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EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

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Issues relating to the design and funding of ESOPs will be discussed, including:

- o Future of leveraged ESOPs
- o Typical practice in the design of ESOPs
- o Current administration and legislative proposals affecting the design of ESOPs
- o Scenarios where an ESOP program may be the right choice for employers and employees.

MR. ANTHONY C. DEUTSCH: The subject of ESOPs is one which has taken on increasing importance in recent years and months. The possible use of an ESOP as an anti-takeover measure has a great deal of topical interest. The pension actuary who works on a defined benefit pension plan for a corporate sponsor is oftentimes the consultant of greatest contact with that company regarding qualified pension plans. Therefore, while the subject matter of ESOPs is not specifically actuarial, I think it's important that any practicing pension actuary be familiar with ESOPs. ESOPs can frequently get the attention of the

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highest levels of a corporation's management. Oftentimes the types of decisions and financial issues that have to be analyzed come up very, very quickly, so it's nice to have a general idea, if not all the exact rules, of an ESOP.

We're very fortunate to have two real experts on the subject. Mr. Joel Horowitz is currently with the law firm of Ballard, Spahr, Andrews & Ingersoll in Philadelphia. Joel is an attorney; he formerly was in the IRS Chief Council's Office, and he was responsible for some of the ESOP regulations. He has a master's in legal letters from Georgetown University and specializes in tax law. Karl Lohwater is benefits counsel with Bell Atlantic Corporation. Bell Atlantic Corporation has 75,000 employees and has over $7 billion in its pension fund. Formerly, Mr. Lohwater was with the law firms of Morgan, Lewis & Bockius and Pepper, Hamilton & Scheetz in Philadelphia. He's a graduate of the Columbia Law School and was a Harlan Fiske Stone scholar. I'm an actuary with Towers, Perrin, Forster & Crosby in Philadelphia. I work primarily in the defined pension plan area, but I will attempt to give you a flavor for the kind of actuarial issues which can emerge in a real life situation.

MR. KARL LOHWATER: I'm going to do a survey of the various uses to which an ESOP can be put. In the old days it used to be very simple -- it could be an employee benefit plan or it could be a corporate financing technique. In recent years people have been using ESOPs in a lot of different areas, and we're going to talk about them separately. That doesn't mean that you can't adopt an ESOP with the intent of killing two birds with one stone, and Mr. Deutsch has an example of that.

Let's start with just the traditional leveraged ESOP, a corporate financing technique. It's a three-cornered ESOP, where an ESOP borrows from a bank, an insurance company or another lending institution. The ESOP then takes the proceeds of the loan to buy stock from the employer corporation, and that stock is held in a suspense account in the ESOP. The employer makes deductible contributions to the ESOP, and the ESOP uses those contributions to pay off the loan. As the loan is paid off, the shares are released from the suspense account and allocated to the accounts of participants. Viewing it as a corporate financing technique and viewing the corporation as the borrower -- remember, the ESOP is the actual borrower -- the corporation gets an infusion

of funds and then makes a loan. In essence, when it makes deductible contributions to the ESOP, both the principal and the interest on the loan are deductible. In addition, in today's world, if the dividends on the ESOP stock are paid out, then the corporation can also get a deduction for the dividends, which ordinarily would not be the case.

A drawback to an ESOP as a financing technique in this instance is that you're diluting your existing shareholders and you have an adverse impact on earnings per share, which can be very important. When you're using an ESOP as a financing technique in this sense, you're balancing the cash flow -- the immediate infusion of funds into the corporation and the ability of the corporation to deduct in essence both the principal and interest of the loan -- against the dilution effect and your reduction in earnings per share. I've seen a number of actuaries asked to make those types of financial calculations for corporations; in fact, Bell Atlantic has our financial people redo those computations in-house every three, four or five months. We've always been put off by the negative impact on earnings per share.

When you're doing that balancing act, you should also view the ESOP as an employee benefit plan. Then, some of the negative impact of the earnings per share can be offset by the fact that you are providing an employee benefit plan. If the ESOP is established in lieu of wage increases, you might have a very nice situation.

There are three basic tax rules on which an ESOP used as a financing technique relies. First, you have an expanded deduction limit and an expanded Section 415 limit. The $30,000 limit can actually be doubled up to $60,000 under the right circumstances. Second, the lender -- either the bank, the insurance company, or the financial institution -- can exclude one-half of the interest on the loan from its gross income. Therefore, you will get a break on the interest rate charged to the ESOP. Last, the corporation will be allowed to deduct the dividends if the dividends, which are paid out of the ESOP, are passed through to the participants. Ordinarily, the corporation cannot deduct the dividends.

Mr. Horowitz is going to talk about the technical rules for the loan and the technical plan qualification rules for establishing an ESOP. I'm going to leave ESOPs as a financing technique and survey the uses of an ESOP.

I would like to spend one short moment on ESOPs as an employee benefit plan, as a motivational tool. There's a lot of disagreement as to whether ESOPs motivate employees to be more productive. There's a lot of literature on the subject. Some companies have been successful after putting in an ESOP, and they give all the credit to the ESOP, and some have not been successful.

I thought I would share with you two anecdotes. When Conrail was being bailed out by the federal government, Congress required Conrail to adopt an ESOP. It was really a stock bonus plan; a stock bonus plan presents an ESOP as the true employee benefit plan that it is (i.e., there's no leveraging). Conrail employees own 15% of Conrail through this stock bonus plan. It was a unique stock bonus plan, because there was special legislation that required forfeiture of the stock if the labor cost of Conrail did not improve. Forfeiture is not ordinarily allowed in a qualified plan. In fact, Conrail's labor cost did improve, and so the stock did vest in the employees. But, in the summary plan description and the materials distributed to Conrail employees, the securities lawyers added a very clear disclaimer: while the intent of Congress was to encourage employees to work harder for the success of Conrail, the fact was the financial success of Conrail was probably outside of the hands of the employees and probably subject to economic factors beyond their control.

While Conrail has been successful, I have not seen anybody attribute that to the ESOP. I think it is attributed more to the economic factors in the Northeast which improved.

On the other hand there's Bell Atlantic, my own corporation. I believe our stock price has doubled in the last two years and has gone up by well over a third in the last six months. Our employees own about 5% of our stock, so the increase in the value of the stock has created for our employees hundreds of millions of dollars of wealth. I think that we have benefited by having very happy employees. There is probably a down side to that, too, when our stock goes down. But, again, I don't think that you can attribute our stock price to

the work that our employees do. I'm going to stop talking about ESOPs as a motivational tool because I think you can start a philosophical debate.

Another use of ESOPs is redeeming a principal shareholder in a closely held corporation. This can be a triangular type of ESOP. A typical fact situation is as follows: a 55- or 60-year-old fellow who has a very successful, privately held company has a tremendous amount of value in the stock and doesn't have a son or daughter to whom he wants to leave the company. If he doesn't have ready access to a market for his shares, he can sell the company to an ESOP. This is an alternative to having the corporation redeem his shares. The ESOP, if it could find a lender, would borrow from a bank, insurance company or a financial institution. The ESOP would then purchase the shares of the principal shareholder, and the company would make deductible contributions to the ESOP, which the ESOP pays to the shareholder on the note. This can be done without the bank, since the ESOP can buy directly from the shareholder, so the shareholder in this situation has a note rather than cash. The shareholder has a note from the ESOP, and he gets payments each year as the company makes its contributions. The shareholder can get capital gains treatment on the sale of his shares. This is sometimes difficult to do when the corporation redeems the shares, because of some tax rules in Section 302 of the Code, dealing with when a redemption of shares will be treated as a capital gain and when it will be treated as an ordinary income. In the last year or so, the selling shareholder has had the additional option, perhaps the most attractive of all, of deferring the gain on the sale of shares to an ESOP by reinvesting the proceeds in domestic stocks and bonds.

Mr. Horowitz is going to talk about the deferral rules, which are in Section 1042 of the Code. The main point is that if the ESOP owns 30% of the company after the sale, the selling shareholder and his family don't participate in the ESOP, and the shareholder reinvests the proceeds of his stock sale during a 15-month period -- 3 months before the sale, 12 months after the sale -- then the gain can be deferred. This is a tremendous advantage. The lender can exclude one-half of the interest on the ESOP loan so that in borrowing, the ESOP should get a break on the interest rate. The few that I've seen seem to be about a 10% to 15% break on the interest rate. I don't know if anyone has had different experience.

PANEL DISCUSSION

MR. JOEL E. HOROWITZ: We've seen as much as a 20% drop. I think it varies as the interest rates have dropped also. It seems to have settled out at 85%. Because they're excluding 50% of the interest doesn't mean you're going to get the 50% break, but it certainly makes for a more attractive borrowing opportunity.

MR. LOHWATER: If you're ever going to do this kind of a sale to an ESOP, you will want to take a look at certain revenue procedures. This use of an ESOP to buy out shareholders, which has been around for years, has developed into the same type of an ESOP that is now used in a leveraged buyout, in taking a public company private or in management's buying out the subsidiary of a company. Again, the ESOP works the same way. You can use an ESOP as part of a leveraged buyout, or management could establish an ESOP and buy out a subsidiary of a company without any other financing.

Bell Atlantic, as well as other large corporations, has been looking at redeeming its own shares or a small portion of its own shares when its earnings increase. I think Ford Motor Company is redeeming about $40 million of its shares right now. Bell Atlantic has not been redeeming its own shares, but we haven't been issuing any shares for a year or so in the hope that our outstanding shares will decrease slightly. I think you would find a lot of interest on the part of large companies in using a leveraged ESOP to buy back some of their shares. This would be the case if they're inclined to buy back their shares and they have an ESOP or some kind of a stock bonus plan where they're giving their employees' shares anyway. While I have never seen it done, the procedure is to have a leveraged ESOP go into the market and make a tender for your shares, as opposed to the company's doing it itself. It takes advantage of the same basic rules, such as the lending institution's excluding some of the interest and the dividends' being deductible as they're paid out to the employees in the ESOP. The company in essence can be redeeming its shares with pretax dollars. Obviously, if we go into the market and redeem our shares, we're buying them back with aftertax dollars. But if an ESOP went into the market and redeemed some of our shares, we would be buying them with deductible dollars. Again, you have to make a very careful analysis of your earnings per share if you're going to attempt this.

EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

In these days of hostile takeovers, I think a lot of large companies feel happier if a large block of their stock is in friendly hands. A leveraged ESOP is a nice way to do this. When the ESOP goes out to borrow, it takes advantage of the company's creditworthiness. If Bell Atlantic were afraid of being taken over, we could take our tremendous ability to borrow, guarantee an ESOP loan, go out and buy 5%, 10% or 15% of Company stock and put it in an ESOP. While the stock is in a suspense account waiting to be allocated each year as the company makes contributions, the voting control of that stock would remain with whoever was designated by Bell Atlantic. It could be our officers or it could be a trustee. A large block of shares is in friendly hands immediately through the leverage.

On the other hand, if you put a large number of shares in friendly hands with an ESOP and you have a hostile takeover bid, then you run into some very difficult fiduciary issues which are laid out in the *Donovan v. Bierwirth* case -- the LTV situation. A summary of *Donovan v. Bierwirth* is that the trustee who has voting control of the shares clearly has an independent fiduciary obligation to the employees. If it's a tender offer, the decision is whether or not to tender the shares; or if it's a proxy fight, the question is how to vote the shares. The Bierwirth case sets up a structural prudence requirement -- that is, the trustee or management committee or whoever has control of the shares has to be able to demonstrate to a court either that there was a structure in place or that he behaved in a way that demonstrates that he was looking out for the interest of the participants rather than the company.

MR. HOROWITZ: I think that's right. *Donovan v. Bierwirth* raises a fairly obvious issue. These are qualified plans; these are employee benefit plans under ERISA. Are we saying that this is a great way to use the employees' money, i.e., to use the retirement fund theoretically to entrench management? It's sold as one of the great uses of an ESOP. I think it is fairly well established that the same concepts of protecting the employees' interests as applied in the defined benefit pension plan don't apply equally to an ESOP. Congress has recognized in part the purpose of an ESOP as getting stock into employees' hands.

In the takeover context, you're in better shape if you have the plan in place. It's great if you have an existing ESOP that's been there for a couple of years that buys stock on a regular basis and not the night before the company finds out that it's getting a hostile tender offer. *Donovan v. Bierwirth* doesn't say you can't have an ESOP trustee vote management's recommendation in connection with a tender. In *Donovan v. Bierwirth*, for example, after the tender offer came, the board of directors decided how they were going to fend this takeover. Later, somebody said, "We should take off our board of directors' hats and put on our trustees' hats." This is what the court looked at, and this is what Karl is alluding to about having the protective framework in place. We have the problem of wearing the two hats and of making sure that it's the employees' interest and not management's interest that is being protected. The court required that an independent fiduciary make the determination on how the shares were going to be voted; whether the shares were going to be tendered. This technique may make sense, but the point is that we can't blithely say it's a great way to get 10%, 15% or 30% of the company stock theoretically into employees' hands and then have the trustee vote it all the way they want.

A variation on that theme is to have stock in an ESOP when the company has become a takeover target. Then, even if the stock is not yet allocated to participants' accounts (because the loan has not been repaid yet), the plan can provide for the vote on the unallocated shares to be directed by the participants instead of having the trustee vote the stock. In that case the company might not care whether the participants vote with the tender or with management, because it might take ten days to two weeks to get the results of a vote. And you're not going to get 95% of the shares voted one way anyway. This avoids the quick hit where a tenderer can come in and try to get that block of stock from the trustee, because there is diffused ownership with a couple of thousand employees directing how the shares are voted. It takes a couple of weeks to get the votes, and you're going to get a 60%/40% split and not 100% of the shares being tendered.

MR. DEUTSCH: I think also the presumption would be that the employees would vote with management, although that may turn out to be an incorrect assumption when the votes are actually counted.

MR. HOROWITZ: The point is that it doesn't matter how the employees vote if it takes two weeks to get the votes. It precludes a tenderer's getting a block of stock on the basis of the trustee's snap decision to turn over the stock.

MR. LOHWATER: You don't want to confuse voting rights with the decision to tender. A decision to tender is an investment decision that has nothing to do with your right to vote the shares.

MR. HOROWITZ: I think there's a Department of Labor letter that says that this is an investment decision that winds up being a delegation of authority to the participants. The employee has the right to decide whether or not the shares are going to be tendered.

MR. LOHWATER: The trustee is only off the hook when there are self-directed investments. I don't think that passing through the decision on a single investment or passing through the right to decide whether to tender makes this a self-directed account.

MR. HOROWITZ: That's specifically the issue, and I'm not sure it's settled. Clearly companies have passed through the option to employees to tell the trustee whether or not to tender the shares, and rightly or wrongly, that's been enough to set up one more impediment to the takeover.

MR. LOHWATER: As a practical matter, I think you're probably safe if that procedure is set up long before a hostile takeover bid is made. I think you're all right if there's no indication that a company is being sought after and you put an ESOP like this in place.

MR. HOROWITZ: I think one of the lessons in *Donovan v. Bierwirth* is that it looks a lot better if you've had an existing plan rather than one that's set up specifically for the purpose of entrenching management.

MR. LOHWATER: I think there is a big difference between establishing an ESOP in the midst of a hostile takeover and putting in an ESOP in quieter times. If you establish an ESOP in the midst of a hostile tender, you will encounter securities law problems that you may not find a way around. If you put an ESOP

in place in quieter times, you'll have more luck with its being successful. On a related note, the Department of Labor is going to scrutinize a leveraged buyout involving an ESOP very carefully. It is going to compare the value that the employees are getting with the value that the management buyout team may be getting. It is going to see whether there are two classes of stock and examine the price that's paid for the stock by the ESOP and someone else.

We've mentioned that in the last year it has been possible to get a deduction for the dividends paid from an ESOP if the dividends are passed through to employees. This has created the idea that you can convert existing savings or thrift plans to ESOPs and take advantage of the deduction for the passed-through dividends. I think technically that this can work with some rather superficial changes to an existing thrift plan. You could qualify a thrift plan as an ESOP, notwithstanding the fact that it's not leveraged. I think you could satisfy the Section 4975 regulations. The problem that Bell Atlantic had is that thrift plans and savings plans are to encourage long-term savings. Paying the dividends out of a thrift plan by converting it to an ESOP undercuts the purpose of the plan.

There have been a number of defined benefit plans with surplus assets on a termination basis that have been converted in essence to floor offset plans. The accruals are frozen or the formula is cut back, and then the surplus assets are dedicated to purchasing employer securities. These are released from a suspense account as contributions are made. The employee will get the greater of the value of the employer's securities when he retires or the floor pension formula. If you're going to look into that approach, I think you'll want to comply with the termination guidelines in spirit even though they may not be applicable.

MR. DEUTSCH: Do you mean that the kind of arrangement where you set up an ESOP within the framework of an existing defined benefit plan is probably viewed as a plan termination from the point of view of the guidelines, and you therefore have to comply with all of the requirements of the guidelines, such as purchasing annuities, etc.?

MR. LOHWATER: I think working on such a transaction is a tax benefit problem. Whenever the employer is going to use surplus assets to satisfy its obligation to contribute to the ESOP, then you have a potential that it will be deemed a reversion of the assets. It is followed by a contribution, and if the deduction limit for the contribution is not as large as the amount of surplus assets brought over, your company could find itself in a position of having to pay tax on income that it never really received under the tax benefit rule. I think you can cure that problem by moving surplus over in an amount not in excess of your deduction limit. That's basically it for some of the reasons why you can use an ESOP.

MR. DEUTSCH: Table 1 is taken from an actual client example. This company was very concerned about being a target of a hostile takeover. The company had in place a rather substantial thrift plan. It was substantial in the sense that it represented a very significant percentage of ownership of company stock. At least 10% or 15% of the outstanding common stock of the company was owned by the thrift plan. The idea was to put a big block of stock in the friendly hands of the employees. If the company took the device referred to earlier of allowing the unallocated shares to be voted in accordance with how shares that had been allocated to employees were voted, and not putting them into the trustee's hands, then possibly this could be a clever way of avoiding a takeover attempt.

Initially a $100 million ESOP loan was contemplated, and the principal repayments were going to be structured to match anticipated future thrift plan contributions over the next ten years. Based on a steady population and a modest growth in salary and past employee contribution patterns, a forecast of future anticipated employer matching contributions could be made. On the basis of that, the principal repayments could be structured to be close to anticipated thrift contributions over the next ten years. In the years that the stock price declines, ABC Company will have to make additional contributions, because the value of the shares released in those years will not be sufficient to generate the required matching contribution. However, in years when stock prices rise, there is not necessarily an equal offset available as a gain to the company. So that, on balance, they expect a loss will probably occur.

TABLE I

ILLUSTRATIVE STOCHASTIC STRING

(1) Year	(2) Number of Shares Released (000)	(3) Stock Price	(4) Thrift Match ($000)	(5)=(4) -(2)x100 Expected Additional Outlay ($000)	(6)=(4) -(2)x(3) Actual Additional Outlay ($000)	(7)=(5)-(6) ABC Gain (Loss) ($000)	(8) PV of ABC Gain (Loss) ($000)
1	100	$100.60	$ 10,000	$ 0	$ 0	$ 0	$ 0
2	100	108.04	10,500	500	0	500	429
3	100	114.85	11,025	1,025	0	1,025	814
4	100	97.05	11,576	1,576	1,871	(295)	(217)
5	100	82.01	12,155	2,155	3,954	(1,799)	(1,225)
6	100	83.32	12,763	2,763	4,431	(1,668)	(1,051)
7	100	91.40	13,401	3,401	4,261	(860)	(502)
8	100	91.13	14,071	4,071	4,958	(887)	(479)
9	100	85.57	14,775	4,775	6,218	(1,443)	(722)
10	100	89.16	15,513	5,513	6,597	(1,084)	(502)
Total	1,000		$125,779	$25,779	$32,291	$(6,512)	$(3,456)

The assumptions we are using are as follows. Initial stock price is $100 a share. This is a very conservative, utility-type company, and it is not unreasonable to have an anticipated growth stock price of 0%. Standard deviation is 20%. The ESOP loan interest rate was assumed to equal the dividend rate, and dividends on shares in the suspense account are assumed to be sufficient to pay the interest on the loan, in order to simplify the mathematics. It's not as unreasonable an assumption as it might sound, because this company had a very high dividend rate and the loan rate on the ESOP is typically subsidized, so the two perhaps would be expected to be fairly close.

We have a $100 million loan being amortized over 10 years. We did some stochastic modeling based on the probability distribution we mentioned before. We did 100 different stochastic strings, took an average, and generated percentiles to give the company a flavor for what the expected loss and the worst scenario might be based on this kind of scheme. Now, based on the assumptions outlined above, the expected loss was about $6 million, and at the bottom 5th percentile we had an expected loss of $20 million. This was all relative to the initial loan of $100 million.

Table 1 shows the heart of the computer calculations that we did for 100 strings. I've illustrated one sample stochastic string. We generated a string of numbers for 10 years as the stock prices in column 3. We started from $100.60, which moved from its initial value to a high in year 3 of $114.85 down to a point as low as $82.01 in year 5. We had 100 generations and averaged them to come up with $6 million. The stock price in the fifth year plunged to $82.01. The thrift match that is anticipated in the fifth year has been compounded at 5% a year starting from an initial point of $10 million, so that by the fifth year, it is anticipated the company would have had to put in $12,155,000 in the absence of this program. So initially there's a $10 million match and a growth rate of 5% per year that was the anticipated outlay. Because 100,000 shares are released at $82.01, there was a shortfall of approximately $18 a share, and that causes the loss in column 7 of $1,799,000. In most of the years on the string illustrated, a loss has been generated. That's not an accident, because there's a limit to how much of a gain you can pick up, because in any one year, there is a certain amount of windfall that will go to the employees. For example, in the first year, if the stock price

rises dramatically, it doesn't insure to the benefit of the employer but, like any defined contribution setup, would fall back to the employees. Therefore, you don't get the balancing from the random movements in stock prices that you would expect to have when you do 100 different strings of the stock.

In this particular scenario, the loss of about $6.5 million was very close to the median. On a present value basis, it was $3.5 million; this was the cost to the company on an expected basis for putting in this program. Just as a practical note, the company did not go through with any of these schemes. The plan was dropped not for these reasons, but for some other more basic business reasons.

We also went through a conversion of a defined benefit plan into an ESOP floor plan. There is a certain cost of a more traditional pension actuarial nature associated with that type of plan. In all of these calculations, there is room for significant actuarial work, and this is just scratching the surface on some of the kinds of issues with which you can get involved.

Joel Horowitz will speak largely about the technical rules governing ESOPs, and he will also address some of the current legislative proposals.

MR. HOROWITZ: There are one or two things I would like to discuss before we get into some of the specifics of the ESOP loan rules and some of the special features of ESOPs. First of all, we spent a lot of time talking about $100 million loans and defending takeovers of Bell Atlantic. All of my clients don't have $100 million loans, and all my clients aren't Bell Atlantic. The fundamental structure is the same whether it's an ESOP for a 20-person group or a 75,000-person group. It is the same in terms of the flowchart, in terms of where the dollars go and where the arrows go, in terms of the restrictions on the plan, and the plan sponsor's obligations. Things vary depending on whether or not the stock of the company is publicly traded. That's something that we will get into because we're not sure under the ESOP rules what is publicly traded and what isn't. These technical rules apply equally to big plans and small plans.

We didn't get into the details of what's become a fairly popular use, and that is not only the redemption or capital gain treatment on the stock, but deferral of capital gain treatment. There are a few issues that arise in connection with that under section 1042 of the Code. That section was added in the 1984 Act, so we're just now seeing shareholders who are cashing in their chips, and, instead of taking their capital gain, are seeing how they might defer it. The rollover of the capital gain treatment is available for shareholders who have held stock of the company for at least a year and sell it to either an ESOP or a worker-owned cooperative. A worker-owned cooperative was an alternative to an ESOP that was established by the 1984 Act. The stock must be of a domestic corporation and can't be readily tradable. The shareholder cannot have acquired the stock either by virtue of participation in a qualified plan or by having exercised stock options. The theory is that he's already gotten some significant tax break if he's exercised stock options. Section 1042 explains how some of these elections are made. The selling shareholder, for example, has to designate the replacement securities and file a required election with the Service so that the Service can determine whether the shareholder has met the required holding periods and met the rules for continued deferral of the capital gain.

The ESOP must own at least 30% of the company's stock immediately following the sale to the ESOP. The stock need not have been all acquired in that transaction; the incremental sale might have been 1% or less of the stock so that the ESOP that now holds 10% or 20% or 26% of the company stock can buy 3% or 4% or 15% to get over the 30% hump. That sale of the 3% or the 10% or whatever will be sufficient to permit the rollover. So in fact there's no obligation for the selling shareholder to decide to sell 100% of his stock. The selling shareholder might sell a third of his stock and defer the gain. Further, in determining whether the 30% rule is met, we're not looking solely at so-called qualified employer securities. We don't have to worry about whether these have voting rights and whether it's common stock or readily convertible preferred stock. The question is, Does the ESOP own 30% of the outstanding securities of the company immediately after the sale?

Unlike the typical sale rules where the selling shareholder might get capital gain treatment, not only can the seller not receive any allocations under the

plan, but neither can any family member or any 25% owner of the company. We can't sell the stock and allocate to a wife or a son or a brother. For this purpose the definition of family member doesn't include the whole universe, but it's fairly extensive. If the ESOP has acquired the stock and sells it within three years, if the plan or cooperative owns fewer shares than before the acquisition or owns less than 30% of all of the outstanding securities, then there is a 10% excise tax imposed by Section 4978 on the value of the stock disposed of by the plan. For this purpose, distributions to participants by reason of death, disability, etc., aren't treated as disqualifying dispositions. The taxpayer has to use the proceeds to acquire so-called qualified replacement property within the replacement period of a 15-month window. I believe the joint committee's explanation of the provisions suggests that while the proceeds must be invested in securities of domestic corporations, you can't buy tax-free municipals, for example, even if those would otherwise technically qualify under the definition. You have to buy something on which the shareholder's going to pay capital gain tax. We're really looking at traded stock.

The ESOP rules were added by ERISA in 1974. We had stock ownership plans before that, but the rules run from 1974 hereto; the laws changed in 1976, 1978, 1981 and 1984, and there are at least two different approaches in pending congressional bills. The regulations were written between the 1974 and 1976 Acts and changed in 1976. The regulations that are set forth under section 4975, the -7 and -11 regulations, are very helpful and are the controlling rules in this area except to the extent that they've been explicitly superseded.

Also, the TRASOP regulations under section 46-8 are very helpful in looking at rules relating to voting rights and distribution requirements from these plans and what happens where there's been a change, for example, in the identity of employer securities. Those are two very helpful sources.

We've heard the good business uses and reasons why you might consider using an ESOP. My role as a lawyer here is to complicate matters and tell people why they can't do what seems to make sense. Title I rules say that no qualified plan may invest in excess of 10% in employer securities except if they're qualified employer securities and the plan is a leveraged ESOP. A leveraged

EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

ESOP is an eligible individual account plan or stock bonus plan, or it could be set up in a profit sharing mode. The plan is designed to invest primarily in employer securities. We have an exemption from the prohibition on acquiring company stock.

In addition, there is a prohibition in section 406 of ERISA and corresponding rules in 4975 of the Code against an extension of credit between a plan and a party in interest. The plan may stay qualified, but if a plan goes out and borrows money from a shareholder, borrows from the employer, or borrows from an unrelated third-party lender but has the loan guaranteed by the employer or some other qualified person, that is a prohibited transaction. There may be civil liability for Title I purposes and a stiff prohibited transaction excise tax under 4975 of the Code.

The name has changed from leveraged ESOP to leveraged employee stock ownership plan, ESOP, and also TRASOPS and PAYSOPS. For this purpose, what we're talking about is plans that either do use a loan for the uses we've talked about or plans that are set up in such a way that they may use a loan. They're designated as ESOPs, they have the required distribution rules under the Code and may not have engaged in an otherwise prohibited transaction, i.e., a loan, but they are permitted to.

The ESOP loan rules are set forth in section 4975-7. The ESOP loan rules should not be the tail that wags the dog, but in some cases at least, there are rules that have to be confronted and may make it difficult to acquire financing or force the company to guarantee that the loan will be repaid: The rules apply both to the loan from a disqualified person or a loan from an unrelated third party that's guaranteed by the disqualified person, usually the employer. The loan must be for the primary benefit of participants and beneficiaries. That's a factual issue that's subject to special scrutiny because we're dealing with qualified plans. If the exclusive benefit rules have any application, then they have that much more application in this case where the plan is not only going to use its assets to pay principal on the loan, but is going to use its assets to pay interest. The usual fiduciary considerations that might apply in a qualified plan generally, even one which is properly investing in company stock, must be considered.

The Service says that the loan transaction and the decision to buy company stock have to be defensible. The loan proceeds can only be used to acquire qualifying employer securities to repay the loan that was just made or to repay a prior loan. Refinancing to capture lower interest rates winds up being a new loan that also must meet these rules. We have some time limits on how long the loan can run, what happens to the security, etc., so that any time there's a change in the terms of the financing I suggest going back and making sure that the new loan, which will be used to repay the prior one, also meets the qualification rules of the regulations. No plan asset can be given as collateral for the loan except the securities that are to be or were acquired with the prior loan, and the lender may not have recourse against the plan. The lender is only going to be able to look to the stock that's bought with the loan to get its money back; that's the only source of security. There's no recourse against other plan assets. There may be recourse against plan fiduciaries, but not if they set the loan up right.

The recourse routinely then is against the guarantor, which is why the guarantee is going to be necessary. The lender can't go against other assets of the plan, especially a plan that may be 60% or 80% invested in company stock. I'm not sure that there are that many circumstances where a borrower without other substantial assets can simply walk in and try to get 100 cents on a dollar to go out and buy stock, much less 100 cents on something that might not really be worth the dollar that he is trying to borrow to pay big for.

On default, if the lender is not a disqualified person, the value of the securities transferred to satisfy the lender can't exceed the amount of the default. There's a more restrictive rule: the only satisfaction that the lender can seek if he is a disqualified person is the portion of the security that is equal to the loan payment -- that has not been made on schedule. Otherwise there would be too much potential for abuse. The lender could call the entire security on something that might be a technical breach under a standard loan agreement.

Under the loan, the loan itself has to provide that for each year during the duration of the loan, some of the shares encumbered by the repayment obligation have to be released and allocated to participants' accounts. Even if the

lender might be inclined to release security as the loan is paid down rather than when the loan is paid off, typically, a prudent lender is going to say, "Release the security? I'll release it as the principal is paid down and your obligation is released."

The ESOP rules say that the security has to be released on a fractional basis based on the length of the loan. The number of shares released each year is determined by multiplying all of the encumbered shares -- let's say 100 shares for a ten-year loan -- by a fraction the numerator of which is the principal and interest paid for the year, and the denominator of which is the outstanding balance of principal and interest to be paid in future years. For this purpose, we need a determinable length of time under that loan and a determinable interest rate. (If it's a variable rate, you could use the rate applicable to that year's payment.) If one-tenth of the future principal and interest is paid down in year one, even if it's all interest, then one-tenth of the security has to come out in year one.

There's an exception to that rule. For a loan that does not exceed 10 years in length and has fairly flat amortization, the release can be made by reference to the amount of principal that's paid down each year. Now obviously we can't call everything interest forever in an attempt to try to get all of the stock out just in one year. As long as the loan is not for more than a term of ten years and the payments are relatively flat, the shares are released at the end of the year and allocated to participants' accounts for the year in the same relative proportion of the entire number of shares as the principal paid for the year to the principal of the entire loan. The effect, of course, is that there are very small allocations to participants in early years as interest is amortized and fairly large allocations in later years. If we had the fractional release, then, in a ten-year loan, one-tenth of the stock would come out each year and be allocated to participants' accounts. If we have this back-loading of the release from security, in the later years the participants are going to receive relatively larger allocations. This has the same effect as a vesting schedule. We might have somebody who gets his allocation in year one and still have ten-year cliff vesting under the plan. Then we have forfeitures being reallocated each year. But even assuming that someone's fully vested (if we have, for example, a five-year cliff vesting schedule), having some stock

come out in later years may make some sense as a reward to longevity. If somebody comes to work in year 8 and stays long enough after the allocation to become fully vested, then of course it's somewhat of a windfall. There's a planning opportunity there.

Two other fairly significant operational rules that aren't in loan rules are special rules applicable to ESOPs and not to qualified plans generally. For this purpose, some of the rules also apply to profit sharing and stock bonus plans under section 401(a)(22) and (23) of the Code, and these are the distribution rules and voting rights pass-through.

The stock that has to be used in the ESOP under 4975(e)(8) refers to 409(l) of the Code, now Tax Credit ESOP rules. The plan has to use readily tradable common stock. If there isn't any tradable common stock in the controlled group of corporations, then the plan can use common stock having dividend and voting rights that are at least equal to the best class of securities otherwise outstanding or convertible preferred stock. This doesn't mean you have to have super stock if you have two different classes of securities -- one with dividend rights, one with voting rights. The Senate Finance Committee Report to the 1978 Act makes it fairly clear that you can use some mix of employer securities. It's clear that you have to have voting rights in that plan if there are voting rights anywhere in the corporation. The employees theoretically have stock with some value.

Section 409(h) of the Code states that at the employee's death, disability, termination, etc., the employee has to have the right to demand employer securities. The plan may provide for the distribution of cash, if there's cash in the plan. The plan can provide for the distribution of cash if there are no readily tradable shares. The employee may be happy with the fair market value of the stock if there's not going to be a market anyway.

Nonetheless, the employee with a right to a distribution has the right to demand securities. When somebody leaves at age 35 with ten years of service, the plan can provide for deferred distributions at age 65. When the employee leaves and has the right to demand employer securities, he becomes your partner in business. The ESOP rules under -7 regulations state that we can have a

right of first refusal in favor of the plan and/or the employer. If the participant who left gets a bona fide offer to buy that stock, the employer has the opportunity to keep it for itself or to keep it in friendly hands if the plan, in fact, chooses to repurchase the stock. The right of first refusal can't effectively tie up the offer indefinitely. The right of first refusal must be acted on within 14 days after the shareholder brings in the offer. The price to be paid has to be the higher of fair market value or the price that the shareholder's been offered. At the same time, there's no obligation for the plan or the company to buy back the stock if there's another buyer.

If there are other buyers, Section 409(h) says that the employee who leaves must have a put option right. The put option must allow the participant to require the company to buy back the shares for a limited period immediately following distribution and the immediate period in the subsequent year. The regulations say that's a 15 month put option -- 15 months from distribution or, if later in that 15 month period, when the shares don't cease to be readily tradable. The employer may be obligated to buy back the shares. The plan may not be obligated under its terms to buy back the shares -- it's the employer's obligation. I had said that the regulations say that's a 15-month put option. That's changed a couple of times; I think we're down to a 60-day/30-day/30-day split window. I point you to the 1978 Act *Blue Book*, which has some further discussion of the put option provisions that have superseded the put option provisions that are set forth in the regulations.

MR. DEUTSCH: Would you like to say a word or two about the legislative rumblings on the Hill?

MR. HOROWITZ: The President's proposal, Treasury 2, would have recognized that ESOPs are different from defined benefit pension plans. It would have gotten them out of the qualified plan rules and said instead that we could have this qualified employee stock ownership trust under which the employee would have greater rights to direct the investment of his account. Also, an employee who had reached early retirement age would have had the right to require investment diversification of his account up to age 60 and could require the trustee to sell up to 50% of his shares and invest instead in one of at least three other investment options. The President's proposal would have also

required that the shares be distributed currently as allocated to an account (that is, as the loan is paid off) or at the latest soon after an employee leaves the company's employment. There were liberalizations in the proposal, and it was said that it would be the death of ESOPs except in the large corporation situation, where they are truly being used as a device for equity ownership.

The Senate Finance Committee proposal would have virtually no change from the existing rules. The Senate Finance Committee, of course, has been the bastion of ESOPs for a long time.

The House bill would make a few changes. It would accelerate vesting to 20% graded vesting starting in year five. It would restrict the allocations that can go to the restricted group -- basically 10% shareholders and people who are relatively highly paid. It would also require greater pass-through on voting rights. Currently, if shares are not of a so-called registration type -- with registration type roughly corresponding to publicly traded or publicly tradable, but not exactly the same thing -- the voting rights have to be passed through only to the extent of super-majority issues that have to be decided by more than a majority of outstanding shares voted. The House bill would require the pass-through on all issues for somebody who has at least ten years of service and on major corporate issues for someone who doesn't have at least ten years of service. The House bill would kill all of the DEFRA incentives, the 1042 rollover, the 404(k) deduction of dividends, and certain state tax and favorable estate tax treatment.

MR. DEUTSCH: Which one seems more likely at this point to prevail, or don't you want to hazard a guess?

MR. HOROWITZ: What bill's doing best? No.

MR. HOWARD ALAN FREIDIN: When an employee terminates and exercises his put option, what factor should be considered in deciding whether the plan or the company buys back the stock?

MR. HOROWITZ: First of all, the plan, by its terms, can't be obligated to buy back the stock. I think that it's therefore a fiduciary decision to be made. Obviously the availability of shares and all the other corporate uses we've talked about are fine. There's another question of whether the company has an interest in retiring the shares and cash flow considerations. It seems to me that those would be the major considerations.

MR. LOHWATER: Retiring shares brings you back to your dilution in your earnings per share.

MR. FREIDIN: How much of the ESOP assets must be held in company stock?

MR. HOROWITZ: The regulations say an ESOP is a plan designed to invest primarily in qualified employer securities. The regulations also say that part of the plan assets can be in securities other than employer stock. I think that the prudent approach is to recognize that to the extent that there is an ESOP loan, the ESOP loan proceeds should be invested in employer securities. Beyond that, I think the normal fiduciary considerations that apply in the case of a stock bonus plan should be applied -- that is, Does it always make sense to have all the assets in stock? Are temporary investments so good, or is the temporary investment/ongoing investment in company stock so bad, that it makes sense to at least temporarily get out in part of the assets? I think that's been the Service's view also, that it's okay to have temporary investments in assets other than employer securities, and more ongoing investments to a lesser extent in something other than employer securities. I don't think there's a hard-and-fast number.

MR. LOHWATER: I don't know if the Service would consider itself bound by it, but there's a Department of Labor advisory opinion 8306A that says "primarily" means 50% of the ESOP assets over the life of the plan are invested in employer securities.

MR. HOROWITZ: I think that's one of those things that is indicative that the plan is satisfying its statement that it's designed to invest in employer securities.

PANEL DISCUSSION

MR. ROBERT DUGAN: I'd like to go back to one of Mr. Lohwater's scenarios of a closely held company that uses an ESOP to redeem the shares held by a major shareholder. My question is, At that point when the transaction is accomplished, who is running the company? You have the trustee who is voting the unallocated shares in the suspense account of the ESOP, and yet presumably, the Board of Directors could name a new trustee. Who's really in charge here?

MR. HOROWITZ: The Board of Directors that's been elected by the trustee.

MR. LOHWATER: The trustee doesn't have to vote the shares. The times I've seen it with small companies, there's a management group that's left behind, either one person or a group of people. The trustee doesn't have to vote. You can pull the voting rights away from the trustee and give them to the remaining management group. There are always two or three people left running the company, and either they or the trustee has the voting rights, so they're left with existing management.

MR. DUGAN: Would the answer be different if the ESOP loan were made by an outside financial institution rather than directly by the former shareholder himself? In either case, is the voting right typically with management, or would an outside financial institution want a piece of that action?

MR. LOHWATER: You mean when you have a triangular loan, would the bank want a say? I suspect that would be part of the loan document, if it did.

MR. HOROWITZ: We have a delegation here of fiduciary responsibility. We get into the same problem of wearing more than one hat, but I have seen that at least where there's been a fiduciary named or one determinable by reference to the loan documents -- even if it's to meet fiduciary obligations -- we know who's going to be acting as the person who has responsibility to vote the stock.

MR. LOHWATER: A bank could insist on voting, couldn't it?

MR. HOROWITZ: If the bank wants to, sure. We can set it up in any way that we delegate fiduciary responsibilities. There are two ESOP uses that we haven't

alluded to that I wanted to talk about. I talked about the 1042 treatment. I didn't talk about the wage concession model. That's been a popular one in the trucking industry and to a certain extent in the airline industry. In that context, we've had a couple of cases in the trucking industry where in exchange for 10% to 15% wage give backs, the truck drivers wind up owning 40 to 50% of the company, but on a five member board they might have one director. The truck drivers want representation, but they don't want to run the company.

MR. DONALD S. GRUBBS, JR.: Mr. Horowitz described the history over the last fifteen years, a road with many turns, most of which have been designed by Senator Russell Long, the great ESOP enthusiast who through most of the period was chairman of the Senate Finance Committee. This year Senator Long is retiring. With the great emphasis upon solving the deficit problems and thus generating revenue without raising tax rates, are we going to see the Congress taking away some of these goodies with no champion to protect them?

MR. HOROWITZ: It is my understanding that there are champions there. Senator Bradley is a fan to a certain extent; I think Senator Packwood is a fan to a certain extent; but nobody's a fan like Senator Long. I think the intriguing thing is people are finally coming to the realization that we have some interest in retirement plans and we have interest in capital accumulation and 401(k) plans. But I think it may better fall into the split between whether we are going to encourage retirement plans or we are going to encourage capital accumulation. Some of the rules that I alluded to in Treasury 2 were the same rules that would apply to non-defined benefit plans generally. But I expect this being 1986, we'll have another four changes in the next ten years.