illustrated in the following diagrams:

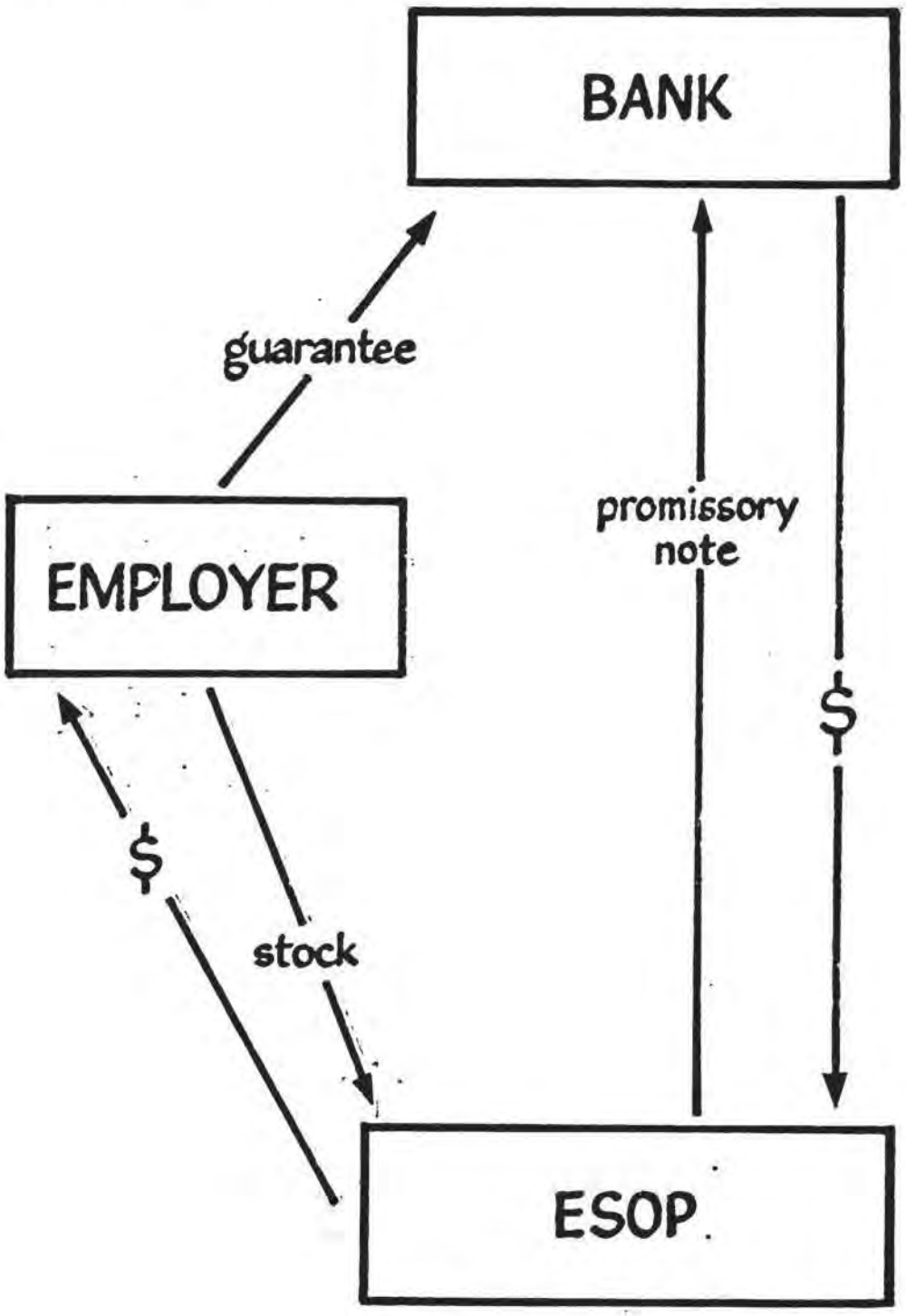
In this situation, the ESOP borrows the money from a bank, and signs a promissory note for the money:



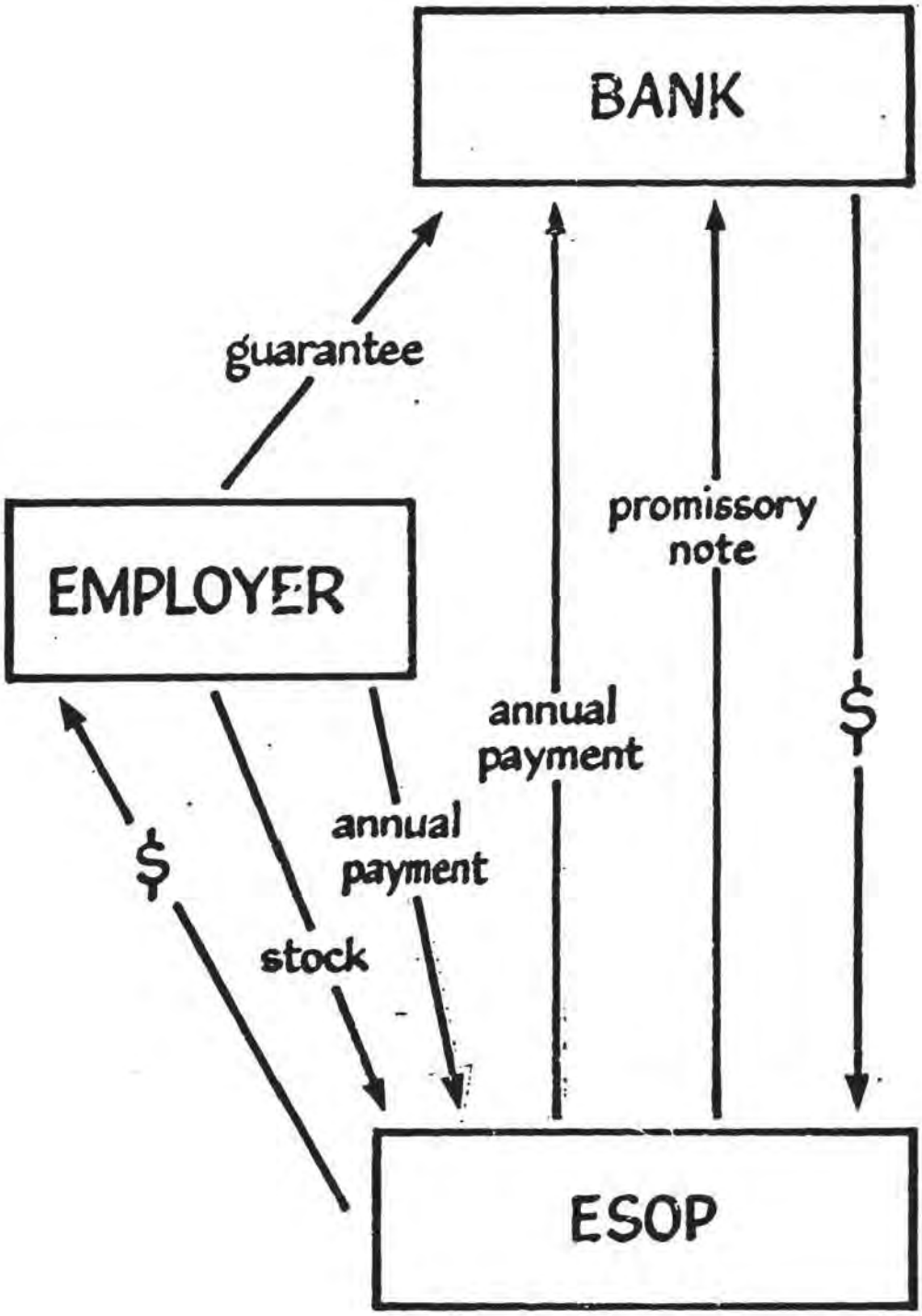
As part of the ESOP loan, the employer gives a written guarantee to the bank, promising that the ESOP will repay the loan and that each year the employer will pay to the ESOP enough money to permit the ESOP to make its annual repayment of the loan:



The ESOP then uses the money from the loan to buy stock from the employer:



Each year, the employer makes a tax-deductible payment to the ESOP, sufficient to let the ESOP make its annual debt repayment to the bank:



Through this technique of ESOP financing, non-recourse corporate credit has been extended to acquire employer stock for the benefit of employees, while enabling the corporation to finance its capital requirements with pre-tax dollars. In economic terms, it is the earnings generated by the underlying capital which are used to repay the acquisition indebtedness (of the ESOP) incurred for financing new capital. ESOP financing builds beneficial ownership of employer stock into employees, on a tax-deferred basis, without any personal financial risk by the employees and without requiring any reduction in their take-home pay.

B. Other Applications of ESOP Financing

The use of ESOP financing applies not only to the financing of new corporate capital for expansion purposes. With the consent of the lender, existing corporate debt may be refinanced through the ESOP, so that it is repayable (both principal and interest) with pre-tax corporate dollars. An existing corporate debt may be assumed by the ESOP, with the debt repayment guaranteed by the employer corporation. In such a case, the corporation will issue new shares of its stock to the ESOP equal in value to the principal amount of debt transferred to the ESOP. In addition, the new shares may be pledged as collateral to the lender, or specific corporate assets may be pledged as additional security for the loan. As the ESOP loan is repaid to the lender through annual employer contributions (or dividends on employer stock) received by the ESOP, shares of stock are allocated to accounts of participating employees. From the lender's standpoint, the debt should be more secure since repayments are made with pre-tax corporate dollars.

ESOP financing may also be used to finance acquisitions of other corporations. Loans may be secured from outside lenders to raise cash for financing the acquisition. The employees of the acquired corporation may be included as participants in the ESOP to provide a larger payroll base on which to make tax-deductible contributions to the ESOP to repay the debt. In addition, the pre-tax earnings of the acquired corporation are available for debt repayment.

ESOP financing provides an alternative for raising capital to closely-held corporations which are unable or unwilling to raise capital through a public offering of stock. The costs of a public underwriting (including SEC registration) and the expenses of operating as a publicly-traded company may be avoided through the alternative of ESOP financing. In addition, it may be preferable to existing owners and management to build ownership interests into employees of the corporation, rather than to create ownership by outsiders. For corporations which are already publicly-traded, the ESOP provides an alternative to the costs (and underwriting discounts) of a secondary offering of securities.

C. ESOP Financing of Transfers of Ownership

ESOP financing may also be used for the acquisition of employer stock from existing shareholders. Purchases of stock from existing shareholders may be financed through loans from outside lenders to the

ESOP or through loans to the ESOP directly from the employer corporation. Alternatively, the sale of employer stock to an ESOP by an existing shareholder may be effected through a cash (non-financed) transaction, or on an installment basis.

From the corporation's standpoint, a sale of stock to an ESOP by a shareholder enables pre-tax corporate dollars to finance the transaction, as compared to the use of after-tax dollars being used to finance a stock redemption by the corporation. More significant, however, may be the fact that a sale of stock to an ESOP would be treated as a sale to a third party other than the employer and may allow the selling shareholder to treat any gain on the sale as a capital gain, without being subject to the restrictions on corporate redemptions under Code section 302. That is, a sale of stock to an ESOP will not generally be treated as a sale to the corporation which may result in dividend treatment to the shareholder. However, an individual who is considering the sale of employer stock to an ESOP may wish to secure an advance ruling from the Internal Revenue Service so as to ensure capital gains treatment on the proceeds of the sale. In such a case, it would be necessary to satisfy the requirements of Revenue Procedure 77-30, Revenue Procedure 78-18 and Revenue Procedure 78-23.

The use of an ESOP for financing transfers of ownership of corporate stock has bread applications in corporate tax and financial planning, as well as in estate planning for major shareholders of corporations. The ESOP creates an "in-house" market for corporate stock, which may be available to acquire stock offered for sale by existing shareholders during their lifetime, upon their retirement from the business, or in the event of death.

A typical situation may involve a corporation which desires to establish an ESOP for building employee ownership, while at the same time allowing shareholders of non-publicly-traded stock to diversify their personal investments by selling a portion of their stock to the ESOP. An existing shareholder may generally treat any gain on the sale of stock to an ESOP as capital gain, whether he sells all or a part of his stock interest. A lifetime redemption through a sale of stock to the corporation directly will generally be treated as an exchange (rather than as a dividend distribution) only if the redemption is not essentially equivalent to a dividend, or is substantially disproportionate, or results in a termination of a shareholder's interest, under the provisions of Code section 302(b). Many private rulings from the Internal Revenue Service have concluded that a properly structured sale of employer stock by a shareholder to an ESOP (or to any qualified employees' plan) is not a redemption of the stock by the corporation, and therefore produces capital gain tax treatment on the sale proceeds.

Also, upon the death of a major shareholder, the ESOP may acquire all, or a portion, of his stock in the corporation from his estate, without being subject to the redemption limitations under Code sections 302 and 303. This use of an ESOP should permit the estate (and heirs) of the deceased shareholder to retain an ownership interest in the corporation, without the attribution rules of section 318 restricting the degree to which they may achieve diversification of investments.

In addition, an ESOP which has been in operation for several years will generally have had annual evaluations of the fair market value of its stock for purposes of sales of stock to the plan and annual reporting. This would also provide a basis for determining the value of the stock in a closely-held corporation for estate tax purposes, thereby providing greater certainty in estate planning for the major shareholders of the corporation.

An ESOP also provides an effective vehicle for financing the transfer of ownership from a retiring major shareholder to the employees of the corporation. It may be that the employees as a group are the logical successors in ownership, and it may prove difficult for the remaining employees (or the management group) to finance the purchase with personal after-tax dollars. An ESOP allows all employees to acquire ownership interests, with the purchase financed with future pre-tax earnings of the corporation, where employee interests are provided on a tax-deferred basis. In order to finance the acquisition, the ESOP may receive loans from an outside lender, from the corporation, or a portion of the purchase price may be paid to the selling shareholder on an installment basis by the ESOP.

ESOP financing may likewise be used in the divestiture of a corporate division or subsidiary to its employees. The stock of a subsidiary, or the stock of a new corporation established to acquire the business and assets of the division or subsidiary, may be sold to an ESOP. The ESOP may finance the purchase price with third-party loans or through an installment purchase. Any debt financing may be guaranteed, if necessary, by the transferor corporation as well as by the transferee corporation.

ESOP financing is also available to a publicly-traded company which desires to acquire stock for the benefit of its employees and to restrict (or even eliminate) public trading of its stock. However, the entire "going private" issue is extremely complex and an employer should consult experts in the securities law field before attempting to utilize an ESOP for this purpose. In such a case, the ESOP could make a tender offer for all or a portion of the employer's outstanding shares, financing the purchase price through loans from outside lenders or directly from the corporation. The objective of building employee ownership through an ESOP may well provide a valid business purpose for the use of corporate funds for "going private." Again, it is future pre-tax earnings of the corporation which will be available to finance the acquisition of its stock for the benefit of its employees.

D. Non-Financed Acquisitions of Employer Stock

In addition to the use of debt financing for the acquisition of employer stock, an ESOP may be utilized to provide employee ownership on a non-leveraged basis. In such a situation, it would function as a traditional stock bonus plan. Cash contributions to the plan or other eligible individual account plan may be used to acquire employer stock from existing shareholders by cash purchases on an annual basis. In addition, the ESOP may function as a conventional stock bonus plan which annually receives direct contributions of employer stock from the employer corporation. Direct stock contributions by the employer will result in tax deductions under Code section 404(a) (without any cash outlay) equal to the fair market value of the stock as of the date of the contribution.

V. FIDUCIARY RESPONSIBILITY

A. General Requirements Under The Employee Retirement Income Security Act of 1974

Like all qualified plans, an ESOP is subject to the fiduciary responsibility provisions of ERISA and the "exclusive benefit of employees" requirement under the Code. Specifically, the ESOP must satisfy the requirements of ERISA section 404(a)(1), which imposes upon fiduciaries the standard of discharging their duties under the plan ". . . solely in the interest of the participants . . . and for the exclusive purpose of providing benefits to participants. . . ." In addition, the "prudent man" standard of ERISA section 404(a)(1)(B) is applicable to ESOP fiduciaries, and the ESOP loan and stock purchase exemptions from the prohibited transaction provisions of ERISA section 406 must be met when the ESOP acquires employer stock.

In applying these fiduciary standards to an ESOP, it is important to understand the purposes of an ESOP as an employee benefit plan and the basis on which it is recognized for tax-qualified status. In the Revenue Act of 1921, stock bonus plans (the basic element of an ESOP) were first granted (along with profit sharing plans) tax-exempt status. It was not until the Revenue Act of 1926 that such status was extended to pension plans. The purpose for which stock bonus plans were granted tax-exemption was to encourage corporations to provide stock ownership interests to their employees. Providing retirement benefits for employees has always been a secondary purpose for the establishment of a stock bonus plan. In Revenue Ruling 69-65, the Internal Revenue Service stated that the purpose of a stock bonus plan is ". . . to give the employee-participants an interest in the ownership and growth of the employer's business . . ." The existing regulations under Code section 401(a), in defining the three categories of qualified plans, specify retirement benefits as a feature of pension plans, but not as a feature of profit sharing plans and stock bonus plan (except that benefits may be deferred until retirement). There appears to be no requirement under code section 401(a) that a stock bonus plan be a "retirement plan."

It may be argued that ERISA, in stating the objective of protecting retirement security of employees, has now imposed the standard of providing retirement benefits as the objective of all qualified employee benefit plans. However, there are specific references under ERISA to a different standard being applicable to different types of plans.

The definition of "pension plan" in section 3(a) of ERISA recognizes that a "pension plan" is one which "provides retirement income to employees *or* results in a deferral of income by employees for periods extending to the termination of covered employment or beyond." Section 402(b)(1) of ERISA requires " . . a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan . . ." (not the objective of retirement security). Section 404(a)(1)(B) of ERISA sets out the prudent man standard as one applicable to ". . . the conduct of an enterprise of a like character and with like aims." The legislative history of ERISA recognizes

". . . the special nature and purpose of employee benefit plans . . ." and ". . . the special purpose . . ." of certain individual account plans which are designed to invest in employer securities. In addition, the definitions under ERISA Section 407(d)(6) and Code section 4975(e)(7) specify that an ESOP is ". . . designed to invest primarily in qualifying employer securities. . . ." The recognition of an ESOP as an employee benefit plan which may borrow to acquire employer stock further demonstrates Congressional intent that an ESOP is not primarily a retirement plan, but rather has as its primary objective the providing of stock ownership interests for employees.

This recognition by Congress of the special purposes of an ESOP does not exempt the ESOP from the general fiduciary standards of ERISA, but rather requires that the interpretation of these standards must be based upon the ESOP objective of providing stock ownership for employees. Retirement benefits may be provided to employees through their stock ownership acquired under an ESOP, but the fiduciaries are primarily directed to provide stock ownership (rather than retirement benefits) for employees in a manner consistent with the fiduciary duties under Title I of ERISA.

Accordingly, it would appear that a prudent ESOP fiduciary, subject to fiduciary duties under ERISA section 404(a)(1), is one which prudently acquires and holds, and in some cases distributes, employer stock for the benefit of participants (and their beneficiaries), prudently using debt financing where appropriate, in a manner consistent with the plan documents and the provisions of title I of ERISA. In order to avoid having ESOP acquisitions of employer stock be prohibited transactions under ERISA section 406 and Code section 4975, the special exemptions under ERISA section 408 must also be complied with by the ESOP fiduciaries.

B. Exclusive Benefit Requirement

ESOP purchases of employer stock must comply with the "exclusive benefit of employees" requirement under Code section 401(a), as well as the "exclusive purpose" and the "solely in the interest of the participants" requirements of ERISA section 404(a)(1)(A). In Revenue Ruling 69–494, the Internal Revenue Service outlined various investment requisites under the exclusive benefit rule which should be satisfied when a qualified employees' trust invests funds in employer securities. That ruling recognized that the exclusive benefit requirement with respect to investments does not prevent others from also deriving some benefit from a transaction with the trust, as a seller would make employer stock available to the trust only if there was a benefit to him by so selling. Accordingly, before ERISA, the Internal Revenue Service established the following "safe harbor" investment test which must be met for a purchase of employer stock to comply with the exclusive benefit requirements:

(1) the cost must not exceed fair market value at the time of purchase;

(2) a fair return commensurate with the prevailing rate must be provided;

(3) sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan; and

(4) the safeguards and diversity that a prudent investor would adhere to must be present.

With respect to an ESOP, it appears that only the "fair market value" and "prudent investor" requirements are applicable. Revenue Ruling 69–65 specifically exempts stock bonus plans (and presumably any ESOP) from the requirement for a fair return on employer stock. The ESOP is likewise exempt from the diversification of investments requirement under ERISA Section 404(a)(2), as an "eligible individual account plan" to the extent of investments in employer securities.

Therefore, an ESOP's acquisition of employer stock from the employer corporation, or from an existing shareholder, would satisfy the exclusive benefit requirement of ERISA and Code section 401(a), so long as the investment is one that is prudent for an ESOP fiduciary and the purchase price does not exceed fair market value. Section 408(e) of ERISA, which provides for an exemption from the prohibited transaction rules for the acquisition of employer stock from a party in interest, appears to require a purchase price equivalent to the fair market value of the stock.

C. Diversification Exemption

Section 404(a)(2) of ERISA specifically provides that an eligible individual account plan is not subject to the general diversification requirement of section 404(a)(1)(C), nor any diversification requirement under the prudent man standard, to the extent that it acquires and holds qualifying employer securities. ERISA section 407(b)(1) specifically exempts eligible individual account plans from the 10 percent limitation on investments in employer securities. An ESOP is included in the definition of eligible individual account plan under section 407(d)(3) if the ESOP explicitly provides for the acquisition and holding of employer stock. As long as the acquisition and holding of employer stock satisfy the general prudence and exclusive benefit requirements, it would appear that up to 100 percent of the assets under the ESOP may be invested and held in employer stock without violating the fiduciary duties of ERISA section 404(a).

The degree to which an ESOP *must* be invested in employer stock, in order to satisfy the ". . . designed to invest primarily . . ." requirement of ERISA section 407(d)(6)(A) and Code section 4975(e)(7)(A), is not specifically set forth in the Internal Revenue Code or the income tax regulations. This requirement was intended by Congress to be of a qualitative nature (based upon the purposes of an ESOP and its design), rather than a quantitative test to be satisfied at all times.

D. Prohibited Transaction Exemptions

Without the special exemptions provided in ERISA section 408 and Code section 4975(d), ESOP financing transactions might be prohibited transactions under ERISA section 406(a) and Code section 4975(c). Congress, however, recognizing the special purposes and objectives of an ESOP, as both an employee benefit plan and a technique of corporate finance, included exemptions for certain transactions from the general prohibited transactions rules.

1. Acquisitions of Employer Stock

Section 406(a)(1)(A) of ERISA and section 4975(c)(1)(A) of the Internal Revenue Code include as a prohibited transaction a ". . . sale or exchange . . . of any property between a plan and a party in interest (or a disqualified person). . . ." Without an exemption, an ESOP (or any other eligible individual account plan) would be prohibited from acquiring employer stock from the employer corporation or from any shareholder who is a party in interest. This would generally limit acquisitions of employer stock to purchases from shareholders who own (directly or indirectly) less than 10 percent of the employer's stock and are not otherwise "insiders." However, ERISA section 408(e) and Code section 4975(d)(3) provide exemptions that permit the acquisition of employer stock by an ESOP from a party in interest (or a disqualified person) so long as the purchase price constitutes "adequate consideration" and no commission is charged with respect to the transaction.

"Adequate consideration" is defined in ERISA section 3(18) in a manner which generally restates the requirement for "fair market value" set forth in Revenue Ruling 59–494. Where there is a generally recognized market for employer stock, adequate consideration is the price prevailing on a national securities exchange (if applicable), or the offering price established by current bid and asked prices quoted by independent parties. Where there is no generally recognized market for employer stock, adequate consideration is fair market value, as determined in good faith and in accordance with generally accepted methods of valuing closely-held stock and in accordance with regulations to be promulgated by the Secretary of Labor.

In the event that the purchase price paid for employer stock by an ESOP to a party in interest exceeds adequate consideration, a prohibited transaction results. If the party in interest is a disqualified person as defined in Code section 4975(e)(2), the excise tax and correction requirements of that section are applicable. An initial 5 percent per year excise tax is imposed on the disqualified person, based upon the "amount involved." If the transaction is not "corrected" within the allowable correction period, the additional excise tax of 100 percent of the amount involved is imposed. Any excise tax imposed is paid by the seller, and is not tax deductible.

It is important to note that the Internal Revenue Service, in the self-dealing regulations for private foundations states that a good faith effort to determine fair market value is ordinarily shown where (a) the person making the valuation is not a disqualified person and is both competent to make the valuation and is not in a position to derive an economic benefit from the value utilized, and (b) the method utilized in the valuation is a generally accepted method for valuing for purposes of arm's length business transactions where valuation is a significant factor.

Therefore, the valuation of employer stock is the most significant aspect of ESOP transactions when there is no generally recognized market for employer stock and a valuation by an independent appraiser, experienced in valuing closely-held corporations, is essential for alleviating the potential liabilities for prohibited transaction excise taxes. Presumably, traditional IRS guidelines for valuation in

estate tax matters, as set out in Revenue Ruling 59–60, will be the basis for Department of Labor regulations defining fair market value under ERISA.

2. Debt-Financing Transactions

Section 406(a)(1)(B) of ERISA and Code section 4975(c)(1)(B) include as a prohibited transaction any ". . . direct or indirect . . . lending of money or other extension of credit between a plan and a party in interest (or disqualified person). . . ." Without an exemption, this provision would prohibit any debt financing for the acquisition of employer stock by an ESOP, where a party in interest extends credit through a direct loan, a loan guarantee or an installment sale.

However, ERISA section 408(b)(3) and Code section 4975(d)(3) provide an exemption from the prohibited transaction rules, available only to an ESOP and not to other eligible individual account plans, which permits an ESOP to borrow money involving an extension of credit from a party in interest to effect its acquisitions of employer stock. It is this exemption that distinguishes an ESOP from other plans which invest in employer stock and characterizes an ESOP as a technique of corporate finance.

The following conditions are imposed by ERISA for the ESOP loan exemption:

(*a*) the ESOP must satisfy the statutory definition of ERISA section 407(d)(6), Code section 4975(e)(7) and IRS regulations;

(*b*) the loan must be primarily for the benefit of participants;

(*c*) the interest rate must be reasonable; and

(*d*) any collateral given by the ESOP to a party in interest must be limited to qualifying employer securities.

In addition, further guidelines have been established in regulations promulgated by the Internal Revenue Service (and the Department of Labor) through an interpretation of the term ". . . primarily for the benefit of participants. . . ." Certain of the additional conditions for the ESOP loan exemption are clear from legislative history relating to the ESOP financing concept (both before and after ERISA) and from the regulations issued by the Department of Labor. The following additional requirements are included in the regulations and must be satisfied in order to exempt an ESOP debt financing transaction from the general prohibited transaction rules.

(1) The loan (or other extension of credit) must be for the purpose of acquiring employer stock or repaying a prior exempt loan and must be based on equitable and prudent financing terms. The interest rate must not be so high that plan assets might be drained off, and the terms of the loan must be as favorable to the ESOP as the terms resulting from arm's length negotiations between independent parties.

(2) Any collateral pledged by the ESOP (whether or not pledged to a party in interest) must be limited to the shares of employer stock acquired with the proceeds of that loan or freed from prior encumbrance by the proceeds.

(3) In general, any shares of employer stock given as collateral by the ESOP must be released from pledge on a pro-rata basis as loan principal is repaid.

(4) The liability of the ESOP for repayment of the loan must be limited to contributions received from the employer corporation (other than contributions of employer stock) and to earnings on trust assets, including dividends on employer stock.

(5) The lender must have no recourse to assets held in the ESOP other than employer stock remaining pledged as collateral.

If an ESOP debt financing transaction fails to satisfy the conditions for the exemption, a prohibited transaction may result under Code section 4975. In that event, the initial 5 percent per year excise tax would be imposed on any disqualified person extending credit to the ESOP, with the additional 100 percent tax being imposed if the transaction is not corrected. For purposes of the excise tax, the entire loan principal may be the amount involved, or the amount involved may be limited to that portion of the loan (or interest thereon) which causes the prohibited transaction to occur. Correction may require adjustment in the terms of the ESOP loan or, in some situations, rescission of the transaction. The regulations promulgated by the Internal Revenue Service and the Department of Labor deal with this issue on a more in-depth basis.

VI. ESOP AND TRASOP PROBLEM AREAS

A. Conversion of Existing Plans Into ESOP

Many employers maintaining a qualified plan may wish to replace that plan with an ESOP. This can be accomplished by amending the plan (such as a defined contribution plan like a profit sharing plan or money purchase plan) into an ESOP or terminating the plan (such as a defined benefit pension plan) and replacing it with an ESOP. Each such transaction carries with it certain additional responsibilities or potential problem areas which must be considered when conversion to an ESOP is contemplated.

The clearest example of additional responsibilities and potential problem areas which arise occurs when an ESOP replaces an existing defined benefit pension plan. Under the Internal Revenue Code, the replacement of a defined benefit plan by a defined contribution plan (such as an ESOP) constitutes a termination of that plan. Each participant in the defined benefit plan is deemed by the Code to be 100 percent vested in his benefits under the plan to the extent that they have been funded; this overrides any vesting schedule established under the pension plan. In addition, each participant's pension benefit may become subject to the plan termination insurance provisions of ERISA. These pension benefits may be guaranteed up to certain limitations by the Pension Benefit Guaranty Corporation (PBGC). If the employer has failed to sufficiently fund the retirement benefits of its employees under the plan, the PBGC will make up the difference between the guaranteed benefits and the funded amount. This becomes critically important to the employer which considers terminating its pension plan, because the employer may be liable to the PBGC for all or a portion of this amount. This potential liability must be carefully considered.

In addition, the PBGC has established certain procedures which might prove troublesome if the employer wishes to use the assets in the defined benefit pension plan to acquire employer stock under an ESOP. The PBGC requires that each employee be given an opportunity to elect, in writing, to have his pension plan assets converted to employer stock; this brings the closely-held employer into a direct confrontation with the securities laws, as explained more fully later in this handbook under *Securities Laws*, because this is considered an investment decision on the part of the employee and, absent some specific exception from registration, the employer would be compelled to register its securities with the Securities and Exchange Commission (SEC). SEC registration is very expensive. This potential liability must also be carefully considered.

Even if the employer determines that the potential PBGC and SEC obstacles are not insurmountable, a final problem remains. Absent a plan provision which gives employees the investment discretion on plan assets, the conversion of assets which are invested in a diversified portfolio to a single investment (employer stock) could create "prudence" liabilities for the plan trustees, especially if the value of the employer stock decreases in value or fails to increase in value at the same rate as that previously attained by the diversified assets.

It is critical to note that problems relating to asset valuation, prudence and exclusive benefit also exist if an existing profit-sharing plan or money purchase plan is amended into an ESOP and diversified assets are converted to employer securities, although the PBGC and SEC obstacles are not present.

However, this is not to state that conversion of an existing plan to an ESOP should not be undertaken. For example, assuming that existing plan assets are left in a diversified investment portfolio, revision of a profit-sharing plan or money purchase pension plan into an ESOP and investment of future employer contributions in employer stock should present no problem nor should the conversion of a defined benefit pension plan (provided that the plan termination results for the defined benefit plan are not deemed to be too serious). The employer should analyze the objectives in converting the plan to an ESOP and decide whether any potential obstacles present too severe a problem.

B. Securities Laws

As explained earlier in this handbook under *Conversion of Existing Plans into ESOP*, certain aspects of an ESOP may require compliance with the rules and regulations of the SEC. For publicly-traded employers, this should create no problem, since such an employer is already satisfying the reporting requirements of the SEC. However, the filing of an S-8 registration with the SEC may still be necessary. For the closely-held employer, however, the resulting costs of SEC compliance might be too expensive and troublesome. For this reason, the closely-held employer should administer its ESOP in a way which will not subject its stock, or the ESOP, to SEC registration requirements.

Historically, the SEC has not required the registration of the securities of an employer adopting a non-contributory ESOP or TRASOP

or of the participants' interests in the ESOP or TRASOP. Initially, as reflected in numerous SEC "no action" letters, this was based upon the determination that there was "no sale" of employer securities to ESOP participants. In later "no action" letters, the SEC based its decision upon a determination that its policies did not warrant the expensive reporting and disclosure which would accompany the sale of these securities.

However, certain aspects of ESOP operation may result in a requirement by the SEC that registration of these securities be made. If employees are required or permitted to make ESOP contributions for the acquisition of employer securities, or, if the employee TRASOP contributions are used to acquire employer securities other than on the public market, this would clearly constitute the sale of these securities to the employees and require SEC registration unless another exemption is available. This would also be true if the ESOP were to give each employee any discretion as to whether or not plan assets were to be used to acquire employer stock. This discretion, like the election required by the PBGC, would be treated as an investment decision and require SEC registration.

With the exception of these limited situations, however, no SEC registration problem should arise for the closely-held employer. However, stock distributed to participants would generally be restricted stock under applicable securities laws.

C. Liquidity Problems

An employer which adopts an ESOP or TRASOP and whose stock is not publicly traded must be sure that the plan is sufficiently funded to permit a distribution of benefits to each participant. This is true whether the participant's benefit is distributed in cash or closely-held employer securities which are resold to the plan or the employer in exchange for cash.

As described earlier in this handbook under *Distribution of ESOP And TRASOP Benefits And Stock Repurchases*, subject to the right of the ESOP or TRASOP participant (or beneficiary) to demand that benefits be distributed in shares of employer stock, the plan may elect to distribute these benefits in cash. In such a case, it is important that the plan have sufficient cash available to make cash distributions to each eligible distributee.

If the distributee elects to demand a distribution of employer stock, and this stock is closely-held, there must be sufficient cash available to permit the employer or the plan to acquire that stock if the distributee exercises his "put" option on these securities and the plan wants to acquire the stock in lieu of the employer, or to permit the plan to exercise its "right of first refusal" in the event the distributee desires to sell this stock to an unrelated third party.

Finally, if the distributee desires to resell this stock at a time when the "put option" has expired, or if the distributee of publicly-traded employer stock desires to resell this stock, the plan may need sufficient cash if it wishes to repurchase this stock.

For this reason, the employer should maintain the plan so as to provide sufficient liquidity from its inception. Reference would be made to

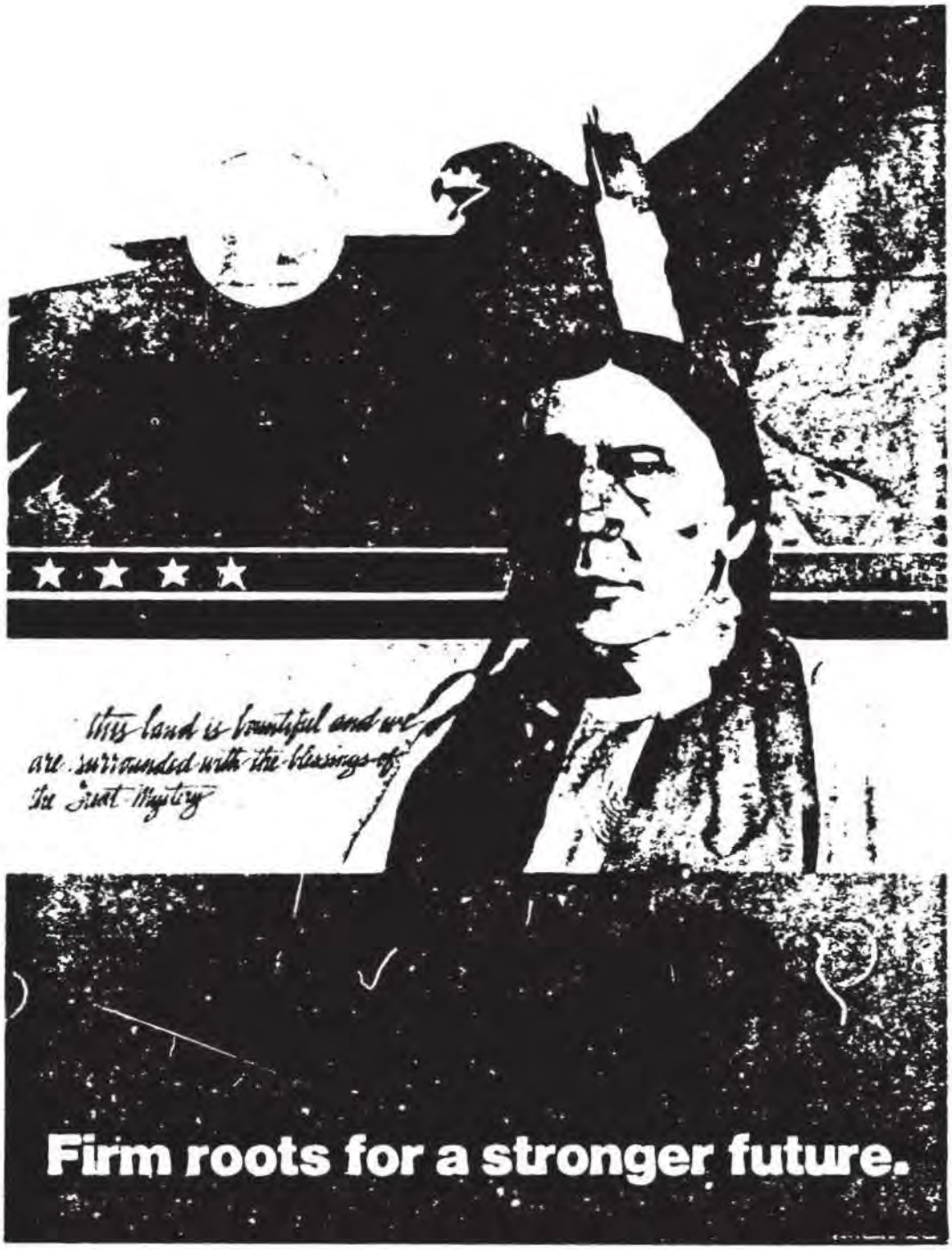
the turnover history of plan participants, each participant's annual compensation, and the financial history and future projections of the employer. If an employer encounters difficulties in making these determinations, an analysis should be performed by someone experienced in making such determinations.

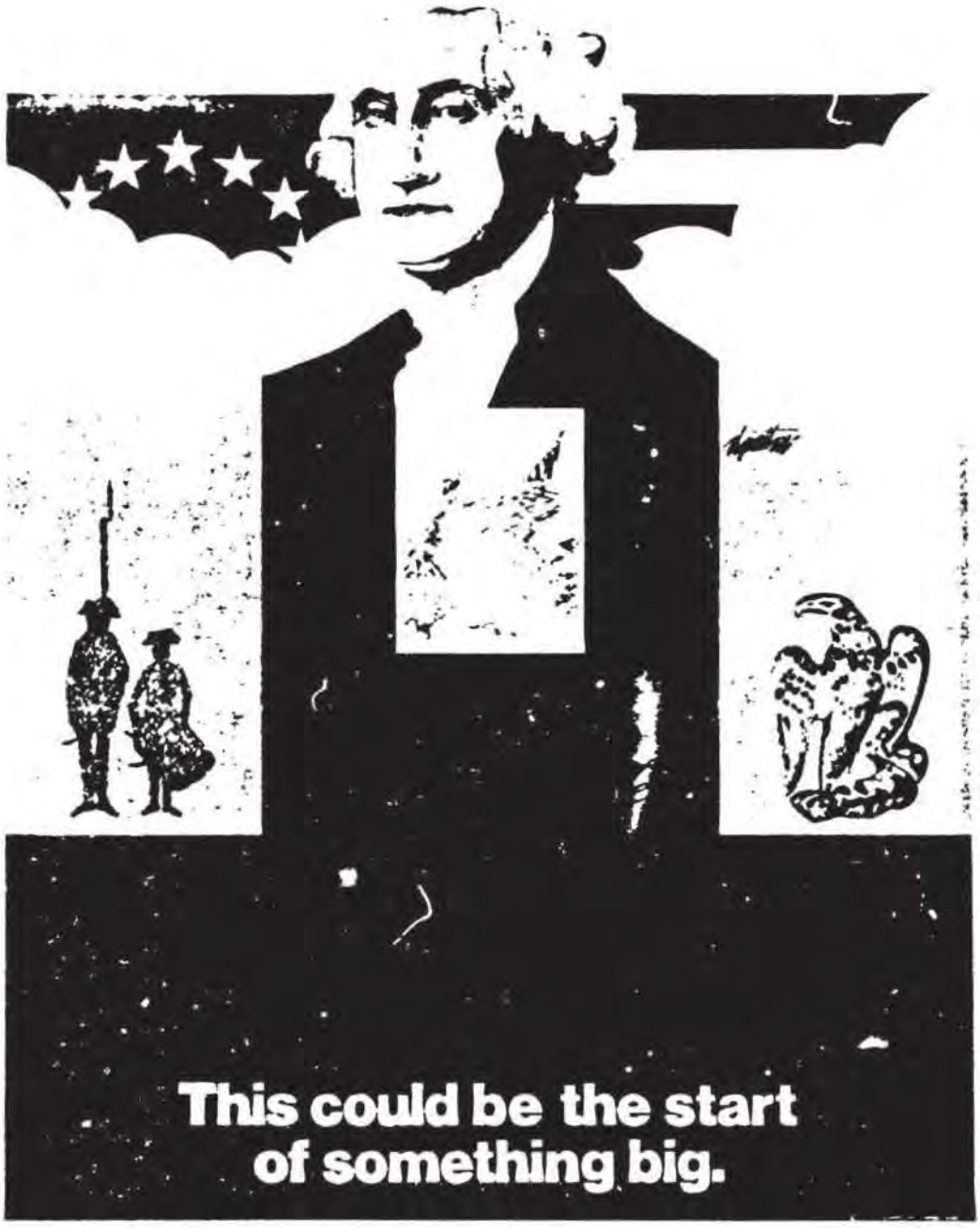
VII. EMPLOYEE COMMUNICATIONS

For an ESOP or TRASOP to have its best effects on increased employee motivation and productivity, the committee believes that the plan concepts must be adequately communicated to employees. Clearly, an employee will be most concerned about the economic future of his or her employer if that employee recognizes that he or she has an ownership interest in the company. However, most employers have been unable to develop adequate communications materials to deal with concepts as sophisticated and technical as employee stock ownership plans. Accordingly, the committee has included in this handbook samples of several alternative employee communications materials. These materials are included herein merely as examples, since they are copyrighted by the companies which created them; the committee appreciates the willingness of these companies to have the communications materials included in this handbook.

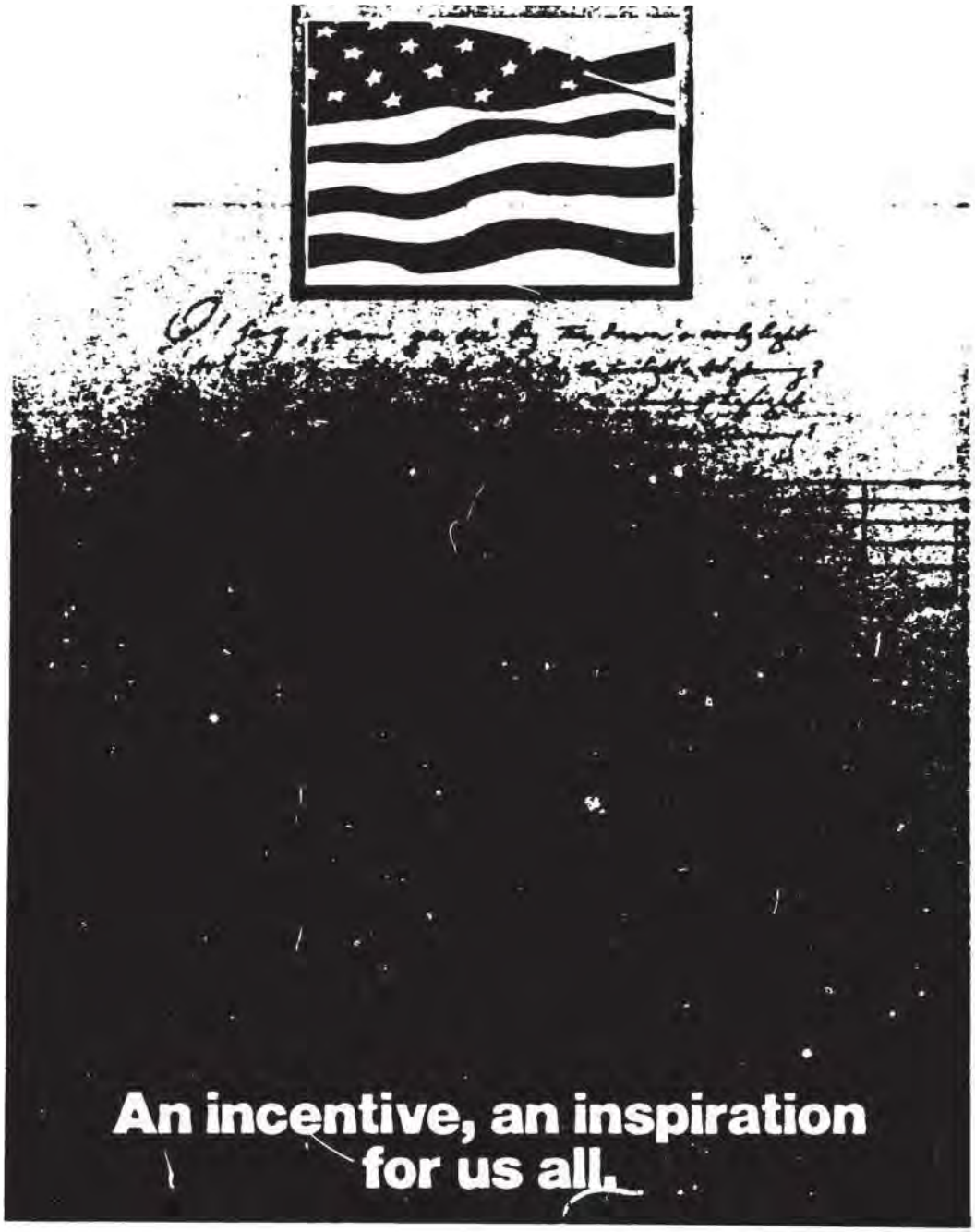
A. ESOP Posters

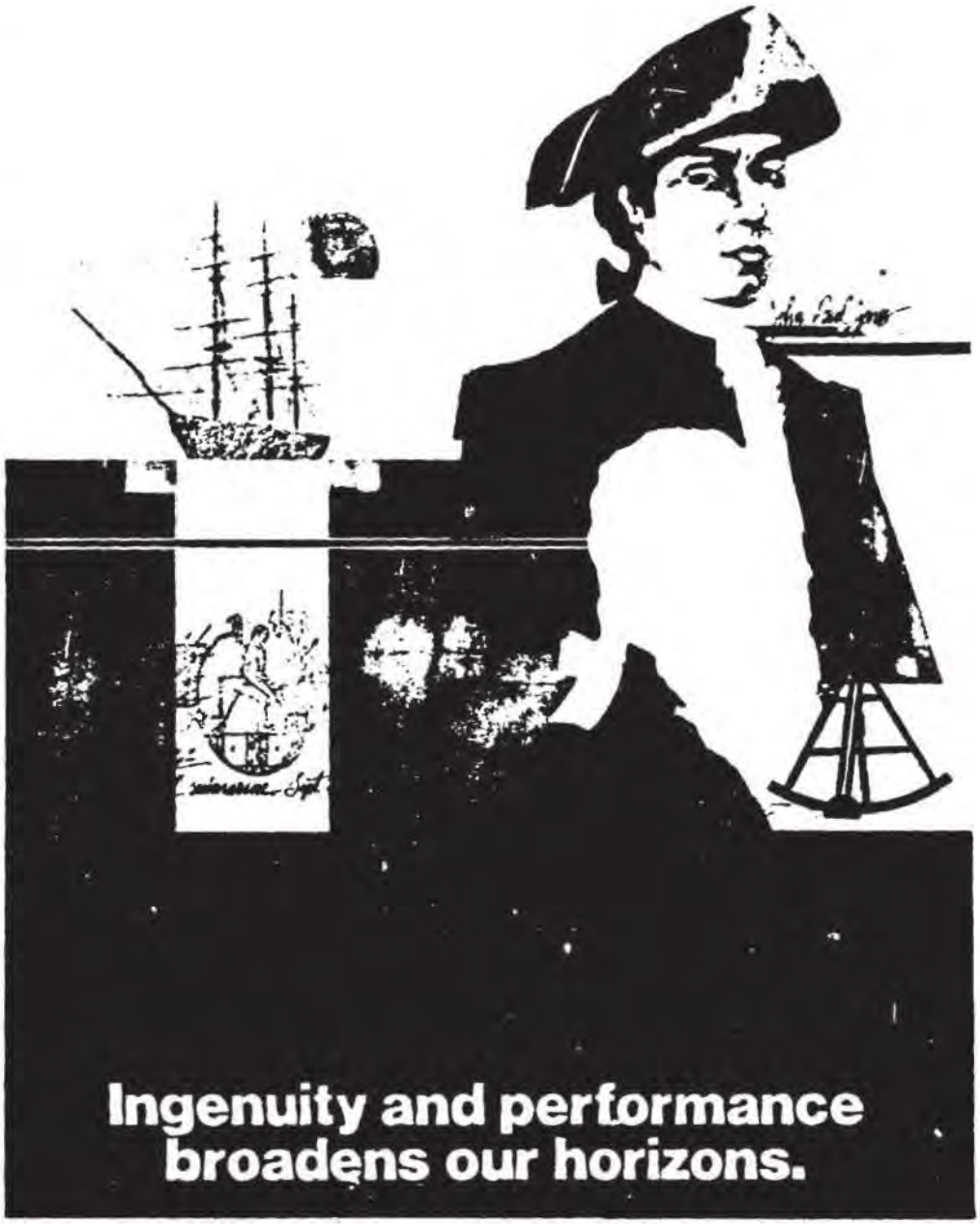
At E-Systems, every individual is uniquely involved in the company.




This could be the start
of something big.


We all have a piece of the action
at E-Systems.


An incentive, an inspiration
for us all.


Ingenuity and performance
broadens our horizons.


Don't waste a good idea.

On time, on target pays off.


Th Jefferson
Geo. Wythe
John Hancock
John Adams
Arthur Middleton
IN CON
JULY 4. 1776.
The unanimous
States of America
Our common interests
are served by teamwork.


A symbol and a system
for a better tomorrow.

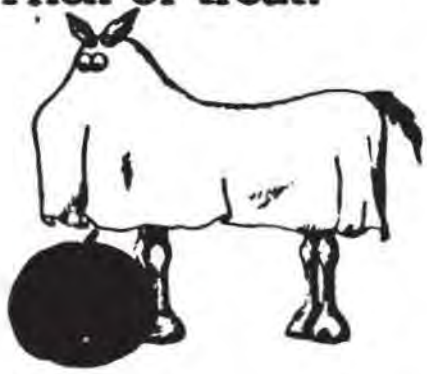
B. ESOP Payroll Envelope Inserts

Thinking of moving on?

Are you restless for a change? Does the job down the street or across the country seem more attractive? Everybody always thinks that they are going on to bigger things and greener pastures. But do they always? It is a big step to leave your job, and if you are thinking about it, think carefully. Your ESOP can grow fastest when you are here to help it grow. ESOP is another important reason it pays to stay with your company. Thinking of moving on?

With ESOP the best move is to stay!

Trick or treat?



It's that time of year for ghosts and goblins and ghouls of all sorts. Black cats and orange pumpkins. Little witches and vampires fill the streets where children played the day before. It's scary and it's fun. After all, it's only make-believe. But it's no fun to be afraid of the future, and that's where ESOP can help out. Your ESOP can help protect you against financial tricks in your future. Trick or treat?

ESOP-make it a treat!

Ready for the turkey?

Thanksgiving is coming up and that means food. Turkey and pies and everything in between. Food was an important part of the very first Thanksgiving, too. Those early Americans didn't have an ESOP, but they did have courage, ingenuity and enthusiasm. And they worked very hard. Those were the qualities which were responsible for their success then. Those are the same qualities which will make your ESOP a success today. And that's talking turkey.

ESOP-something to be thankful for!

Come to work in a covered wagon?

Come to work in a covered wagon? Of course not. But sometimes we forget that many of our forefathers did. They went West to stake their claim on the old frontier and to have the opportunity to achieve financial security for themselves and their loved ones through ownership. It was the chance to turn hard work into property. Today, we don't have covered wagons or much unclaimed land — but we do have ESOP. ESOP is your new frontier which gives you the same opportunity to acquire property for financial security.

ESOP-stake your claim!

Ready for the holidays?

Has anybody ever really been ready for the holidays? There is so much to do. Parties to go to, the house to decorate, finding that perfect present for someone special. That's what makes the holidays so exhausting, and that's what makes them so enjoyable. Holidays give us the opportunity to celebrate important events in our lives. Your ESOP is like that, too. It's an important event with something special for you. Ready for the holidays?

ESOP-it's worth celebrating!

Ringing in the new?

It's a new year and the time everybody makes resolutions. This is the year that they're really going to Hawaii; lose that last ten pounds; finish the patio; or clean out the attic. Even if this year's resolutions turn out to be the same as last year's, this time they're really going to do it. Why don't you resolve to do your best for your ESOP? You will be doing your best for yourself at the same time. What better way to start off the new year. Ringing in the new?

ESOP-a resolution worth keeping!

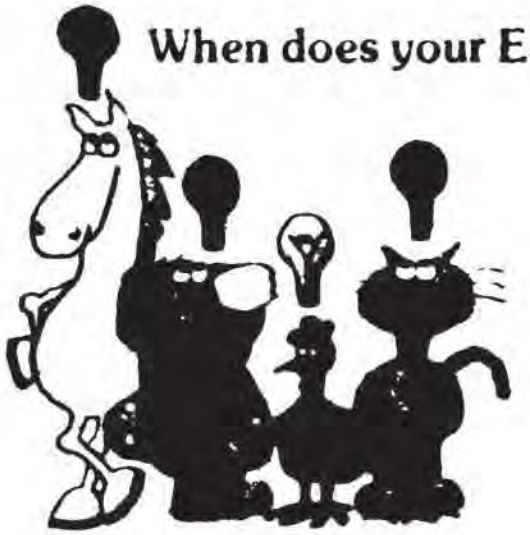
ESOP-the most vital part is you!

Love your job?

Love your job? Most of us enjoy our work. We also appreciate our friends that work with us. But everybody has bad days now and then, and friendships can wear pretty thin. When things go wrong, remember that your ESOP always goes right. You will feel better knowing that your hard work is still working for you. Let ESOP turn your bad day into a good one. And fall in love again.

ESOP-put your heart into it!

When does your ESOP work best?



Americans are famous for great ideas. We call it Yankee ingenuity and it has produced ideas like the quilting bee, the bucket brigade, the car pool — and now ESOP. All of these ideas are ways Americans have devised to help each other out. By pitching in together, each person achieves more than by working alone. But everyone has to do his share or the idea is not a success. When does your ESOP work best?

When you do!

Who cares about your ESOP?

Congress has passed many laws to encourage ESOPs. It wanted to make sure that your company and similar businesses across the nation received the many advantages ESOP has to offer. Congress also established strict regulations to make sure that your ESOP is administered for your benefit. Your company has taken care to see that your ESOP meets these high government standards and your ESOP has received the government's stamp of approval. Who cares about your ESOP?

The Government and your company that's who!

Keeping in the pink?

Most of us get sick now and then. It can't be helped. But there are positive steps we all can take to enjoy good health — eating the right foods, getting enough rest and receiving proper medical attention. When you miss a day because of sickness, you miss out on more than work. You miss a chance to help your ESOP grow. When you are healthy, you can pitch in and do your share, and that will help make your ESOP more valuable. So keep in the pink!

Help ESOP keep you in the green!

Time for Uncle Sam?

Benjamin Franklin once said, "the only things certain in this world are death and taxes." All of us worry when Uncle Sam comes around. It seems he arrives earlier each year, and always with his hand out. But with ESOP you get a break. You pay absolutely no tax on the value of your ESOP benefits while they are held by the ESOP. And when you do receive your benefits, you will receive special tax advantages too. It's Uncle Sam's way of saying he believes in ESOP. Time for Uncle Sam?

With ESOP he's your friend!

Thinking about your future?

When asked which of his works he would select as his masterpiece, architect Frank Lloyd Wright replied "My next one." It's a good idea to think ahead. When you plan tomorrow's work today, tomorrow will be more productive. Your ESOP works on the same principle. It gives you an opportunity to make your economic tomorrow as [illegible] through careful thought and ap- [illegible] today. Thinking about your future?

With ESOP your future begins right now!

Spring in the air?

A wise man once said that in springtime a young man's fancy turns to thoughts of love. A young girl's, too. Everything seems so fresh. Flowers begin to blossom and baby colts try valiantly to stand. It is a time for new beginnings. Your ESOP is a new beginning, too. It gives you a way to help your assets grow and grow and grow. But like all new things, ESOP needs your attention and care. Spring in the air?

ESOP-make it a blooming success!

Going on vacation?

[illegible]

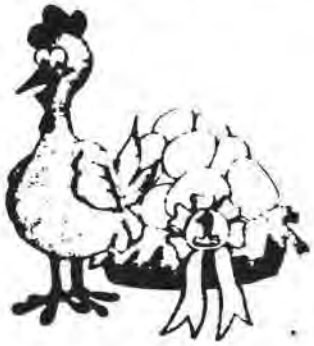
ESOP-always at work for you!

Would you hire yourself?

Would you hire yourself? Most of us believe that we are worth our salary, but are we? When we were first hired, we tried hard to prove that we could do our job better than anyone else. We tried hard to make sure that our company stayed in business by doing our best to please our clients and customers, and by making our company an enjoyable place to work. Do you still do your best? Your ESOP gives you a permanent incentive because now you are working for you. Would you hire yourself?

With ESOP you have!

Take pride in your work?



Most of us are disappointed in the products and services we use today. An expensive new car that never quite works right, a suit or dress that is poorly made, a toy that doesn't last the weekend. We wait for hours in hospitals, restaurants and banks. We fume while the salesperson is making his date instead of making a sale. We watch the clerk filing her nails instead of filing our form. But most employees are not owners. With ESOP you are an owner, so take pride in your work. Make sure your customers get their money's worth, and you will make sure that you get their business.

ESOP - for the pride of ownership!

Ready for the Fourth?

Everybody likes the Fourth of July. With fireworks, picnics and parades, we celebrate the revolution that won us our independence. ESOP is also a liberating idea. If you work as hard now as our patriots did then, you can win financial freedom. And that is an important goal for every American. Independence. It's an idea that's still worth working for, just as it was back in 1776. Ready for the Fourth?

ESOP - it's patriotic, it's revolutionary!

Born with a silver spoon?

Born with a silver spoon? If you weren't, don't worry. Very few people inherit all the money they ever need. The rest of us must work hard in order to have the good things in life and to provide for the future. But it isn't easy. Our work earnings alone usually don't stretch far enough to cover all the things we want to buy and do. Your ESOP gives you another way. A way to acquire stock which can increase in value and help build your financial future. Not born with a silver spoon?

With ESOP you can end up with one!

Who profits from profits?

Everybody knows that profits are important. But to whom? When your company makes a profit, it means that consumers want your products and services. It means that your company will stay in business and will grow and develop new products and services. It means that your hard work has finally paid off. And it means that your company's contributions to your ESOP can be larger — and that means more for you. Who profits from profits?

With ESOP you do!

Careless on the job?

Nobody's perfect. Everyday some of us have little accidents on the job. A broken typewriter, a busted tool, a product ruined during assembly, coffee spilled on the files. We have big accidents too which destroy equipment, start fires, and cause serious personal injuries. All of these accidents cost money. And that costs you. Your ESOP assets will grow quickest when people do their job as safely and with as few accidents as possible. Careless on the job?

ESOP-it's no accident!

Want to get rich?

Want to get rich? Andrew Carnegie, who rose from telegraph boy to multi-millionaire, obviously knew how. "It's easy," he said. "Just put all your eggs in one basket and watch the basket very closely." That is the way all of America's great fortunes were made, by investing time, energy, and money in a single company and helping it grow. Your ESOP works in the same way. By investing in your company, ESOP gives you a way to make sure that your hard work pays off for you. Want to get rich? It's up to you.

ESOP-help it grow!

Something missing again?

Have you ever gotten ready to start a job only to find that a tool is missing? Do you have to keep requesting supplies because things just seem to disappear? Sometimes people who take home a handful of pens, a pair of pliers or a product sample don't realize that they are taking property which doesn't belong to them. Sometimes they do. Your ESOP is hurt every time materials disappear. And that hurts you. Something missing again?

ESOP-it's no steal!

Getting older?

It's a psychological fact that the older we get, the faster time seems to fly. The little boy who was digging in his sandbox yesterday is digging up your flowers with his motorcycle today. The angel in the church play is now the bride in the church wedding. It seems a little harder to run up the stairs and a lot easier to run up the bills. But remember that your ESOP is maturing, too. Every year, your ESOP assets should increase in value. That makes birthdays a lot easier to face. Getting older?

With ESOP you're getting richer too!

C. ESOP Questions & Answers

ESOP

Answers to the Ten Most Frequently Asked Questions

The number of owners of SP stock increased substantially this month when the Company's Employee Stock Ownership Plan (ESOP) was officially begun.

"More than $2.5 million has been transferred to the Plan's outside trustee who will purchase and hold all shares of stock belonging to eligible participants," notes ESOP Committee Chairman F. E. Kruchel.

SP's ESOP applies to all employees who are age 25 or over, have worked for the Company for at least three years and have three months of compensated service during the Plan year.

Naturally, the establishment of the ESOP has aroused a great deal of interest and a number of questions. Here, the ESOP Committee answers 10 of the most frequently asked questions concerning the Plan.

1 Will I have to pay anything to participate in the ESOP?

No. The Plan will be funded entirely by Company contributions and no employee contributions will be required, or even permitted, under the Plan.

2 Where is the money coming from for the ESOP? Am I losing out on some other benefit by participating in the ESOP?

The money to fund the ESOP comes from a special tax credit which was recently made available to employers who establish employee stock ownership plans. All of this additional tax credit is passed on directly to the ESOP trustee for allocation to participating employees and for payment of administrative costs of the Plan.

3 How much can I expect to receive per year through the ESOP?

For the first year's allocation, we expect each participating employee will receive approximately $60 in Company stock. Future contributions might be more or less.

4 Can I participate in the ESOP if I have an Individual Retirement Account (IRA)?

Although there are proposals in Congress to change the law, the present law provides that individuals who participate in a "qualified" employee benefit plan cannot at the same time make tax deductible contributions to an IRA. Since Southern Pacific's ESOP is a "qualified" plan, to protect those employees who might have IRAs, our ESOP provides that IRA participants who notify the committee of their status are automatically ineligible.

5 What will be the tax consequences of my participation in the ESOP?

In general, the amounts allocated to an employee's account and dividends earned on stock held for the employee will not be taxable until actually distributed to the employee.

6 If I belong to another stock purchase plan or company employee benefit plan, am I still eligible to participate in the ESOP?

Assuming you meet the eligibility requirements for the ESOP, the only reason you could not participate in the Plan is if you contribute to an IRA or similar program (this might be called an Individual Retirement Annuity, an Individual Retirement Account, an Individual Retirement Bond, etc.).

7 What further information will I receive regarding my allocation of stock?

The trustee will send participants annual statements showing their account balances. Participants will be sent all annual and quarterly reports and other information normally sent to stockholders. It is important that the ESOP Committee have your correct address so that this information may be sent to you. Notify the ESOP Committee of any change of address.

8 What rights will I have with respect to the stock?

You will have all rights normally available to stockholders, with one exception. Each year's allocation to the account of an active, continuing employee must remain with the trustee for at least seven years before it can be withdrawn. However, employees who retire or terminate will receive all of the holdings in their account shortly after the end of the year during which they leave the Company.

9 What will happen to dividends earned on the stock held in my account?

All dividends will be automatically reinvested in Company stock which will be added to your account balance.

10 What happens if I did not fill out the enrollment card recently sent to employees? Am I still eligible to participate in the ESOP?

All employees meeting the eligibility and participation requirements, based on Company records, will be considered participants in the Plan unless they advise the Committee that they are actively contributing to an IRA. The enrollment cards (Form CS 6696) are designed to provide the Committee with additional information which will eventually be needed before distribution can be made to the employee. Failure to fill out the card may delay somewhat a distribution from the Plan, but will not affect actual participation in the Plan.

Can I ever lose my shares?
No! Shares which have been allocated to your account cannot be taken from you. You are "100% vested" in your shares each time they are allocated.

When do I receive my shares?
Distributions of TRASOP shares are made each December and February to those participants who have either retired, terminated employment, or been placed on long term disability during the plan year. In the event of death, your designated beneficiary will receive all the shares in your account during the same distribution periods as mentioned above.

A copy of the Plan document may also be reviewed upon request and in the case of any discrepancies, the Plan document will always govern. While Eastern reserves the right to amend or terminate the Plan at any time, it is generally intended that TRASOP will continue as long as [illegible]

Eastern
GAS AND FUEL

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Retirement Committee
Eastern Gas and Fuel Associates
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EMPLOYEE STOCK OWNERSHIP PLAN

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EMPLOYEE STOCK OWNERSHIP PLAN

Eastern Gas and Fuel Associates provides a comprehensive benefits package that is responsive to the changing economic needs of its employees and contributes to their financial security.

An important component of Eastern's employee benefits program is TRASOP (Tax Reduction Act Stock Ownership Plan), which became effective January 1, 1976 for eligible salaried employees of the company.

TRASOP was created to increase employee participation in stock ownership at no cost to the employee. The Tax Reduction Act of 1975 and the Tax Reform Act of 1976 included provisions under which companies can establish such programs.

TRASOP is a valuable benefit that will continue to grow for you as the company prospers. Since it is important for you to understand how TRASOP works, we have prepared this brief summary of Eastern's Plan. If you have any additional questions, we urge you to consult your Summary Plan Description or contact your local personnel office or the Plan Administrator.

When do I become a member?

You become enrolled in Eastern's TRASOP, provided you are eligible for participation in the EG&FA Retirement Plan, on the January 1st after you have completed two years' employment (during each of which you have worked at least 1,000 hours, or about six months).

Who pays for TRASOP?

All the stock allocated to you as a participant in the Eastern TRASOP is paid for by the company.

Each year, Eastern contributes a sum of money to TRASOP, according to a formula specified by Federal tax laws. The formula is based on one percent of the company's capital expenditures (the amount of money the company has invested in its facilities) during the most recently completed plan year.

Example: Eastern's 1977 capital expenditures $6[illegible] 204,400 × .01

1977 plan year contribution to TRASOP $ 6[illegible] 044

How does TRASOP work?

The company's cash contribution to TRASOP is paid to the Trustee, a bank appointed by the company.

The Trustee purchases shares of Eastern stock on the open market. The shares are then allocated proportionately to the accounts of employees who were TRASOP members during the year for which the contribution was made. The number of shares allocated to your account is based on the ratio of your salary to the total compensation of all TRASOP members for the previous plan year. The law stipulates that any individual compensation over $100,000 is to be disregarded when TRASOP shares are being allocated.

Example: for each $10,000 of individual compensation earned in 1977 (up to a maximum of $100,000) a participant would have approximately eight shares allocated to his or her account.

What happens to dividends?

The amount of any cash dividends paid on stock owned by TRASOP members is used by the Trustee to purchase additional shares. These shares are then proportionately allocated to each member's account.

Can I vote my shares?

Yes. As a member of the Eastern TRASOP, you have the same voting privileges as other shareholders. Each year, usually in March, you will receive a proxy statement detailing the items of business to be voted on at the Annual Meeting of Shareholders in April. You will also receive a proxy card to fill out and return to the Trustee. The Trustee is responsible for tallying the proxy returns, and voting at the Annual Meeting as directed by the participating members.

Will I be taxed on my shares?

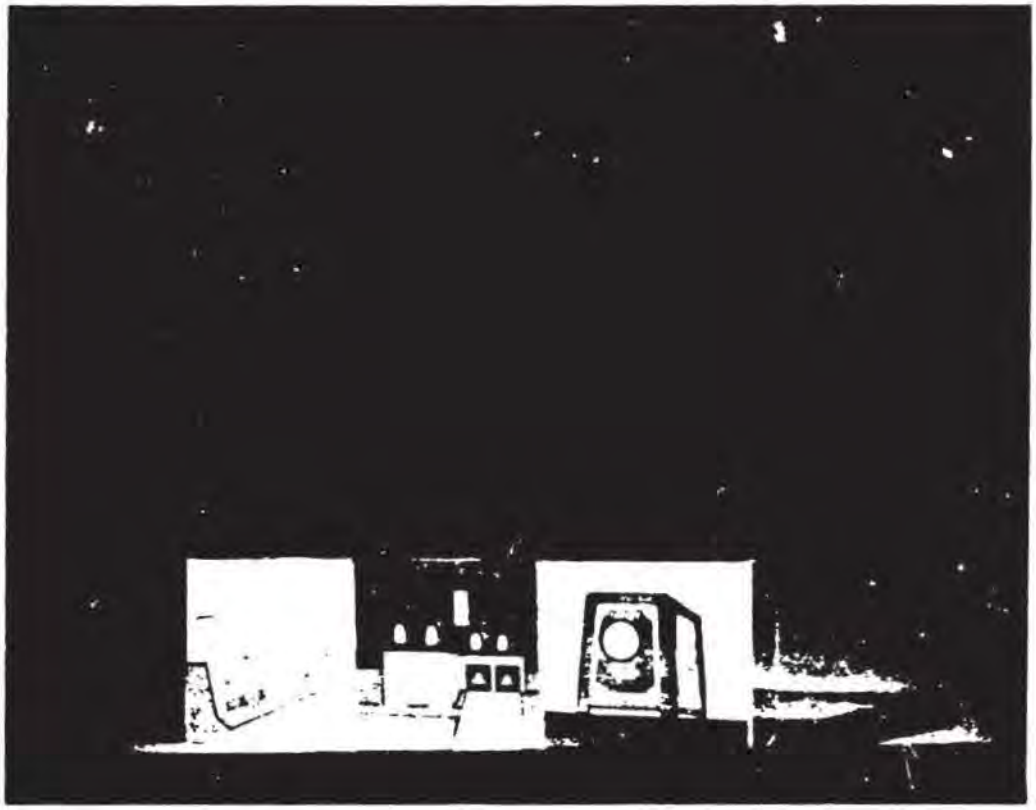
You do not have to pay any taxes on your TRASOP shares during the time these shares are held by the Trustee. Under present Federal income tax laws, you are only subject to taxation after the shares have been distributed to you. In addition, you should check with your own income tax advisor about a special ten year tax averaging option which may be more favorable to you.

D. ESOP Slide Shows

(Samples from one slide show)

"The ESOP is an investment in your future—it is not a get-rich-quick scheme."

"In the long-term, the added financial security of your allocation of stock through the ESOP will be a supplement to other benefits the company provides and to your own personal investments. For each of us today, building for the future is an ever-increasing necessity."



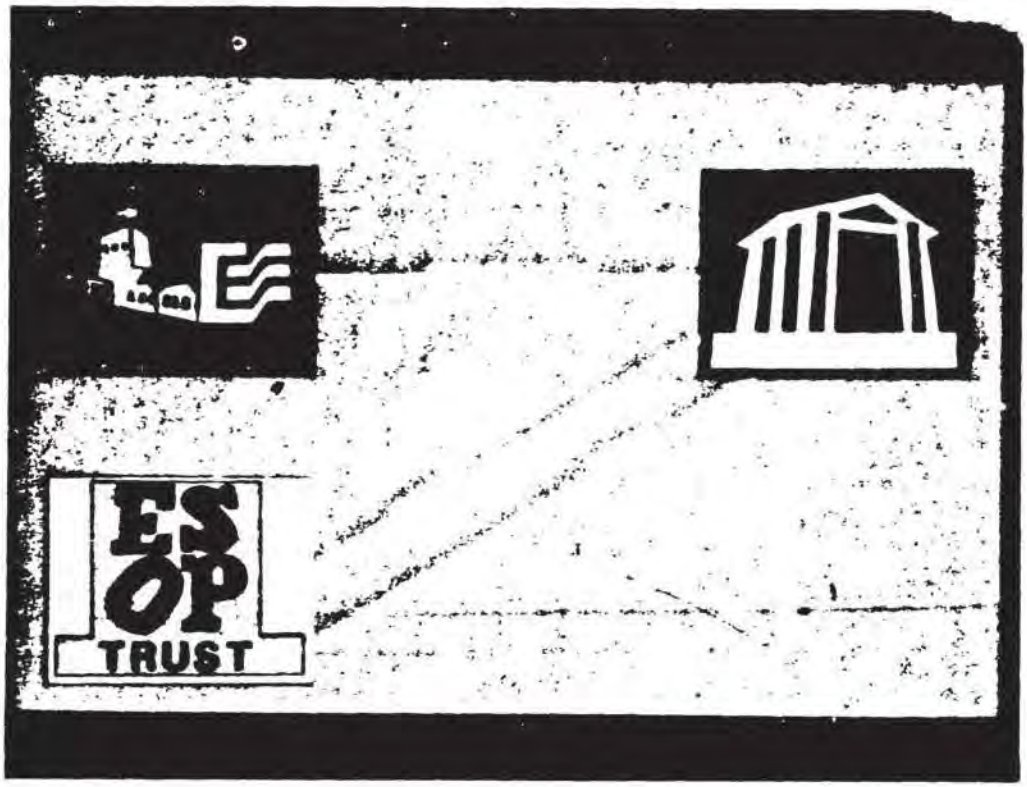
"Each person works to build his or her future. This is done through such things as your home, your savings, and social security."

"You are building your future day-by-day through a career, and by constructing block-by-block a personal estate for retirement security."

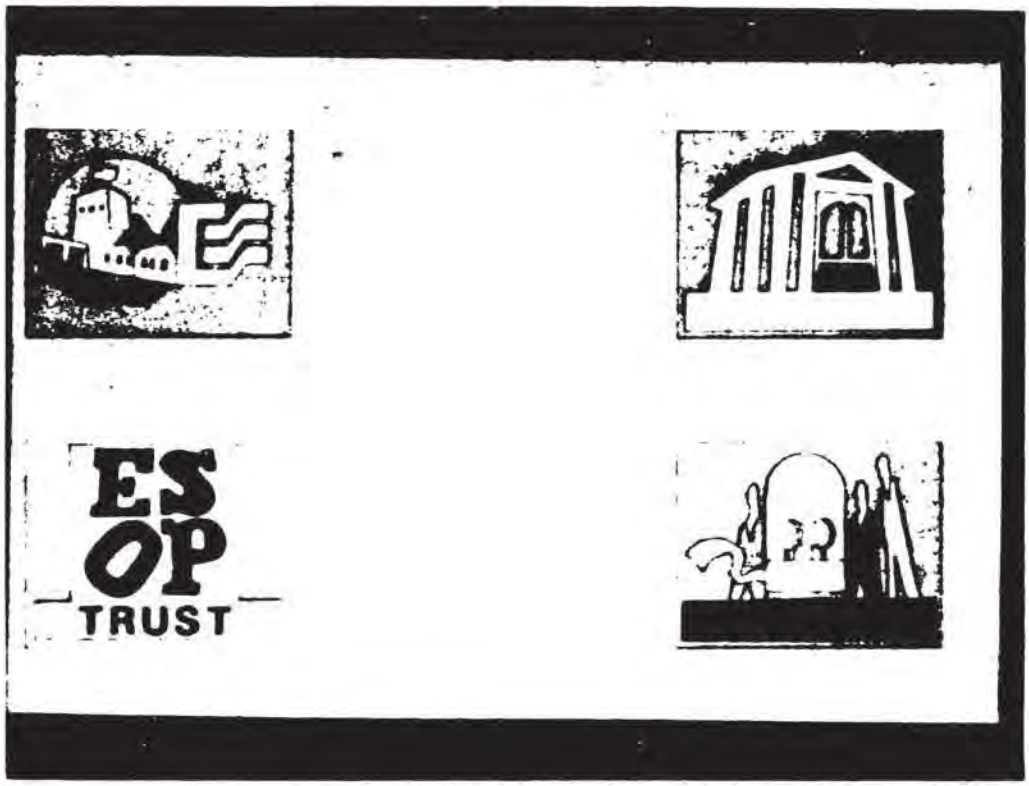
"The company is also building an investment in your future with benefits such as the retirement plan, life insurance, and social security. In addition, to give you a stake in the future growth of the company, the company is providing you with an ownership interest through the ESOP."

"To get a better understanding of where we are today, let's go back to 1973 when the company helped pioneer this unique form of coownership."

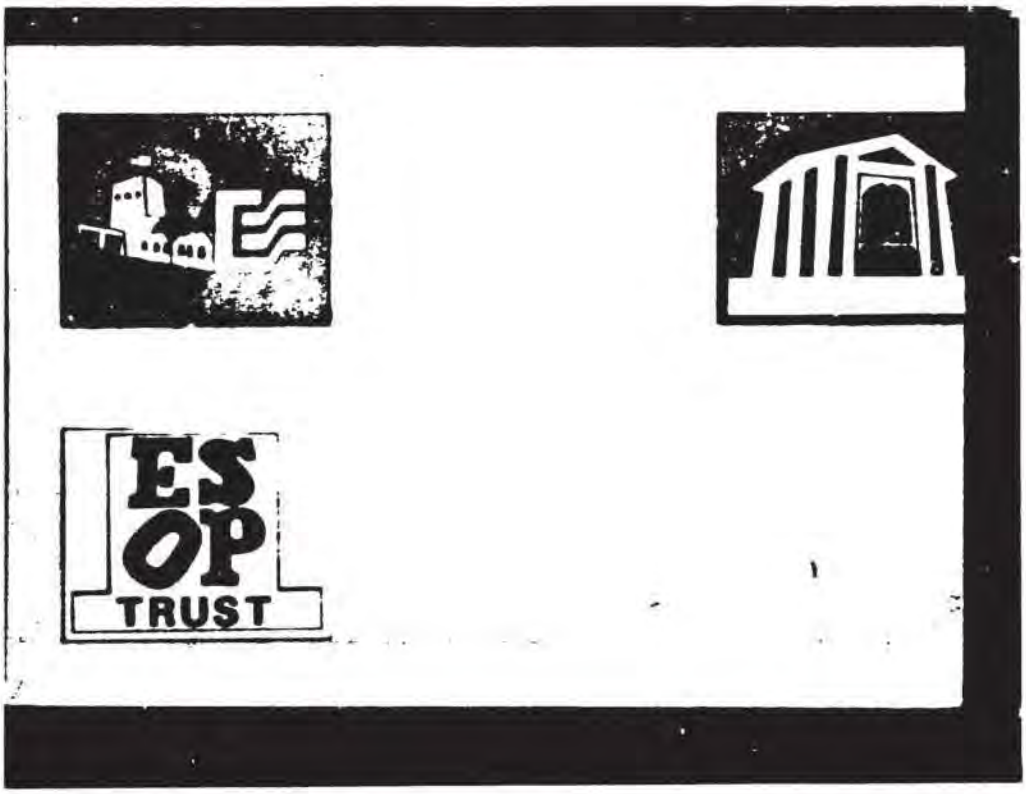
"The company formed the employee stockownership plan (we call it an ESOP) and established a trust to administer it."



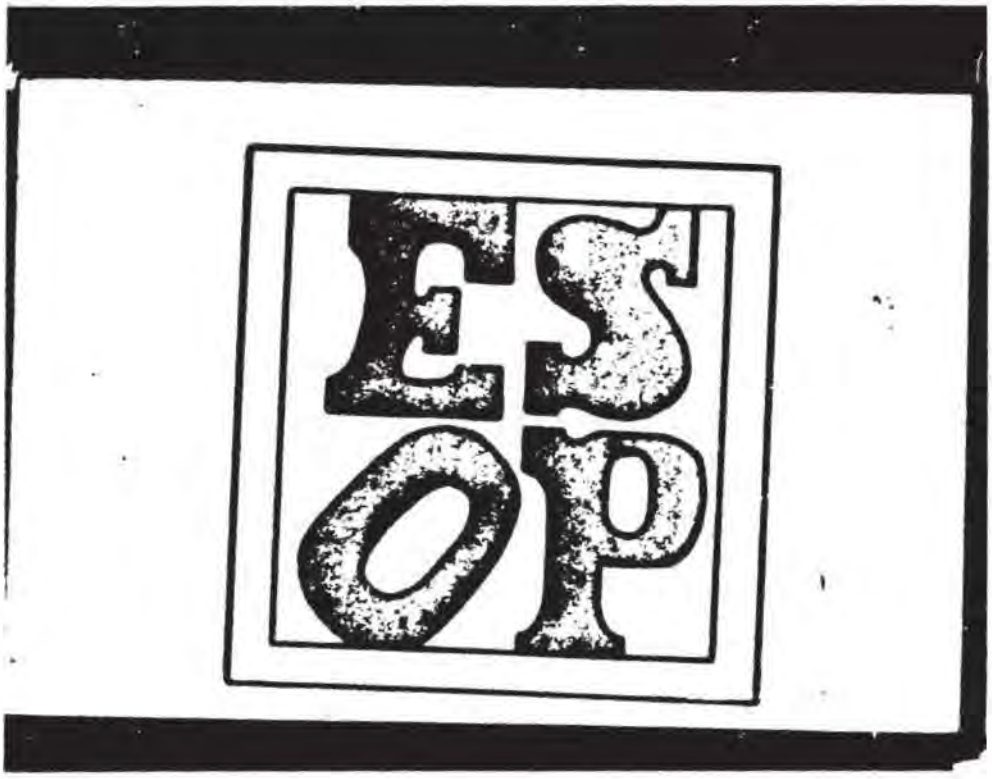
"The ESOP trust borrowed money from a bank and, in return, gave a promissory note, promising to repay the money. The company guaranteed the loan as well."



"Using this money, the ESOP trust purchased shares of stock from the company or its shareholders."



"Each year, the company contributes money to the ESOP trust which is used to repay the loan to the bank. Each payment releases some of the stock in the ESOP trust for allocation to the individual accounts of each participating employee."



"In a time when financial security and personal investment are a necessary and worthwhile ambition, you must be positive that your efforts are helping to increase and strengthen your future goals. That's why the Employee Stock Ownership Plan is so important. After all, ESOP is growth - growth of your company, growth of your future estate, and growth of a partnership that combines the long-term goals of each employee with the goals of their company."