

EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

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I. What Is An ESOP?

A. Introduction

An ESOP ("Employee Stock Ownership Plan") is a qualified plan designed to invest primarily in the employer's securities and thus give the participants in the ESOP an ownership interest in their employer. An ESOP may also be leveraged and deal with related parties to acquire the employer's securities in what would be prohibited transactions for other types of qualified plans. As a result, an ESOP may serve as a financing vehicle for the employer.

The Tax Reform Act of 1984, which forms a part of Deficit Reduction Act of 1984 ("DEFRA"), and the Tax Reform Act of 1986, present the most important legislative breakthroughs in the history of ESOPs. These Acts not only provide substantial incentives for institutions making loans to ESOPs and employers maintaining ESOPs, but also includes significant federal income and estate tax planning opportunities.

B. Description of an ESOP

1. Stock Bonus Plans Under Section 401(a)

The basic element of an ESOP is generally a stock bonus plan qualified under Internal Revenue Code §401(a). (An ESOP under Code §4975(e)(7) must contain a stock bonus plan element.) An ESOP may also be a combination of a stock bonus plan and a qualified money purchase pension plan.

A "stock bonus plan" is defined by the regulations under Section 401(a) as a plan established and maintained to provide benefits similar to those of a profit sharing plan, except that benefits are distributable in stock of the employer. A stock bonus plan is subject to the same general qualification requirements as a profit sharing plan and either type of plan can provide for discretionary employer contributions. There are, however, several distinctions between stock bonus plans and profit sharing plans:

- The investments under a stock bonus plan will usually be made largely (or exclusively) in the stock of the employer.
- A stock bonus plan is exempted from any "fair return" requirement with respect to investments in employer stock.
- Benefits from the stock bonus plan must be "distributable" in whole shares of employer stock, although the value of any fractional share may be paid in cash. However, a stock

bonus plan may include the "cash distribution option" available to ESOPs under Code §409(h), subject to the right of a participant to demand that distribution be made in stock. Distribution of non-publicly traded employer securities from a stock bonus plan are also subject to the put option requirements applicable to ESOPs. The extension of put option requirements to stock bonus plans applies to distributions attributable to stock acquired after December 31, 1986.

- The voting rights requirements of Code §409(e) apply to the stock bonus plans of those employers whose stock is not publicly-traded, while profit sharing plans are not subject to such requirements.
- A stock bonus plan may be designed to be an ESOP, while a profit sharing plan may not elect such "ESOP status."

2. Money Purchase Plan as Part of an ESOP

A money purchase pension plan alone may not be an ESOP, but may be combined with a stock bonus plan as part of an ESOP. The money purchase plan which forms a part of an ESOP will generally be subject to all of the requirements applicable to money purchase plans (except the 10% limit on investments in employer stock under ERISA §407(a)), as well as the special requirements which apply to an ESOP under Code §4975(e)(7) and the regulations thereunder.

The primary purpose for including a money purchase plan as part of an ESOP is to increase the tax deductible limits on employer contributions from the normal 15% of compensation limit applicable for stock bonus plans to 25% of compensation, when "credit carryovers" are not available under Code §404(a)(3)(A). Subsequent to the enactment of the Economic Recovery Tax Act of 1981 (ERTA), however, such use of a money purchase pension plan will generally no longer be necessary, because ERTA increased the deduction limits applicable under Code §404(a)(9) with respect to employer contributions used to repay an ESOP loan. In the case of a non-leveraged ESOP, the use of a money purchase plan may still be attractive to increase tax deductible contributions, provided the employer is willing to make the definite contributions required each year under the money purchase plan.

C. Statutory Definition of an ESOP and Analysis of Definitional Requirements

1. General Characteristics

ESOPs must be: (1) a defined contribution plan; that (2) meets the requirements of Section 401(a); (3) is designed to invest primarily in employer securities; and (4) meets the requirements of Section 409's subsections (e) [giving participants certain voting rights], (h) [giving participants the right to demand employer securities and to require the employer to repurchase them], and (o) [giving participants certain distribution rights].

a. Defined Contribution Plan

The Code groups all deferred compensation plans in two categories defined contribution plans and defined benefit plans. Under a defined contribution plan, a participant's benefits are based solely on the sum of: employer contributions to his accounts; contributions made by the participant himself; forfeitures, if any, allocated to his account; and the account's ratable share of the trust's income, loss, and expenses. As a result, the level of a participant's benefits depends on the amount of contributions and earnings experience during his participation in the plan. This is in contrast to a defined benefit plan, under which a scheduled level of benefits is paid irrespective of the level of contributions and earnings experience of the plan. Profit sharing plans, stock bonus plans, money purchase plans, thrift plans, and savings plans are all forms of defined contribution plans.

In a money purchase plan, the amount of employer contributions must be fixed by a formula in the plan. In other defined contribution plans, the amount of employer contribution may be, but is not required to be, fixed by formula. If the plan does provide a formula, the employer must make contributions to the plan in accordance with the formula.

A defined contribution plan may either allocate forfeitures to the accounts of the participants or use the forfeitures to reduce the amount of the employer's contribution (if its contribution is fixed by a formula). Under a defined benefit plan forfeitures may not be used to increase employee benefits, but must serve to reduce the employer's contribution or pay plan expenses.

b. Requirements of Section 401(a)

Section 401(a) governs the qualification of all deferred compensation plans.

c. Designed to Invest Primarily in Employer Securities

"Employer securities" are defined by Section 409(1) as common stock issued by the employer which is readily tradable on an established securities market. If such common stock does not exist, "employer securities" generally means common stock issued by the employer having a combination of voting power and dividend rights equal to or in excess of the class of common stock of the employer having the greatest voting power and the class of stock having the greatest dividend rates. In addition, "employer securities" include noncallable preferred stock if such stock is convertible at any time into the qualified common stock described above, at a conversion price which (as of the date of acquisition by the ESOP) is reasonable. Employer securities issued by any member of a controlled group of corporations are treated as employer securities for all members of the controlled group. Nonvoting common stock of an employer may be used in limited circumstances.

The phrase "designed to invest primarily" has not been interpreted by the IRS. The phrase implies that an ESOP must permit the plan trustees to invest or hold the major portion of the plan's assets in employer securities. In absence of a more restrictive IRS or Department of Labor interpretation, this phrase apparently denotes a qualitative standard relating to the purpose of an ESOP as an employee benefit plan, and no quantitative test applies.

d. Voting Rights

In general, if the employer has a class of securities required to be registered under Section 12 of the Securities and Exchange Act of 1934 (the "Exchange Act") or class of securities that would be required to be so registered except for the exemption from registration provided by Section 12(g)(2)(H) of the Exchange Act, then the ESOP must permit each participant to direct the voting of the securities of the employer allocated to his account.

Apparently, this requirement applies to the voting rights of all securities of the employer (not just employer securities within the meaning of Section 409(1)) allocated to the account of the participant, even if they are not part of the class of securities required to be registered under the Exchange Act.

An employee stock ownership plan maintained by an employer that does not have registration-type class of securities is not required to pass through voting rights to plan participants, unless a pass-through is required under the vote pass through rule generally applicable to defined contribution plans. Consequently, the vote pass-through is only required (1) with respect to any corporate matter which involves the voting of shares for or against corporate mergers, consolidations, sales of all or substantially all of the corporation's assets, recapitalizations, reclassifications, liquidations, and dissolutions, (2) if the plan is maintained by an employer whose stock is not publicly traded, and (3) if, after acquiring securities of the employer, more than 10% of the plan's assets are invested in securities of the employer.

Effective December 31, 1986, the pass-through voting requirement is eliminated for ESOPs maintained by certain newspapers which are published on a regular basis for general circulation and whose stock is not publicly traded. ESOPs established by such employers may also acquire nonvoting common stock in certain cases. This provision applies to the acquisition of securities after December 31, 1986.

On and after October 22, 1986, an ESOP may permit each participant to have one vote with respect to each issue he or she is entitled to direct the trustee to vote (without regard to the actual number of shares allocated to his or her account) and the trustee may vote the shares held in the plan in the proportions so directed by participants.

For ESOP loans made after November 17, 1989 for which the lender wants the Section 133 interest exclusion, any stock acquired with the proceeds of such a loan must provide full voting rights pass through to ESOP participants.

e. Right to Demand Employer Securities; Put Option

An ESOP must provide that a participant who is entitled to receive a distribution from the plan has a right to demand that his benefits to be distributed in the form of employer securities. In the absence of such a demand, benefits may be distributed in cash.

Unless the employer securities are readily tradable on an established market, the ESOP participants must be given the right to require the employer (not the ESOP) to repurchase employer securities under a fair valuation formula.

Distributions of non-publicly traded employer securities from a stock bonus plan are also subject to the put option requirements applicable to ESOPs. The extension of put option

requirements to stock bonus plans applies to distributions attributable to stock acquired after December 31, 1986.

f. Distribution Requirements

An ESOP must provide that, unless the participant elects otherwise, the distribution of a participant's vested account balance will begin not later than one year after the end of plan year during which a participant terminates employment because of retirement on or after normal retirement age, disability or death or, if he resigns or is dismissed, not later than one year after the end of the fifth plan year following the plan year during which a participant terminates employment (unless he is reemployed by the employer before such year). An ESOP must further provide that, unless the participant elects otherwise, the distribution of a participant's account balance must be as rapidly as substantially equal annual installments over a period not longer than five years. However, if a participant has an account balance exceeding \$500,000, the distribution may be over a period not exceeding five years plus one year for each \$100,000 (or fraction thereof) by which a participant's account balance exceeds \$500,000. The \$100,000 and \$500,000 limits are adjusted at the same time and same manner as the \$30,000 and \$90,000 limits under Section 415. Subject to these requirements, an ESOP may retain discretion in determining the timing and form of distributions without regard to the limitations on employer discretion as to the form and timing of distribution generally applicable to qualified plans under the Retirement Equity Act of 1984.

The foregoing distribution requirements are not applicable to that part of a participant's account balance consisting of employer securities acquired with the proceeds of an ESOP acquisition loan until the end of the plan year in which the entire loan is repaid. This exception may require separate accounting within a participant's account for allocations from ESOP loans which become due at different times and for non-leveraged shares. The requirements are also not applicable to employer securities acquired before January 1, 1987, although some employers may elect to extend such requirements to all plan distributions.

2. Additional Characteristics of ESOPs

a. Statutory Definition

Section 4975(e)(7) defines "employee stock ownership plan" as a defined contribution plan which (1) is a stock bonus plan qualified under Section 401(a) or a combination of a stock bonus plan and money purchase plan both of which are qualified under Section 401(a); (2) is designed to invest primarily in qualifying employer securities; (3) is otherwise defined in regulations prescribed by the Secretary of the Treasury; and (4) meets the requirements of subsections (e), (h), and (o) of Section 409.

b. Stock Bonus Plan

A leveraged ESOP may be a stock bonus plan or a combination stock bonus and money purchase plan. §409(a) and §4975(e)(7).

c. Allocation of Employer Contributions and Forfeitures

An ESOP, like all qualified defined contribution plans, must provide a formula for allocating employer contributions and forfeitures to the individual accounts of the participants. The allocation formula may not discriminate in favor of highly compensated employees and, for plan years commencing after December 31, 1988, must disregard annual compensation in excess of \$200,000 (indexed for cost of living increases). Normally, allocations will be proportionate to the employee's compensation, but other factors, such as years of service, may be considered. Generally, ESOPs may not be integrated with Social Security.

Regulations Section 54.4975-11 (issued before the amendment of Section 4975 by the Revenue Act of 1978) provides that the qualifying employer securities acquired by the plan are to be allocated in accordance with the standards generally applicable to other types of qualified defined contribution plans unless the securities are acquired with the proceeds of an exempt loan. Such securities are to be placed in a suspense account. As the principal and interest of the exempt loan is repaid, a pro rata amount of securities must be released from the suspense account and allocated to the accounts of participants for such year. The Regulations specify an alternative release and allocation method based on principal payments only.

Income derived from securities acquired with the proceeds of an exempt loan must be allocated as income from the plan or, if the plan so provides, used to repay the exempt loan.

In the event of forfeitures, securities released from the suspense account must be forfeited only after other assets.

d. Loan Requirements

A loan to an ESOP from a disqualified person, or which is guaranteed by a disqualified person, or collateralized by assets of a disqualified person, is prohibited except for the limited exemption granted leveraged ESOPs. Section 54.4975-7(b) of the Regulations (issued before the Revenue Act of 1978) details the requirements for this exemption.

Use of Loan Proceeds

The loan proceeds must be used within a reasonable time after their receipt to acquire qualifying employer securities (within the meaning of Section 409(1)) or to repay the loan or a prior exempt loan.

Limited Liability of ESOP

The loan must be without recourse against the ESOP, except to the extent of employer securities acquired with loan proceeds (or with the proceeds of an outstanding exempt loan to the extent that loan is repaid with loan proceeds), contributions made to meet the ESOP's obligation under the loan, and earnings attributable to such employer securities and contributions. Furthermore, if plan assets are pledged as collateral the collateral must be released in installments over the term of the loan in accordance with a schedule at least as rapid as one of two schedules set forth in the Regulations.

Repayment Schedule; Default

The loan must be a term loan, not a demand loan. The maximum term of a Section 133 loan is limited to 15 years. Although a repayment schedule is not specified, an ESOP may not make loan payments other than from contributions made to enable the ESOP to meet its loan obligations and earnings attributable to the collateral and such contributions. If the loan becomes in default it may be accelerated, but the value of plan assets transferred in satisfaction of the loan must not exceed the amount of the default. If the loan is from a disqualified person, the default may be only to the extent of the failure of the plan to meet the payment schedule of the loan.

Other Requirements

The terms of the loan must be at least as favorable to the ESOP as the terms of a comparable loan resulting from armslength negotiations between independent parties and bear a reasonable interest rate. The loan may bear interest at a variable rate.

e. Increased ESOP Contribution Deductions

For taxable years beginning before January 1, 1982, under Section 404(a)(3)(A), an employer who maintained an ESOP consisting of a stock bonus plan only could contribute and deduct annually up to 15% (up to 25%, if pre-1987 "credit carryovers" were available) of the compensation of its participating employees. If the employer included a money purchase pension plan as part of the ESOP, the deductible limitation for the employer's contribution could be increased to 25% of the compensation of participating employees. Commencing with taxable years beginning on or after January 1, 1982, increased limits for employer contributions used to repay an ESOP loan (incurred to purchase employer stock) are available. Contributions used to pay loan interest will be fully deductible. In addition, contributions used to pay loan principal will be deductible up to 25% of covered payroll. If an ESOP does not allocate more than one-third of the contributions (used for loan repayment) to highly-compensated employees (within the meaning of Section 414(q)), contributions used to pay loan interest and forfeitures of leveraged employer stock will not be included in determining the individual allocation limitations under Section 415.

3. Miscellaneous Requirements

a. Form of Contributions

Contribution of Employer Securities

An ESOP generally must make distributions in employer securities if demanded by the participant entitled to the distribution. An employer may contribute the necessary securities to the plan, or it may contribute cash with which the plan may purchase the necessary securities. Under Sections 409(m) and 1032, a corporation recognizes no gain or loss on contributing its securities, including treasury stock, to the plan.

Contribution of Cash

It may be desirable that the plan's holdings include liquid assets such as cash, as follows:

- **Payment of Administrative Costs** -- The plan may provide that administrative expenses will be paid by the employer or from the assets of the plan. If the latter option is chosen, the plan must hold some liquid assets in order to meet these expenses.
- **Purchase of a Shareholder's Interest** -- A corporation may desire to establish an ESOP to provide an in-house market for its securities, or a major shareholder may wish to divest himself of part of his interest by selling it to the ESOP. An ESOP established under §4975(e)(7) is permitted to obtain a loan to purchase this interest. Alternatively, if the sale were anticipated, contributions of cash could be made to the plan so that it could acquire the shareholder's interest.
- **Repurchase of Securities Distributed to Participants** -- Since the securities of a closely held corporation are generally not readily marketable, the plan may desire to maintain liquid reserves with which to repurchase distributed securities. Further, by repurchasing the securities, the plan can maintain sufficient holdings of securities for future distributions.
- **Cash Distributions** -- Finally, in the case of many closely-held corporations, participants (and the employer) may prefer cash distributions rather than distributions of stock. In such event, substantial liquid assets would be desirable.

b. No Integration With Social Security

An ESOP, if designated as an ESOP after November 1, 1977, may not be integrated with Social Security. ESOPs established and integrated before such date may remain integrated. Although the integration level may not be increased by plan amendment, it may be increased in operation if under the plan such increase is limited by reference to a criterion existing apart from the plan.

c. Characteristics of the Employer

An ESOP must be established by a corporate employer. However, an S Corporation which establishes an ESOP would lose its S Corporation status and it may be difficult (or impossible) for a professional corporation to establish an ESOP.

S Corporations

Except in limited circumstances, a trust may not hold shares of an S Corporation. Since a trust established under an ESOP generally must hold shares of the employer corporation, an S Corporation may lose its S Corporation status upon funding of an ESOP.

Professional Corporations

There are no provisions in ERISA or the Code that prevent a professional corporation from establishing an ESOP. However, most state statutes proscribe the ownership of shares by anyone who is not a member of the respective profession. Thus, in some states, shares could not be held by a trust or distributed to a participant who was not a member of the respective profession.

In 1975, the Attorney General of Georgia issued an opinion concerning an ESOP whose assets were held by a trustee who was not a member of the requisite profession. The opinion states that the fact that the trustee holds the legal title of the shares does not result in a violation of the state's professional corporation law. The Attorney General of Michigan has issued an opinion that an ESOP may own stock of a professional corporation where the trustees and all participants are duly licensed professional employees of the employer.

However, the Code requires that a plan not discriminate in favor of highly paid employees. Therefore, an ESOP of a professional corporation must include any nonprofessional employees of the corporation. Ultimately, shares of the corporation would be distributed to these employees and such a distribution would violate most states, statutes. The nondiscrimination requirement and the state statutes might be satisfied by establishing a qualified plan other than an ESOP to cover the nonprofessional employees of the corporation. The use of two plans to avoid the nondiscrimination requirement is questionable. Proposed Regs. Section 54.4975-(11)(e) states that an ESOP shall not be designated as one of two or more plans for purposes of Section 410(b)(1). A House Report indicates that an ESOP and another plan should not be considered a single plan for purposes of determining whether the plan meets the nondiscrimination requirements. The additional participation requirements of section 401(a)(26) also make such a scheme questionable.

d. Written Instrument

All employee benefit plans must be established pursuant to a written instrument which must:

- Name one or more fiduciaries or delineate a procedure by which the fiduciary is named by the employer or an employee organization;
- Provide a procedure for establishing and carrying out a funding policy consistent with the plan;
- Describe any procedure for allocating responsibility under the plan for the operation and administration of the plan;
- Provide a procedure for amending the plan; and
- Specify the basis on which payments are made to and from the plan.

e. Valuation of Employer Securities

Proper valuation of employer securities contributed or sold to the plan is an important and difficult aspect of plan administration. Improper valuation of employer securities contributed to the plan may result in the loss of some deductions if the valuation is overstated. If the ESOP purchases the securities for more than their fair market value, an excise tax could be imposed and, in some limited circumstances, disqualification of the ESOP could result. For non-publicly traded employer stock acquired after December 31, 1986, all determinations of fair market value in connection with an ESOP must be based upon a valuation by an independent appraiser. Treasury regulations will establish standards for determining what constitutes an independent appraiser along the lines of regulations issued under the charitable contribution provisions of Section 170(a)(1).

f. Exclusive Benefit Rule

Any qualified plan, including an ESOP, must be established for the "exclusive benefit" of the participants and their beneficiaries and any loan to an ESOP must be primarily for the benefit of the participants and their beneficiaries. Notwithstanding an ESOP's ability to deal with parties-in-interest in what would be prohibited transactions for other qualified plans, the plan must meet the general standards of benefiting the participants.

g. Annual Additions Limitation

Generally, the amount of "annual additions" (employer contributions, plus forfeitures, plus employee contributions) for a defined contribution plan may not exceed the lesser of 25% of the employees compensation or \$30,000, as adjusted by the Secretary of the Treasury for cost-of-living adjustments under Section 415(d). Under Section 415(c)(6) of the Code, for ESOPs, the definition of annual additions does not include employer contributions used to pay loan interest and forfeitures of leveraged employer stock provided that no more than one-third of the employer contributions are allocated to highly compensated employees (within the meaning of Section 414(q)).

D. Tax Attributes of ESOPs

1. Deductions for Employer Contributions

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

Section 404(a)(3)(A) provides that an employer may contribute to an ESOP consisting of a stock bonus plan only, and claim as a tax deduction, any amount up to 15 percent of the compensation of all participants under the plan for that plan year. In addition, if for any taxable year commencing prior to January 1, 1987 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 ("credit carryovers") to be carried forward to succeeding taxable years so that the employer may contribute, and deduct, an amount not in excess of 25 percent of the compensation of ESOP participants for any future taxable year. This carry-forward of unused tax deductible contributions may apply 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 an ESOP consisting of a stock bonus plan only and a separate pension plan, the employer may, pursuant to Code Section 404(a)(7), contribute, and deduct, up to 25 percent of the compensation of the participants under the ESOP and pension plan.

Effective for taxable years beginning after 1981, the Economic Recovery Tax Act of 1981 significantly increased the limits under the Internal Revenue Code for deductible contributions to an ESOP which are used to repay a loan incurred by the ESOP to finance the acquisition of employer

stock. Under Section 404(a)(9) of the Code, employer contributions used to repay ESOP loan interest will be fully deductible, and employer contributions used to repay loan principal will be deductible up to 25% of the total compensation of all participating employees. These new deduction provisions will apply even if the employer makes contributions to another qualified employee plan.

2. Individual Allocation Limits

a. General Limitations

As stated above, the deduction limitations set forth in the Code 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. Conversely, the enactment of Section 415 of the Code by ERISA imposes a major restriction on the amount of the annual contributions which an employer may make to a qualified plan or plans in any year by imposing limitations on the amount which may be allocated to participants' accounts in any year. The Code now provides that the "annual addition" which may be allocated to the account of a participant in defined contribution plans (including ESOPs) each year may not exceed the lesser of 25 percent of his compensation or \$30,000 (adjusted annually, beginning in 1988, for cost-of-living increases when the \$90,000 defined benefit dollar limit reaches a four-to-one ratio with the defined contribution dollar limit).

In determining the "annual addition" to a participant's account for a year, the following items must be included:

- employer contributions to all defined contribution plans in which the employee is a participant,
- forfeitures allocated to his account, and
- before January 1, 1987, 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 limitation years commencing on or after January 1, 1987, the all employee contributions to the plan count as annual additions. On the other hand, dividends paid on employer stock held by an ESOP which are used to repay ESOP debt are not counted as annual additions.

If the employer simultaneously maintains a defined benefit pension plan and defined contribution plan (including an ESOP), the Code §415(c) 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 fraction, the sum of which cannot exceed 1.0. The defined benefit fraction is: The participant's projected benefit at year end divided by the lesser of (a) the product of 1.25 multiplied by the maximum dollar limitation in effect for that year, or (b) the product of 1.4 multiplied by the maximum percentage limitation in effect for that year. This fraction assumes that the participant's compensation for all future years will remain constant. The defined contribution fraction is: The total annual additions to a participant's account through year end divided by the sum of the annual additions which, for each year, are equal to the lesser of (a) the product of 1.25 multiplied by the maximum dollar limitation in effect for that year, or (b) the product of 1.4 multiplied by the percentage limitation in effect for that year. The defined benefit

fraction and defined contribution fraction are added together, and if their total exceeds 1.0, one or more of the employer's plans will be disqualified. (In applying these limitations, all defined contribution plans maintained by an employer are aggregated together, as are all defined benefit plans, and the increased dollar limitation allowed under Section 415(c)(6)(A) are disregarded in calculating the defined contribution fraction.)

Comment

The limiting effect of Section 415 of the Code must be recognized. While the provisions relating to deductibility of employer contributions have the effect of limiting the amount of employer contributions, this is done indirectly. More direct is the 10% excise on nondeductible contributions to qualified plans imposed by Section 4972 for taxable years beginning after December 31, 1986.

The provisions of Sections 404 and 4972 thus effectively prevent the making of additional, nondeductible contributions. Furthermore, the Section 415 limitations on annual additions specifically preclude the allocation of any employer contributions to a participant's account which, when combined with certain reallocated forfeitures (and in some cases employee contributions) in any year, would exceed the maximum limitations established by Section 415. 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 Code. This might result in an inability of the ESOP to make its full loan amortization in that year, unless dividends are paid on ESOP stock and used to retire ESOP acquisition indebtedness.

b. New ERTA Provisions

The Economic Recovery Tax Act of 1981 (ERTA) added subparagraph (C) of the Code §415(c)(6), permitting the exclusion of certain employer contributions and forfeitures from the individual allocation limit which normally applies. Employer contributions used to pay ESOP loan interest, as well as forfeitures of leveraged employer stock, are disregarded in determining the limitations under Section 415, provided that not more than 1/3 of the total employer contributions used in that year to repay the ESOP loan is allocated to highly compensated employees (formerly officers, 10% or more shareholders of highly-compensated employees).

Several special requirements must be met in order to take advantage of both the deduction and allocation provisions added by ERTA. In order to qualify, the employer contributions must be used by the ESOP to repay the "ESOP loan" not later than the due date (including extensions) for filing the employer's Federal income tax return for the applicable year. In addition, the employer stock generally must be (1) publicly-traded common stock; or (2) other common stock with a combination of voting power and dividend rights at least equal to that of all classes of common stock of the employer; or (3) preferred stock which is convertible (at a "reasonable" price) at any time into qualifying common stock. The new allocation provisions will require the "tracking" of leveraged shares. There is no express requirement, however, that the ESOP acquisition loan be made under

the "ESOP loan exemption" of Code Section 4975(d)(3), and the issuance of an installation note by an ESOP to pay for stock can qualify as a "loan" under these rules.

E. ERISA Fiduciary Rules

An ESOP is subject to the general fiduciary rules of ERISA §404(a), although the application of such rules to an ESOP may differ from their application to other qualified plans. ERISA provides special exemptions for ESOPs with respect to the investment diversification requirements and the prohibited transaction rules.

1. Exclusive Purpose and Prudence Rules

Although an ESOP is subject to the "exclusive purpose" and "prudence" requirements of ERISA, the application of these rules to ESOP fiduciaries must take into account the "special purpose" of an ESOP as a plan "designed to invest primarily in qualifying employer securities." Since the ESOP regulations do not provide a quantitative test for determining compliance with this definitional requirement of an ESOP, the IRS and the Department of Labor have apparently determined that "designed to invest primarily . . ." is a qualitative standard relating to the purpose of an ESOP as an employee benefit plan.

Revenue Ruling 69-65 states the pre-ERISA view of the IRS that a stock bonus plan is intended to provide participants with "a share in the ownership and growth of the employer's business." Subsequent to the enactment of ERISA, the IRS took the position that an ESOP is a "technique of corporate finance." Thus, the primary purpose of an ESOP as an employee benefit plan is apparently to provide participants with an equity interest in the employer, with retirement benefits being provided through employer stock.

Under ERISA §404(a)(1), the fiduciaries of an ESOP are charged with the responsibility of acquiring employer stock for the benefit of participants in a manner which demonstrates compliance with the "exclusive purpose" and "prudence" rules. The responsibility of the fiduciaries would not be to maximize retirement benefits through investments in assets other than employer stock, but rather to maximize the benefits attributable to investing "primarily" in employer stock. ERISA recognizes that employee benefit plans may serve various purposes, and that the purpose of an ESOP is to provide stock ownership interests for participants.

2. Diversification

ERISA §404(a) (2) provides that ESOPs and other "eligible individual account plans" are exempt from the diversification of investments requirements (and any diversification requirement which is part of the prudence requirement) to the extent of their investment in qualifying employer securities (or qualifying employer real property). To the extent that an ESOP invests in assets other than qualifying employer securities, the diversification requirement of ERISA §404(a)(1)(C) will apply.

3. Eligible Individual Account Plans

ERISA §407(a)(1) and §407(a)(2) prohibit a plan from investing in employer securities which are not "qualifying employer securities" and generally limit plan investments in qualifying employer securities to ten percent of the plan assets. ERISA 407(b) provides, however, that the ten percent limitation shall not apply to investments in qualifying employer securities (or qualifying employer real property) by an "eligible individual account plan."

Under ERISA §407(d)(3), eligible individual account plans include the following:

- profit sharing, stock bonus, thrift and savings plans;
- an employee stock ownership plan, as defined in ERISA §407(d)(6); and
- certain money purchase plans which were invested primarily in qualifying employer securities on September 2, 1974 (the date of enactment of ERISA).

In order for such a plan to be an eligible individual account plan, the plan must explicitly provide the extent to which plan assets may be invested in qualifying employer securities.

Under these rules, it is clear that an ESOP may invest 100% of the plan assets in employer stock, subject to compliance with the applicable fiduciary rules of ERISA 404(a)(1).

4. The "Sale" Exemption

ERISA §406 (and §4975 of the Code) generally prohibit transactions between a plan and a "party in interest", as well as self-dealing by fiduciaries. Without an exemption for the prohibited transaction rules, an ESOP would be prohibited from acquiring employer stock from the employer or from other parties in interest (such as major shareholders, officers and directors). This would make operating an ESOP extremely difficult, particularly for the closely-held company. An exemption from the prohibited transactions rules, pursuant to ERISA §408(e), permits an ESOP to acquire employer securities from any party-in-interest, provided that (i) the purchase price is not less favorable to the plan than "adequate consideration" and (ii) no commission is charged to the plan. Department of Labor (DOL) regulations make it clear that this exemption applies not only to party in interest transactions (which would otherwise be prohibited), but also to fiduciary self-dealing (other than the prohibition against "kickbacks").

"Adequate consideration", for purposes of this "sale" exemption, is defined in Section 3(18) of ERISA. In the case of stock for which there is a generally recognized market, adequate consideration is based on the prevailing market price. In the case of a closely-held corporation, adequate consideration is fair market value as determined in good faith by named fiduciaries in accordance with the provisions of the plan and DOL regulations (which have not yet been issued). For employer stock acquired after December 31, 1986, an independent appraiser must determine fair market value under Section 401(a)(28) of the Code.

5. The ESOP Loan Exemption

Section 406(a)(1)(B) of ERISA and Code §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 §408(b)(3) and Code §4975(d)(3) provide an exemption from the prohibited transaction rules, which permit an ESOP (but not any other eligible individual account plan) to borrow money using a direct loan, loan guarantee or installment sale from a party in interest to effect its acquisition 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:

- the ESOP must satisfy the statutory definition of ERISA §407(d)(6), Code §4975(e)(7) and IRS regulations;
- The loan must be primarily for the benefit of participants;
- the interest rate must be reasonable; and
- 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 IRS and DOL regulations interpreting the term ". . . primarily for the benefit of participants. . . ." 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 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:

- 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 on the loan and the purchase price of the stock 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.
- 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 and those that were used as collateral on a prior exempt loan repaid with the proceeds of the current exempt loan (or freed from encumbrance under a prior loan by the proceeds).
- Any shares of employer stock given as collateral by the ESOP must be released from pledge on a pro-rata basis as the loan is repaid. The regulations provide two methods for the release of shares, one based on payments of principal and interest and one based solely on principal payments. The shares are allocated to participants, accounts under the same methods, even if the stock is not pledged.

- The liability of the ESOP for repayment of the loan must be limited to contributions made to the ESOP for loan repayment purposes (other than contributions of employer stock), earnings on such contributions and cash dividends on the employer stock.
- The lender must have no recourse to assets held in the ESOP other than employer stock remaining pledged as collateral.
- The loan must (i) be for a fixed term, (ii) satisfy certain requirements in the event of default, including that a party in interest lender may not accelerate payments in the event of default, and (iii) not be payable on demand of the lender except in the case of default. Reasonable provisions for prepayment penalties are permitted.
- Rights of first refusal on the employer stock are permitted, subject to certain restrictions, and requirements for "put options" must be satisfied (as described below). The employer stock generally may not be subject to any additional puts, calls or other options, or buy-sell or similar arrangements (other than as may be required under securities laws).

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

II. Special Considerations of ESOPs

A. ESOP Distributions

Distributions from ESOPs are governed by section 409(h) of the Code. Under the regulations applicable to stock bonus plans, benefits must be distributable in stock of the employer corporation. The IRS has interpreted this requirement to mean that all benefits from a stock bonus plan must be distributed in shares of employer stock, except that the value of fractional shares may be distributed in cash. However, Code 401(a)(23) now requires a stock bonus plan to conform to the distribution rules applicable to ESOPs.

With respect to stock acquired after December 31, 1986, distribution of a participant's account balance must commence not later than 1 year after the close of the plan year (i) in which the participant separates from service by reason of attainment of normal retirement age under the plan, disability or death, or (ii) which is the fifth plan year following the year in which the participant resigns or is dismissed, unless he is reemployed before such date. Thereafter, distribution of the balance will be made as rapidly as substantially equal periodic payments over a period not longer

than five years (up to ten years for certain balances in excess of one-half million dollars). Thus, on stock acquired after December 31, 1986, an employer's planning opportunities to level out its repurchase liability by deferring and lengthening ESOP distributions are quite restricted. An exception is provided for certain financed shares until the applicable ESOP loan is retired.

Section 409(h) allows an ESOP to make distributions either in cash or in stock, provided that each participant has the right to demand that his benefits be distributed in shares of employer stock. This right of the participant to demand stock must be communicated at the time a distribution is payable. The right to demand stock is apparently also applicable to a money purchase pension plan which forms a part of an ESOP. The distributions and put option rules has been extended to stock bonus plan distributions of employer stock acquired after December 31, 1986.

However, if the sponsoring employer's corporate charter or by-laws restrict ownership of "substantially all" outstanding employer securities to employees or to a trust qualified under 401(a), the ESOP may distribute all benefits in cash without granting participants the right to demand stock, except that the plan may distribute employer securities subject to a requirement that the securities be resold to the employer under terms which meet the put option payment requirements. For this purpose, "substantially all" is likely to mean at least 80%.

The put option requirement under 409(h) applies to all shares of employer stock acquired after December 31, 1979 if the shares are not "readily tradable on an established market" at the time of distribution. The requirement applies to leveraged shares acquired by an ESOP after September 30, 1976. For this purpose, shares of a publicly-traded company which are subject to a trading limitation (under applicable securities laws) may be subject to the put option requirement.

Under section 409(h), a put option must permit the distributee to require the employer to repurchase shares of employer stock under a fair valuation formula, which will be determined by an independent appraiser pursuant to Section 401(a)(28)(C). For this purpose, fair market value as of the preceding valuation date under the ESOP may generally be used. The put option period must be at least sixty days following the date of distribution. If the put option is not exercised during that period, an additional exercise period of at least sixty days must be available during the next plan year after the new valuation of employer stock has been determined and communicated to the former participant.

The put option may not bind the ESOP to repurchase the stock, but may permit the ESOP to purchase stock tendered to the employer. If the employer is unable to repurchase its stock (such as in the event that state law requirements for retained earnings are not met), the put option periods will be deferred until the time the employer is legally permitted to make such a repurchase.

When a distributee takes a total distribution of employer securities in his account in one taxable year and exercises his put option, the employer must pay the option price in either a single sum or in substantially equal annual installments over a period which begins no later than 30 days after the distributee exercises the option and extends no longer than five years. The employer must also provide security for the unpaid amounts and must pay a reasonable rate of interest. If an employee exercises a put option under an installment distribution, the employer must pay the option price within 30 days of the exercise. Where the employer chooses to satisfy its put option liability for a total distribution in installment payments, no guidelines exist as to what is a "reasonable" rate of interest. One case, however, provides guidance as to what "adequate security" means. In that

case, the Court held that "adequate security" involves the pledge of employer assets with a bona fide perfected security interest therein. A mere promissory note secured only by company assets and equity was held insufficient. Under such a standard, many conflicts with existing and future secured credit transactions with probably arise for the employer. In the case of a bank which is prohibited by law from purchasing its own stock, the put option requirement is waived so long as each participant entitled to an ESOP distribution is given the right to receive a cash distribution. If the participant demands a distribution in stock, no put option is required, even if there is no generally recognized market for the stock of the bank.

Observation

The cash distribution option and put option requirements of Code §409(h) recognize that there is a need to "create a market" for employer stock which is not publicly-traded at the time an ESOP distribution is made. A closely-held company which maintains an ESOP must consider the liquidity needs which will arise in the future and the "repurchase liability" which the ESOP will create. Careful planning at the time an ESOP is established (and periodic review thereafter) is strongly recommended in order that participants who desire to sell the stock which they receive as ESOP benefits are able to do so.

B. Rights of First Refusal

The ESOP regulations allow the employer to subject shares of employer stock to a right of first refusal (while held by the ESOP or when distributed to participants). The right of first refusal may not apply to stock which is publicly traded. The right may be in favor of the employer corporation, the ESOP or both, but may not be in favor of other persons. The selling price and other terms under a right of first refusal must not be less favorable to the seller than fair market value of the stock or the purchase price and other terms offered by a buyer making a good faith offer to purchase the stock. The right of first refusal must lapse no later than 14 days after the holder of the stock gives written notice to the holder of the right that a third party offer has been received.

C. Definition of Employer Securities

ERISA section 407(d)(5) defines "qualifying employer securities" for purposes of the fiduciary rules and the prohibited transaction provisions. Under this definition, qualifying employer securities includes any class of capital stock issued by the employer (or an affiliate) and certain "marketable obligations" of the employer which meet the stringent requirements of ERISA section 407(e). Prior to the Revenue Act of 1978, employer securities for purposes of ESOPs were subject to the ERISA definition. However, ESOPs are now subject to the more restrictive definition of employer securities found in Code 409(1) with respect to securities acquired after December 31, 1979. Section 409(1) defines "employer securities" as one of the following:

- Common stock issued by the employer which is readily tradable on an established securities market;

- Common stock issued by the employer having a combination of voting power and dividend rights equal to or in excess of those classes of common stock of the employer having the greatest voting power and the greatest dividend rights; or
- Noncallable preferred stock which is convertible at any time into common stock which satisfies one of the above descriptions, so long as the conversion price is reasonable at the time of acquisition by the ESOP. For this purpose, stock will be treated as noncallable if there is an opportunity for conversion at the time of a call.

Special rules outlined in section 409(1)(4) apply the employer securities rules to controlled groups of corporations.

D. Voting Rights Requirements

All ESOPs must satisfy the requirements of Code §409(e) with respect to voting rights on employer securities. A stock bonus plan which is not an ESOP is subject to these requirements only if the employers' stock is not publicly-traded.

When the employer has a class of securities which is required to be registered under Section 12 of the Securities Exchange Act of 1934, section 409(e)(2) requires that participants and beneficiaries be entitled to direct the manner in which securities of the employer (not just "employer securities") allocated to their respective accounts are to be voted on all matters. When the employer does not have such a "registration type class of securities," voting rights are to be passed-through to participants and beneficiaries only on corporate matters involving the voting of shares with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of all or substantially all assets or similar transactions described in regulations. For ESOPs, these requirements apply only to securities of the employer acquired by the ESOP after December 31, 1979. Certain nonvoting common stock of an employer whose stock is not publicly traded is excepted from the voting pass-through requirements.

An ESOP can be restructured with respect to its pass through voting requirements, whether or not the employer has a registration type of securities, so that the ESOP may provide each participant with one vote as long as the trustee votes the shares held by the ESOP in proportion to the votes of all participants. Accordingly, to utilize this voting method, the trustee must relinquish voting discretion on all unallocated shares.

For ESOP loans made after November 17, 1989 for which the lender wants the Section 133 interest exclusion, any stock acquired with the proceeds of such a loan must provide full voting rights pass through to ESOP participants.

Comment

The voting rights requirements of section 409(e) apply only to shares of employer stock allocated to participants' accounts. To the extent that shares in an ESOP are not so allocated (such as shares acquired since the last allocation date, or shares acquired with loan proceeds and not yet "released" from the suspense account for allocation purposes), it appears that designated fiduciaries may exercise their own discretion in voting such shares, except where the "one-person, one-vote" rule is used.

E. Valuation of Stock Upon Sale or Contribution to an ESOP

The value assigned to employer's stock contributed or sold to an ESOP is critically important. If the ESOP trustee causes the plan to purchase stock at a price greater than its true value, the purchase will be a violation of fiduciary duties, rendering the trustee personally liable to the plan participants for the amount of the overpayment. If the employer contributes stock to an ESOP and claims a deduction based on an inflated price, then the deduction will be disallowed to the extent of the overvaluation and could be held to be a prohibited transaction. An excise tax may be imposed

upon a principal shareholder or employer who sells stock to the ESOP at greater than fair market value. Conversely, a participant who sells shares he receives from an ESOP back to the employer or the plan pursuant to a put option at a price less than their fair market value may have a cause of action against the employer or the plan.

For securities traded on established markets, the market price of the stock on the appropriate day is the readily determinable value. However, closely-held companies have more difficulty establishing the value of their securities. In fact, Section 401(a)(28)(C) now provides that an ESOP is not qualified unless "all valuations of employer securities which are not readily tradable on an established securities market with respect to activities carried on by the plan are by an independent appraiser." This pertains specifically only to employer securities acquired after December 31, 1986 but, practically speaking, will apply to the whole plan if even one share is purchased after that date.

A qualified appraiser is one who states on the appraisal form that he holds himself out to the public as an appraiser, is qualified to make appraisals of the property being valued, and understands that he may be subject to penalties for false or fraudulent over valuations. Interested parties cannot act as independent appraisers, but it is not clear what degree of interest will disqualify an individual from acting as an independent appraiser: this is to be determined under requirements similar to those prescribed under Section 170(a)(1) of the Code.

While Section 401(a)(28)(C) of the Code directs that an independent appraiser must provide stock valuations, little guidance is provided as to how closely-held corporations should calculate that value. ERISA Section 3(18)(B) defines "adequate consideration" for prohibited transaction purposes as "the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary." However, 12 years after the enactment of ERISA these regulations still have not yet been proposed, forcing practitioners to rely on the broad, general principles of Rev. Rul. 59-60, which discusses valuation of closely-held stock for estate and gift tax purposes. This Revenue Ruling defines fair market value as "the price at which the property 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, both parties having reasonable knowledge of the relevant facts." The Revenue Ruling also provides the following list of factors to consider in estimating the value of capital stock:

- The nature of the business and the history of the enterprise from its inception.
- The economic outlook in general and the condition and outlook of the specific industry in particular.
- The book value of the stock and the financial condition of the business.
- The earnings capacity of the company.
- The dividend-paying capacity of the company.
- Whether or not the enterprise has goodwill or other intangible value.
- Sales of the stock and the size of the block to be valued.

- The market price of stocks of corporations engaged in the same or similar lines of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

The significance of each factor depends on the nature of the business being appraised. For example, the net asset value may have the greatest weight in valuing a real estate company, while the capitalized earnings of a consumer product company may be the most important measure of its value. Another closely-held company may best be valued by analyzing the prices of publicly traded stock of companies engaged in the same or similar lines of business. There is current debate among professionals engaged in valuing stock for ESOP purposes with respect to discounting minority blocks of the stock of closely held companies for lack of marketability and whether to place a discount or premium on controlling blocks of stock.

The ESOP regulations state that "valuations must be made in good faith and based on all relevant factors for determining the fair market value of securities." If the IRS determines that shares were sold to the plan at a price exceeding their fair market value, the fiduciaries of the plan who consented to such a valuation may be deemed participants in a prohibited transaction and held personally liable to the ESOP for any losses to the plan and any profits they may have gained from the transaction. In addition, the seller may be assessed an excise tax of 5 percent of the amount involved per year, with an additional 100 percent tax being imposed if the transaction is not corrected. For transactions not involving a disqualified person, value may be determined as of the most recent annual valuation date, and an independent appraisal will be determinative. For transactions between a plan and a disqualified person, value must be determined as of the date of the transaction, and an independent appraisal will be required for acquisitions after December 31, 1986.

F. Diversification

Effective with respect to securities acquired by an ESOP after December 31, 1986, the ESOP must provide "qualified employees" --those who are at least 55 years old and who have at least 10 years of participation in the plan an opportunity to diversify their plan holdings. Section 401(a)(28)(B) imposes this as a qualification requirement: plans must permit qualified participants to direct the investment of at least 25 percent of their ESOP account during the qualified election period. The qualified election period is the six year period commencing with or after the plan year in which the participant attains age 55 (or, if later, with the plan year in which the participant became a qualified participant). Further, in the final year of the qualified election period, the plan must afford the participant the opportunity to direct the investment of at least 50 percent of the balance of his plan account (less any prior portion diversified). Participants are apparently entitled to one election each year during the election period. This provision will have the practical effect of accelerating the repurchase liability created by the put option attached to plan distributions in the case of closely-held corporations.

An ESOP may satisfy this diversification requirement in two ways.

First, the plan may distribute, in stock or in cash, the portion of a participant's account subject to the diversification requirement to him within 90 days of the period in which the diversification election may be made. If the plan distributes (or the recipient demands) stock, put option require-

ments apply or the stock may be rolled over into an IRA or other qualified plan; if it distributes cash, the participant may roll the cash over into an IRA or other qualified investment plan.

Second, to satisfy the diversification requirement, a plan may offer at least three investment options (other than employer stock) to qualified employees. An option to transfer assets to a plan which permits employee complete self-direction of investments satisfies the diversification requirement, but an option to invest in employer securities does not. In either case, it is expected that the mere offering of the option to liquidate ESOP shares will not be considered as a "sale" and "purchase" under Federal and Securities laws which involves onerous and expensive registration and disclosure for the ESOP.

G. Conversion of Existing Plan to an ESOP

Any qualified plan may be converted into an employee stock ownership plan. However, the conversion of a defined benefit pension plan into an ESOP will be treated by the Pension Benefit Guaranty Corporation as a simultaneous termination of the pension plan and adoption of a new plan, thus requiring the filing of a notice of intent to terminate with respect to the termination. Since a leveraged ESOP must be either a stock bonus plan or combination stock bonus and money purchase pension plan, conversion of any other type of defined contribution plan into a leveraged ESOP will probably require a substantially new plan document.

At the time of conversion, plan participants may be given the opportunity to elect whether to receive their accrued benefits under the old plan currently or to roll their accrued benefit into the new plan. If participants are given this option, the interests of those participants who elect to roll over their accrued benefits into the new ESOP (to be invested in employer stock) could be deemed securities by the S.E.C., requiring either registration or the availability of an exemption.

On the other hand, if participants are not given the option to withdraw their accrued benefit at the time of conversion (and possibly even if they are given that option), the fiduciaries of the plan and other plan fiduciaries may be subject to a cause of action on behalf of plan participants for breach of their fiduciary duties if, by investing the assets of the prior plan in employer securities, there is a loss in the value of plan assets. This fiduciary liability is based on a duty to make prudent investments; if investment in employer securities is imprudent, the plan fiduciaries may be held personally responsible.

For example, in one case (Eaves v. Penn), the "purchaser" of a company was installed as new trustee for a profit sharing plan. He then converted the profit sharing plan to an ESOP and used its assets, together with additional contributions by the employer, to purchase 97% of the employer stock held by the previous owner. The "purchaser" bought the remaining 3% for cash. By virtue of his position as trustee of the plan, the "purchaser" controlled all of the stock for purposes of electing directors. When, through mismanagement and excessive employer contributions to the plan, the value of the employer stock held by the ESOP fell well below the value of the assets held by the profit sharing plan prior to the conversion, the plan participants sued the trustee and the previous owner for breach of their fiduciary duties. Noting that the ESOP document did not require that either the employer or ESOP repurchase any stock distributed to plan participants, the court attempted to put the plan participants in the same position as if the profit sharing plan were never converted to

an ESOP by ordering rescission of the purchase of the stock by the ESOP and required the trustee to restore to the plan an amount equal to the contribution which would normally have been made to the profit sharing plan in the year of the transaction.

Both Labor Reg. §2550.407d-6 and Treas. Reg. §54.4975-11(a)(6) state that, if an existing pension, profit sharing or stock bonus plan is converted into an ESOP, the fiduciary duties of ERISA and the exclusive benefit rule of the Code apply to such conversion. In SEC Release No. 33-6188 (Feb. 1, 1980), the SEC has taken the position, as a matter of administrative discretion, that where a conversion of one type of qualified plan to another type (which invests in employer stock) occurs without giving employees any choice, registration is not required. Where employees do have a choice, registration may be required.