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William S. Piper

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INTRODUCTION

An employee stock ownership plan (ESOP) is a qualified stock bonus plan or stock bonus and money purchase plan designed to invest employee earnings and employer contributions primarily in qualifying employer securities.

An ESOP usually obtains a loan from an unrelated lender. A

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2. I.R.C. § 401(a) establishes a number of benefit plan requirements that must be met to gain qualification for special tax treatment.
3. In a stock bonus plan benefits are distributed to the participant in the form of securities of the employer and employer contributions are not necessarily dependent on the existence of profits. Treas. Reg. § 1.401-1(a)(2)(ii), (b)(1)(iii)(1956).
4. A money purchase plan is a defined contribution plan as opposed to a defined benefit plan. It must provide a definite formula for allocating contributions to the individual accounts of the participants. The amount of each participant’s ultimate benefits is a function of earnings gained and losses suffered from the investment of the employer contribution. Kaplan & Cowan, (ERISA)—Employee Stock Ownership Plans—Qualification, 317 T.M. A-3 (1977); see also Rev. Rul. 74-340, 1974-2 C.B. 128.
6. An important characteristic of an ESOP is leveraging—the use of borrowed funds as opposed to immediate employer contributions to purchase the securities in question. The following models provided by the Profit Sharing Research Foundation best illustrate and distinguish the ESOP loan and purchase transaction from the traditional method of corporate financing.

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**MODEL 1
CONVENTIONAL CORPORATE FINANCE**

- CASH
- PLANT
- CORPORATION
- $1,000,000 LOAN (5 Years)
- $1,000,000 NOTE (5 Years)
- LENDER
- STOCKHOLDERS

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party-in-interest, often the employer, guarantees the loan. The employer's guarantee is accompanied by a promise to make certain contributions to the ESOP. The loan proceeds are then used to purchase the securities of the employer and the employer contributions and stock dividends are applied to retire the loan.

ESOPs are seen as a way to secure corporate capital for greater economic growth while permitting ownership of capital by average

While the term ESOP has been used broadly to cover a variety of plans, it technically applies to only those transactions where the purchase of securities is "leveraged" with a loan. See text accompanying notes 22 through 26 infra.

employees, thereby securing their financial future.  

In the Employee Retirement Income Security Act of 1974 (ERISA), Congress continued the previously established policy of encouraging the use of ESOPs to provide retirement benefits. In addition, ERISA maintains the significant tax advantages afforded the benefit plan, the employer, and the employee to encourage the use of ESOPs. However, the statute also imposes significant fiduciary duties upon plan trustees. Unless exempted, the fiduciary and plan may not engage in certain prohibited transactions. Loans to an ESOP are eligible for an exemption in this regard.

The Department of Labor and the Treasury Department have

8. See generally S. REP. No. 93-1298, supra note 7, at 155-60; Note, Employee Stock Ownership Plans: A Step Toward Democratic Capitalism, 55 B.U. L. Rev. 195 (1975). Senator Russell B. Long was quoted as saying, "This is an idea whose time has come. Every person on the payroll should have a piece of the corporate pie." O'Hara & Crawford, Will Every Corporation Have an ESOP? Senator Long Makes It Hard to Say No, 61 A.B.A.J. 1366, 1366 (1975).


10. Congress' intent concerning ESOPs was subsequently expressed more clearly in § 803(h) of the Tax Reform Act of 1976:

The Congress ... has made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free private enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees.


11. Under I.R.C. § 404(a)(3), if the ESOP consists solely of a stock bonus plan and, under I.R.C. § 404(a)(7), if the ESOP consists of a stock bonus plan and a money purchase plan, the employer is granted a limited tax deduction for contributions to an ESOP. Participants are not taxed on contributions or benefits until the benefits are distributed or made available to them. If the distribution is in lump sum, special tax treatment is afforded by I.R.C. §§ 402(a)(2), (e). For a discussion of the federal income tax aspects of ESOPs, see Note, Employee Stock Ownership Plans: A Step Toward Democratic Capitalism, 55 B.U. L. Rev. 195, 206-10 (1975).

12. See text accompanying notes 28 through 56 infra.

13. The trustee is but one fiduciary of a plan. Other individuals subject to fiduciary duties may include the plan administrator, the investment manager, and others identified as a fiduciary by the employer and/or employee organization. ERISA, § 3(21), 29 U.S.C. § 1002(21) (Supp. V 1975).


15. See text accompanying notes 36 through 47 infra.


17. Title I of ERISA (codified in 29 U.S.C. §§ 1001-1144) contains the sections establishing employee benefit rights administered by the Secretary of Labor.

overlapping jurisdiction concerning ESOPs.\textsuperscript{19} Both agencies issued proposed regulations on July 30, 1976 which addressed the scope of ERISA's prohibited transaction exemption for loans to ESOPs. To effectuate the requirement that the loan be for the primary benefit of the plan's participants and beneficiaries,\textsuperscript{20} those regulations established guidelines regarding the use of loan collateral and its release from encumbrance, the possibility of default, the use of loan proceeds, the type of stock which may be acquired, the availability of put option rights, the necessity of rights of first refusal, and the method of valuation.

The proposed regulations evoked extensive public criticism regarding the their complexity and rigidity. For example, during the course of establishing the investment credit for contributions to ESOPs provided in the Tax Reform Act of 1976, Congress stated: "[T]he proposed regulations . . . may make it virtually impossible for ESOP's, and especially leveraged ESOP's, to be established and function effectively."\textsuperscript{21} Leverage refers to an ESOP's immediate acquisition of employer securities through debt financing as opposed to a gradual purchase of the stock with annual contributions\textsuperscript{22} to the trust.\textsuperscript{23} The employer's contributions are used by the ESOP to retire the loan.\textsuperscript{24} Additionally, the participants benefit from the

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  \item \textsuperscript{19} ERISA, § 3003, 29 U.S.C. § 1203 (Supp. V 1975), requires consultation between the Department of Labor and Treasury with respect to the provisions relating to prohibited transactions. ERISA, § 3004, 29 U.S.C. § 1204 (Supp. V 1975), permits the departments to develop rules and regulations which will minimize the burden of complying with conflicting or overlapping requirements. The Senate Finance Committee has recently recommended passage of S. 2352 which would allocate jurisdiction between the two departments over administrative functions presently shared by both under ERISA. The Department of Labor would have administrative responsibility in cases involving prohibited self-dealing or fiduciary misconduct. Other cases involving other ERISA standards will be handled by the Treasury Department. S. REP. No. 95-613, 95th Cong., 1st Sess. (1977).
  \item \textsuperscript{21} CONFERENCE REPORT No. 94-1515 on H.R. REP. No. 10612, 94th Cong., 2d Sess. 539 (1976), reprinted in [1976] U.S. CODE CONG. & AD. NEWS 4118, 4235, [hereinafter cited as CONFERENCE REPORT No. 94-1515]. In § 803(h) of the Tax Reform Act of 1976, Congress went on record as being deeply concerned that the objectives sought by . . . [a] series of laws will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans. 90 Stat. 1520, 1590 (1976).
  \item \textsuperscript{22} The term "annual contributions" as used herein refers to the contribution the employer makes to the trust under the plan documents. It may consist of either cash or securities.
  \item \textsuperscript{23} See Note, Recent Developments in Employee Stock Ownership Plans, 16 WASHBURN L.J. 709, 723 (1977); see also SCHARF, supra note 7, at 72.
  \item \textsuperscript{24} The annual contribution is generally required of the employer by the lender as a
amount, if any, that the stock appreciates in excess of the interest rate of the loan.\textsuperscript{25} With a leveraged ESOP, the corporation receives the benefit of increased cash flow—an immediate substantial infusion of the capital represented by the loan proceed.\textsuperscript{26} It was believed that the proposed regulations jeopardized those benefits by imposing severe restrictions.\textsuperscript{27}

In response, the Department of Labor and the Treasury Department issued final regulations on September 2, 1977 which addressed these objections. Broadly speaking, the regulations expand the scope of the loan exemption, permit an ESOP to acquire securities subject to an employer's right of first refusal, and clarify the "primary benefit" requirement. In effect, the regulations accord the trustee greater flexibility in fulfilling his fiduciary duties and permit features considered essential by employers, while preserving the fiduciary's required standard of performance.

This article examines the character and effect of the proposed ESOP regulations and the criticisms they evoked. In addition, the article explores the responses of the Department of Labor and the Treasury Department as reflected in the final regulations. Finally, the discussion includes an analysis of the likely effect of the new regulations. It will be helpful, initially, to review the general limitations which ERISA establishes for activities in connection with employee benefit plans.

\textbf{The Statutory Scheme of Fiduciary Duties}

ERISA imposes specific affirmative duties within the general requirement that the fiduciary\textsuperscript{28} "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries." First, he must act exclusively to provide benefits to participants and their beneficiaries\textsuperscript{29} and to defray reasonable administrative expenses. Second, the fiduciary must administer the plan as a "prudent man"\textsuperscript{30} would. Third, the fiduciary must diversify\textsuperscript{31} the investments condition to providing the loan. \textit{Scharf, supra} note 7, at 36.

\textsuperscript{25} Even in the event the stock does not appreciate in value, the employee will still receive upon distribution the security allocated to his account. \textit{See Scharf, supra} note 7, at 36-38.

\textsuperscript{26} \textit{Id.} at 73-74.

\textsuperscript{27} \textit{See note 21 supra.}

\textsuperscript{28} A fiduciary in this regard is one who has discretionary authority or control over the management as well as responsibility in the administration of the plan and disposition of the assets. The definition is intended to include paid investment advisors. ERISA, § 3(21), 29 U.S.C. § 1002(21) (Supp. V 1975).


unless doing so is clearly imprudent under the circumstances. However, an ESOP fiduciary is exempt from the latter two requirements insofar as they require diversification. Fourth, the fiduciary must discharge his duties in accordance with the terms of the documents governing the plan.

In addition, section 406 of ERISA forbids a party-in-interest from engaging in certain practices which he knows or should know directly or indirectly constitute “prohibited transactions,” unless an exemption applies. Transactions between a plan and a party-in-interest that are prohibited include: (1) a sale, exchange, or lease of property; (2) an extension of credit; (3) a provision of goods, services, or facilities; and (4) a use of plan assets by or for the benefit of a party-in-interest.

Further, a fiduciary generally may not: (1) deal with the plan assets in his own interest; (2) act in any transaction involving the plan on behalf of a party whose interests are adverse to those of the plan, the participants or the beneficiaries; or (3) receive any consideration for this personal account from any party dealing with such plan. Finally, only qualifying employer securities or real property may be acquired on behalf of an
In order to leverage an ESOP, both a purchase exemption and a loan exemption are required. Section 408(e) provides the exemption for purchases and sales of employer securities and real property to a party-in-interest. Section 408(b)(3) exempts loans to ESOPs by a party-in-interest from the prohibitions established in section 406. However, the loan must be primarily for the benefit of participants and beneficiaries, and the interest rate must be reasonable. Further, a party-in-interest may only receive as collateral qualifying employer securities. Since the ultimate purpose of the loan is to acquire employer securities or real property, the fiduciary must bear in mind that such asset acquisitions are still prohibited by sections 406 and 407 of the Act unless “adequate consideration” is given or received and other requirements are met.

Availability of the ESOP loan exemption is conditioned upon the existence of an employee stock ownership plan formally designated as such in a plan document that also states that the plan is designed to invest primarily in qualifying employer securities. A fiduciary of a plan which disregards the statutory definition of an ESOP will not be protected by the ESOP loan transaction exemption. The plan also must comply with regulations issued by the Secretary of the Treasury.

**Framework for Analysis**

The final Treasury and Labor regulations must be evaluated in...
light of employers' current and pre-ERISA practices and objectives with respect to ESOPs. The purposes for which employers have used ESOPs include: to provide long-term security and retirement benefits for participants; to provide an alternate means of corporate finance and to ease a temporary corporate cash-flow squeeze; to plan for the retirement or death of a major shareholder or key employee; and to increase employee incentive. The investment objectives of the plan are formulated in light of the purposes motivating the employer to adopt an ESOP.

The ultimate investment objective is to maximize the value of the trust. The employer's purposes may determine the relative weight to be accorded that objective relative to other specific objectives. For example, the principal of the trust may be jeopardized where the ESOP is adopted merely to provide an alternate means of corporate finance and alleviate cash flow problems. This danger is countered by the investment practice of paying closer attention to the value of the employer securities held by the plan. Alternatively, the goal of providing maximum benefits to a key employee may require that the plan maximize its potential for gain through high risk investments. The increased risk involved in this objective is contrary to the goal of maintaining the safety of principal. However, given a successful corporation, primary investments in the employer's securities may provide the greatest potential for gain and achieve tertiary purposes of the plan as well. Furthermore, where the overriding consideration of the plan is to provide retirement benefits for employees, the investment objective of the plan must
counteract the effect of increased cost of living and inflation. This objective is reflected in the practice of combining investment in equity with fixed income securities.

**Scope of the Loan Exemption**

ERISA section 406(b)(1) and (2) considered alone would bar a fiduciary who is also a party-in-interest, e.g., employer or trustee-lender, from arranging or participating in the loan transaction. The proposed regulations severely restricted the scope of the section 408(b)(3) prohibited transaction exemption by requiring that an independent fiduciary arrange a loan transaction involving the employer or another interested party. Specifically, the proposed regulations interpreted section 408(b)(3) as exempting ESOPs from the prohibited transactions contained in section 406(a), but not from the ban on fiduciary self-dealing found in section 406(b).

The independent fiduciary requirement was criticized heavily by Congress and the public. Normally, an ESOP’s ability to obtain and repay a loan is dependent upon the employer’s financial condition, since the employer’s guarantee becomes the lender’s primary assurance of repayment. As one senator recognized: “No corporation would be willing to grant authority for an independent party to negotiate terms of an ESOP loan for which its guarantee is necessary. To do so would be a breach of the management’s responsibility to the shareholders of the corporation.” The Congressional Conference Report regarding the Tax Reform Act of 1976 asserted that the proposed independent fiduciary requirement was unreasonable and unduly burdensome. It was thought that adequate protection was afforded by other regulations and fiduciary duties, such as the pri-

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68. Id. at 225.
69. Equity investments may grow in value, and include investments in the various types of company stock. They perhaps keep pace with increases in the cost of living. Id.
70. Fixed income securities include investments in U.S. government securities, corporate bonds, mortgages, real estate, employee loans and insurance. They are designed to keep pace with inflation. Id.
72. Id. § 1108(b)(3) (Supp. V 1975); ERISA, § 2003(a), I.R.C. § 4975(d)(3).
75. 29 U.S.C. § 1106(a) (Supp. V 1975); ERISA, § 2003(a), I.R.C. § 4975(c).
76. CONFERENCE REPORT NO. 94-1515, supra note 21, at 539.
77. [1976] 4 PENS. PLAN GUIDE (CCH) § 25,133.
79. CONFERENCE REPORT NO. 94-1515, supra note 21, at 539.
mary benefit requirement and the interest rate and collateral limitations.\textsuperscript{80}

The final regulations\textsuperscript{81} apply the section 408 (b)(3) exemption not only to subsection 406 (a), but also to subsections 406 (b)(1), relating to fiduciary dealing with the assets of a plan in its own account, and 406 (b)(2), concerning fiduciary actions in any transaction involving a plan on behalf of a party whose interests are adverse to the interests of the plan, the participants, or the beneficiaries. However, the final regulations do not interpret the exemption as extending to subsection 406 (b)(3), which precludes fiduciaries from being compensated by a party with a plan.\textsuperscript{82}

There are two primary justifications for the position adopted by the final regulations. First, although Congress, in drafting ERISA, was aware of the common practices concerning ESOP loan transactions,\textsuperscript{83} it broadly stated the exemption in section 408 (b)(3).\textsuperscript{84} Second, the proposed regulations would have rendered the process of adopting an ESOP too complex and costly,\textsuperscript{85} especially for a closely-held corporation. The final regulations should alleviate those problems while affording adequate protection to the participants. That assurance is found in the "special scrutiny"\textsuperscript{86} that the federal agencies will employ in evaluating ESOP loan transactions under the primary benefit requirement.

\textit{The Primary Benefit Requirement}

An ESOP by its nature\textsuperscript{87} requires the plan to secure a lender of funds and a seller of employer securities. In addition to any benefits individual participants receive, a corporation is benefited by the leveraging of the ESOP. First, it has secured an alternate mode of corporate finance. Second, the corporate trustee of the plan, if it is

\begin{footnotesize}
\textsuperscript{80} Id.
\textsuperscript{82} Thus, the final regulations permit a trustee of a close corporation who is a part of management, and therefore a party-in-interest, to arrange the loan transaction. Likewise, a corporate trustee acting as the lending institution is no longer precluded from negotiating the loan terms.
\textsuperscript{85} Regardless of the type of employee benefit plan used, plan administration expenses often reduce a smaller company's incentive to adopt a plan. Howell, The Spread of Deferred Profit Sharing to Small Corporations through IRS—Qualified Prototype Plans, in \textit{Metzger}, supra note 65, at 593, 594.
\textsuperscript{87} \textit{See} note 6 supra.
\end{footnotesize}
the lending institution, obtains the interest paid by the plan for the loan.

A pre-ERISA IRS ruling held that such incidental benefits received by the employer did not violate the primary benefit requirement. The proposed regulations, however, broadly mandated that a loan to an ESOP be made primarily for the benefit of participants and beneficiaries of the plan. In response to criticism of the proposed regulations' lack of guidance, the final regulations specify two initial tests that will be employed as part of the "special scrutiny" for primary benefit requirement violations.

First, the "net effect on plan assets" test provides: "At the time that a loan is made, the interest rate for the loan and the price of securities to be acquired with the loan proceeds should not be such that the plan assets might be drained off." Like other provisions of the regulations and the Act, this test is designed to protect existing assets when the fiduciary attempts to acquire additional securities. For example, an ESOP's ultimate success is dependent upon the rate of the securities' appreciation exceeding the interest rate charged for the loan. Consequently, the loan would not be found to be negotiated for the primary benefit of the participants where secondary plan assets must be expended for interest payments. The latter situation would prevail where the interest rate exceeds the expected rate of appreciation.

Second, the "arms length" standard provides: "The terms of a loan, whether or not between independent parties, must, at the time the loan is made, be at least as favorable to the ESOP as the terms of a comparable loan resulting from arms length negotiations be-

91. Treas. Reg. § 54.4975-7(b)(7), 42 Fed. Reg. 44388, 44391 (1977) and 29 C.F.R. § 2550.408b-3(g). 42 Fed. Reg. 44384, 44386 (1977) require that a reasonable rate of interest be charged for the loan. In an acquisition or sale of stock, an ESOP is not exempt from entering into a prohibited transaction if less than "adequate consideration" is given or received. ERISA, § 408(e)(1), 29 U.S.C. § 1108(e)(1) (Supp. V 1975).
92. ESOPs REPOirs, supra note 60, at 24.
93. This could occur even though other provisions governing the reasonableness of the interest rate or purchase price may not be violated. For instance, an interest rate may be reasonable when compared with prevailing rates, yet still be too high where the interest rate exceeds the likely security appreciation. Alternatively, even though the ESOP paid adequate consideration for the securities and the interest rate was reasonable, the fair market value might be extremely high, thereby unduly endangering the investment should the value decline. Congress, recognizing that these could be potential problems, recommended that "special scrutiny" of the transaction be employed to protect the interest of the participants. H.R. Rep. No. 93-1280, supra note 83, at 312.
tween independent parties." This provision extends some guidance to the fiduciary negotiating the loan terms without imposing the counterproductive independent fiduciary requirement contained in the proposed regulations.

The government does not intend to limit application of the primary benefit requirement to the foregoing tests. The Department of Labor and the IRS will examine all other "surrounding facts and circumstances" which indicate that the fiduciary did not act for the primary benefit of the participants and the beneficiaries. In this regard, one decision, rendered recently, but prior to the promulgation of the final regulations, required the trustee to give "adequate attention to or assessment of the effect of those transactions on the value of the assets of the plan and the interests of plan participants and beneficiaries." Failure to do so was held to constitute a breach of a fiduciary duty. This case illustrates that a fiduciary should determine what beneficial effects, if any, a loan will have for the plan and the participants before closing the transaction.

Generally, the final regulations appear to strike an admirable balance. They recognize that the goals of and benefits received by the employer and the plan participants are not mutually exclusive. While permitting a loan to an ESOP even where it aids the employer, the regulations focus the trustees' attention, for purposes of the primary benefit requirement, upon such factors as the future economic growth of the company, the loan terms available elsewhere, and the stability of the securities' fair market value over time. In turn, by requiring the trustee to evaluate the employer and the loan in light of external circumstances, they may increase plan costs by motivating the trustee to seek independent counseling. However, these costs may be minimal in light of the already widespread practice of consulting investment counselors. Additionally, they are probably offset by the benefits made possible by the loan.

Collateral and Release from Encumbrance

If collateral is to be given to a party-in-interest to secure a loan,
section 408 (b)(3) of the Act mandates that only qualifying employer securities may be posted for that purpose. The final regulations clarify this requirement. To be an exempt loan, the loan documents must not permit recourse against the ESOP in case of default in repayment of the loan. The only ESOP assets that may be used as collateral are the qualifying employer’s securities either acquired with the proceeds of the loan or those given as collateral for a prior exempt loan that was repaid with the proceeds of the current exempt loan. The fiduciary or trustee may retire the debt with collateral given for the loan, employer contributions (non-securities) to meet loan obligations, and earnings attributable to such collateral and investments of such contributions. While a loan debt is outstanding, the plan’s books of accounts must separately provide for the aforementioned earnings and contributions. Also, while a loan is unpaid, the acquired securities are considered encumbered and must be placed in a suspense account. The final regulations are significantly less rigid than the proposed regulations in that the trustee is not required to release the securities from encumbrance in equal annual amounts. Instead, the final regulations permit release of securities from encumbrance as principal and interest are paid. However, the regulations ca-

102. A suspense account contains encumbered securities not yet allocable to individual accounts.
105. Congress found that the equal annual contributions and the release from the suspense account did not conform with common business practices. CONFERENCE REPORT No. 94-1515, supra note 21, at 540. See also 122 CONG. REC. S13429, S13431 (daily ed. Aug. 4, 1976) (critique submitted for the record by Sen. Stevens criticizing the proposed regulations). Unequal payments might be made through a money purchase plan, using a fixed formula to determine the amount of the annual contribution and, ultimately, the release from encumbrance.
106. The regulations provide the following example:
Corporation X establishes an ESOP that borrows $750,000 from a bank. X guarantees the loan which is for 15 years at 5% interest and is payable in level annual amounts of $72,256.72. Total payments on the loan are $1,083,850.80. The ESOP uses the entire loan proceeds to acquire 15,000 shares of X stock which is used as collateral for the loan. The number of securities to be released for the first year is 1000 shares, i.e., 15,000 shares x $72,256.72/$1,083,850.80 = 15,000 shares x 1/15. The number of securities to be released for the second year is 1000 shares, i.e.,
tion against the possibility of exceeding the general ERISA maximum annual additions\textsuperscript{107} to the participants' individual accounts.\textsuperscript{108} Consequently, while release of the securities in varying amounts is permitted, the IRS warns that such transactions will be observed closely to guarantee that the employer is making the required\textsuperscript{109} substantial and recurring contributions to the ESOP.\textsuperscript{110} The change in the regulations reflects the money purchase plans' current practice of determining the annual employer contribution according to a fixed formula, which, depending on the factors taken into account, may result in different amounts from year to year. Contributions in varying amounts will permit the ESOP to promote employee incentive and to reward increased employee productivity.

\textit{Default}

Although the proposed regulations limited the transfer of plan assets in the event of default by an ESOP for the amounts necessary to meet loan payments,\textsuperscript{111} the final regulations\textsuperscript{112} are more permissive. The general rule regarding default is that the value of plan assets transferred to the lender must not exceed the amount of the default. However, where the "lender" is a party-in-interest,\textsuperscript{113} the final regulations limit "default" to the extent that a plan fails to meet the payment schedule for the loan. Securities serving as collateral for the balance of the loan are not immediately forfeited. But, since the term "lender" is defined to exclude a party-in-interest who merely guarantees the loan to the ESOP, only credit extended in other forms will trigger the latter more restrictive limitation.

The final regulations increase the likelihood that a given plan will be able to obtain a loan. Lending institutions will now extend credit more readily to ESOPs since the lender generally will not be re-

\begin{itemize}
\item[107.] I.R.C. § 415(c) imposes a limit on the annual additions to the individual account of the lesser of $25,000 or 25% of the participant's compensation.
\item[109.] Treas. Reg. § 1.401-1(b)(2) (1972).
\item[113.] Id.
\end{itemize}
quired to engage in overly expensive and time-consuming machinations to recover the funds advanced to the plan. Concurrently, the participants will be protected in those situations where a party-in-interest extends a questionable form of credit without assuming primary liability in the case of default. This procedure should strike a balance which promotes sound lending practices commensurate with the free adoption of ESOPs.

Use of Loan Proceeds and Type of Stock

ERISA defines "qualifying employer securities" as employer securities which are either stock or marketable obligations. A "marketable obligation" is defined as a bond, debenture, note or certificate, or other evidence of indebtedness. The proposed regulations, in essence, required the ESOP to acquire common stock with unrestricted voting and dividend rights. Non-voting common or preferred stock could be acquired only if the stock complied with additional, more restrictive, limitations. Other limitations pertained to options such as puts or calls, and buy-sell arrangements. These severe restrictions were justly criticized as rendering the administration of ESOPs unduly complex.

The final regulations require that exempt loan proceeds be used within a reasonable time after their receipt, only for the acquisition of qualifying employer securities, or the repayment of the principal of a present or a prior exempt loan. Though the final

114. See text accompanying note 46 supra.
116. Id. § 407(e), 29 U.S.C. § 1107(e); ERISA, § 2003(a), I.R.C. § 503(e).
119. These are rights to either sell (in the case of puts) or buy (in the case of calls) within a given time and for a given price.
120. These are agreements whereby a corporation or other shareholder agrees to buy another shareholder's stock on the happening of a certain event, e.g., death of the shareholder.
122. For permissible restrictions on securities, see text accompanying notes 140-55 infra (put options and rights of first refusal).
regulations deleted many of the limitations contained in the proposed regulations, the Department of Labor and the IRS have expressed continued concern regarding the nature of securities acquired with exempt ESOP loan proceeds: a trustee who acquires securities for an ESOP with exempt loan proceeds remains subject to the general fiduciary duty found in section 404 (a)(1) of the Act.125

As noted above, the original regulations would have required that essentially all stock acquired with exempt loan proceeds have voting rights126 and that those rights “pass-through” in a manner enabling the individual participant to exercise them.127 One commentator objected to the proposed regulation, arguing that corporate management would become impossible if every participant had a voting right.128 The duty to notify participants of every voting issue pending would have been extremely burdensome. Apparently, the proposed regulations intended to protect participants from a corporation’s issuance of worthless stock. However, Congress, in the Tax Reform Act of 1976 Conference Committee Report, recognized that non-leveraged ESOPs, i.e., certain stock bonus plans, are not required to pass voting rights through to participants,129 and concluded that the regulations should not distinguish between these types of plans in the proposed manner.

As a result, the absolute requirement that all ESOP-acquired securities carry voting rights was deleted in the final regulations.130 However, while one might assume that the deletion of the voting rights requirement permits an ESOP fiduciary to acquire all non-voting stock, the fiduciary nevertheless remains subject to the section 404 (a)(1)131 duty to administer the plan solely in the interests of the participants and the beneficiaries. He must acquire stock with rights and features sufficient to permit him to provide participants with full benefits and to protect the value of current invest-

An ESOP, just as any other stock bonus plan, may invest in insurance policies so long as the "exclusive benefit" requirement of I.R.C. § 401 (a) is met. However, an ESOP loan will not be exempt if the loan proceeds are used to acquire the life insurance policies. 42 Fed. Reg. 44388, 44390 (1977) (supplemental information to the final regulations).

129. CONFERENCE REPORT No. 94-1515, supra note 21, at 540.
ments. To fulfill this duty, it may, in certain circumstances, be necessary for the stock to carry voting rights. In fact, a 1969 study revealed that over ninety percent of the profit-sharing trusts that invested in employer securities held voting stock.

Even where voting rights accompany the stock acquired by the ESOP, there remains the issue of how they are to be exercised. The primary alternatives in this regard include passing voting rights through to the employees, permitting a plan fiduciary to exercise the voting rights in his sole discretion, or requiring the rights be exercised by a fiduciary only after consultation with a participant advisory board. Although the final regulations do not require voting rights to pass through to the participants, it has been suggested that since the participants share the risk of ownership, voting rights on the stock held by the trust should be passed through. This would be consistent with what some commentators assert is the primary justification for ESOPs: allowing the participant to share fully in capital ownership. It would also avoid the potentially problematical voting of the stock by an ESOP trustee who is controlled by the management or board of directors of the corporate employer. However, prior custom in this regard has been varied and generally has not included a pass-through provision.

132. I.R.S., Technical Information Release 1413, F-3 (1975), with regard to ESOPs under the Tax Reform Act of 1976 (TRASOPs), provides that:
   An ESOP under section 301(d) of the Act, . . . must be funded by (1) common stock issued by the employer or a corporation which is in control of the employer . . . with voting power and dividend rights no less favorable than the voting power and dividend rights of other common stock issued by the employer or such controlling corporation or (2) securities issued by these corporations which are immediately convertible at a reasonable conversion ratio into such stock by employees, to whose accounts the securities are allocated.
133. Such circumstances may involve the possible acquisition of worthless stock.
134. Metzger, supra note 65, at 335. Eighty percent of the ESOPs in another survey held securities with voting rights. ESOPs Report, supra note 60, at 48.
135. Metzger, supra note 65, at 335. Profit Sharing, supra note 60, at 36.
137. See Schaff, supra note 7.
139. Voting rights were exercised by corporate trustees or by parties within the company 44.5% and 42.4% of the time, respectively. In only 7.2% of the time did employees vote their stock. Metzger, supra note 65, at 335. However, regarding profit sharing trusts established by large companies, it has been found that substantially more employees are allowed to exercise the stock voting rights. In a survey of thirty-five trusts holding employer securities, 42.9% had pass-through voting rights while corporate or individual trustees exercised the right in 51.5%. Profit sharing committees directed the trustee how to vote in 2.8%. Profit
Whether or not the purpose of an ESOP is to increase employee input into managerial determinations must be decided on an individualized basis. An ESOP for a closely-held corporation need not be created for this purpose, since participant economic benefits, work incentives, and tax advantages provide sufficient reasons to establish an ESOP. While philosophical and ideological considerations may indicate the desirability of passing voting rights through, such a change in social policy should not be mandated by governmental regulations. The final regulations, by deleting this requirement, properly leave the development of social policy to the private sector. Moreover, where the right to vote stock is given solely to a fiduciary, the exercise of that right must be tempered by his fiduciary duty of increasing the economic value of the ESOP's investment assets.

**Put Option Rights**

The proposed regulations would have also required that all ESOP-acquired employer securities carry the right to "put" the securities back to the employer at the participant's option. Additionally, exercise of the put option would have required the employer to immediately honor the obligation in full. Two primary objections were raised against these requirements. First, under some state laws a corporation may not purchase its own stock, and certain corporations, such as commercial banks and other financial institutions, may not issue put options. Second, the requirement of full and immediate payment upon exercise of a put option could severely limit an employer's cash flow. Both concerns might have resulted in significant impediments to the adoption of ESOPs. The final regulations, however, represent a meaningful response to these criticisms.

Qualifying employer securities acquired with exempt loan proceeds must be subject to a put option if the securities are either not publicly traded when distributed or if they are publicly traded but are subject to a trading limitation when distributed. Thus, the...
final regulations assure a market for the securities of a closely-held corporation\textsuperscript{144} without unduly restricting incentive to adopt ESOPs. Further, the changes in the final regulations conform to the realities of state law and corporate finance.\textsuperscript{145} If state or federal law prohibits an employer from honoring a put option, the plan must permit the security to be put to a third party\textsuperscript{146} having substantial net worth at the time of the loan and whose net worth may be reasonably expected to remain so. Although the ESOP may never be \textit{bound} by a put option, the option may grant the ESOP the \textit{opportunity} to assume the rights and obligations of the employer at or after the time the option is exercised. Buy-sell arrangements are barred. Generally,\textsuperscript{147} the option must exist for fifteen months starting from the date of distribution to the participant from the ESOP. Payment provisions upon exercise of the option must be reasonable.\textsuperscript{148} For example, payment may be made in installments over a maximum five-year period from the time the option is exercised provided the annual installments are substantially equal.\textsuperscript{148} Periodic payments are designed to encourage stable capital formation for the company while permitting the participant to convert his stock holdings to cash within a reasonable time. The final regulations adopt a realistic approach regarding put option rights.

\textsuperscript{146} If a plan has acquired publicly-held securities, no trading limitations exist and a put option is not required.
\textsuperscript{147} This problem was noted in the \textit{CONFERENCE REPORT} No. 94-1515, \textit{supra} note 21, at 541.
\textsuperscript{148} The third party may, for example, be an affiliate of the employer or a shareholder other than the ESOP.
\textsuperscript{149} The duration of the put option may be longer than fifteen months. However, it may not include a period in which the party bound by the put option is prohibited from honoring it because of state or federal law.
\textsuperscript{148} Deferred payments are reasonable if adequate security and a reasonable rate of interest are provided for any credit extended by the participant. The cumulative payment should not be less than the aggregate of the periodic payments. Periodic payments are reasonable if the annual installments are substantially equal. Treas. Reg. § 54.4975-7 (b)(12)(iv), 42 Fed. Reg. 44388, 44392 (1977); 29 C.F.R. § 2550.408b-3(1)(4), 42 Fed. Reg. 44384, 44387 (1977).
\textsuperscript{149} The installment period may be extended to the earlier of 10 years from the date the put option was exercised or the date of repayment of the loan used to purchase the security subject to the put option.
Right of First Refusal

The proposed regulations' ban on an employer's or shareholder's reservation of a right of first refusal\textsuperscript{150} evoked particularly strong criticism. Small businessmen complained that unless they were permitted to retain control of their companies through the right of first refusal, they would have to abandon the use of ESOPs.\textsuperscript{151} Congress also recommended that ESOPs be permitted to acquire securities subject to such a right.\textsuperscript{152}

Consequently, the final regulations\textsuperscript{153} generally permit acquisition of securities subject to a first refusal provision with regard to certain types of securities.\textsuperscript{154} The right of first refusal may lie only in favor of the employer, the ESOP, or both, and must lapse after a period of fourteen days following written notification by the security holder. The selling price must be no less than the greater of either the fair market value of the securities\textsuperscript{155} or the purchase price and other terms offered by a third party buyer bidding in good faith.

The final regulations are primarily advantageous to a closely-held company where investors are interested in maintaining control of the company. Securities acquired with this limitation do not hinder a fiduciary in fulfilling his obligations to the participants and the beneficiaries. The inclusion of this permissive provision removes a potential disincentive for a closely-held corporation to adopt an ESOP.

Valuations

The final regulations\textsuperscript{156} specify guidelines for determining the value of securities at the time a put option is exercised\textsuperscript{157} as well as upon notification regarding a right of first refusal.\textsuperscript{158} More importantly, to qualify an initial acquisition or a subsequent sale of the securities for the section 408 (e)\textsuperscript{159} prohibited transactions exemp-

\textsuperscript{151} \[1976\] 4 PENS. PLAN GUIDE (CCH) ¶ 25,133, at 27,200 (comments by John C. Hough).
\textsuperscript{152} CONFERENCE REPORT No. 94-1515, supra note 21, at 541.
\textsuperscript{154} See text accompanying notes 163-64 infra.
tion, the acquisition or sale of securities must be for "adequate consideration." In the event that less than adequate consideration is received by an ESOP, the IRS has authority to impose an excise tax on the amount involved with respect to the prohibited transaction.

Adequate consideration for securities with a generally recognized market is the prevailing price on a national securities exchange, or if traded over the counter, the offering price as established by current bids and asked prices of persons independent of the issuer or party-in-interest. If the asset is a security without a generally recognized market, i.e., securities of a closely-held corporation, the fair market value of the assets is to be determined in good faith by a trustee or fiduciary.

To substantially minimize the excise tax on the amount involved in the event that a prohibited transaction is made and the ESOP receives less value than it paid, the trustee or named fiduciary must make a good faith effort to determine the fair market value. The amount involved is then limited to the excess of the fair market value of the property transferred by the ESOP over the amount it received, and any excise tax is imposed on this amount if the prohibited transaction is timely corrected.


161. ERISA, § 2003 (a), I.R.C. § 4975 (f)(4) states in part, that "amount involved" means the greater of the amount of money and the fair market value of the other property either given or received. Regarding the definition of the amount involved, Temp. Treas. Reg. § 141.4975-13 (1976) adopted the provisions of Treas. Reg. § 53.4941 (e)-1 (1973) (relating to prohibited transactions and private foundations) until final regulations under I.R.C. § 4975 (e) are issued.

162. ERISA, § 2003 (a), I.R.C. § 4975 (a) imposes an excise tax of five percent of the amount involved. Subsection (b) imposes a tax of 100% of the amount involved if the prohibited transaction is not corrected within ninety days after notification of the original deficiency.

163. ERISA, § 3 (18)(A), 29 U.S.C. § 1002 (18)(A) (Supp. V 1975). While no regulations have been issued under this section, regulations found under similar statutory language in I.R.C. § 503 (e)(1)(A) may provide guidance as to the proper method of valuation. See, e.g., Treas. Reg. § 1.503 (e)-2 (1976), C. SandS, 3 Statutes and Statutory Construction § 66.03 (4th ed. 1974). Those methods are designed to determine the price accurately reflecting the market value of the obligation.


167. If corrected, the excise tax would be five percent of the limited amount involved instead of five percent of the full value of the property acquired. ERISA, § 2003 (e), I.R.C. § 4975 (a). Under ERISA, § 2003 (a), I.R.C. 4975 (f)(5), correction requires "undoing the [prohibited] transaction to the extent possible" or "placing the plan in a financial position not worse than if the prohibited transaction had not occurred. If the trustee pursues good faith
Good faith, in this regard, requires that an independent person, who is competent, make the valuation, utilizing methods generally accepted in arm's length business transactions for valuing comparable assets. The final regulations eliminate the requirement of filing an annual certificate of valuation with the IRS. This alleviates the burden of the potentially high valuation certification, and filing costs complained of at least by smaller companies. While an annual certificate of valuation is not needed, a valuation must be made as of the date of the transaction if the transaction is made between a plan and a disqualified party. In all other cases, the most recent valuation date under the plan documents will be sufficient.

The regulations add that valuations must be made in good faith and be based on all relevant factors for determining the fair market value of the securities. For a closely-held company, the methods in valuing stock are similar as those for estate tax purposes. A 1959 revenue ruling, apparently still valid although, by its terms, applicable to estate and gift tax valuation, instructs the trustee to look to the nature of the business and its financial history. Other subjects for examination include the industry's outlook, the employer's potential growth rate, the stock's book value, the employer's current financial condition, and the employer's earnings and dividend capacities.

The fiduciary must exercise caution in fulfilling the good faith valuation requirement. Where the transaction is between a plan and a disqualified person, even an appraisal by an independent entity may not be conclusive of good faith. However, in other cases such a precaution will be conclusive. Fund evaluations or investment audits are a common practice and have been used with increasing frequency. Although such an audit may be costly, it minimizes the risk of imprudent investment. An investment audit should deter-
mine whether the purposes of the ESOP's adoption and the investment objectives are properly defined, whether the investment plan is designed to accomplish these objectives in a manner consistent with ERISA, the regulations, and sound investment principles, and whether the trustee has considered the merits of the investment independent of any benefit to a party-in-interest.

CONCLUSION

The final regulations attempt to provide that an ESOP trustee engage in loan transactions primarily benefiting the plan's participants and beneficiaries. Deletions from the final regulations of provisions such as the independent fiduciary requirement, the restrictions on the type of employer securities acquired, the annual certificate of valuation, and right of first refusal prohibition make ESOPs more attractive from the employer's point of view. Unfortunately, although the regulations do not specifically require acquired stock to have voting rights, agencies have not addressed the extent to which they may invoke the section 404 fiduciary duties and require certain stock to have voting rights. Until the point is settled, a fiduciary should closely examine the importance voting rights have to the plan's objectives.

On balance, under the final regulations, fiduciaries should find the administration of ESOPs much simpler than it would have been under the proposed regulations. However, while the increase in the flexibility of arranging loan transactions may reduce the risk of liability for breaching a fiduciary duty, the actual administration of the ESOP must comply with the high fiduciary standards that otherwise exist under ERISA. Thus, the participants are not likely to suffer, and, to the extent that the final regulations encourage the use of ESOPs, they will gain the benefits that ESOPs afford.

WILLIAM S. PIPER