

ESOPs In Changing Times

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We do recommend to "be aware..."

Because ESOPs are inextricably tied to the fortunes of their employer sponsors, the most successful ESOP companies are those that react to change when they see the light and not just when, as the saying goes, they feel the heat. This issue of *Focus On Benefits* shines some light on how ESOP companies and fiduciaries need to plan and react and be aware in these changing times.

Economic Change

The always uncertain economy puts pressure on the dynamics of the ESOP appraisal process and company stock values. It is not simply an issue of the fair market value, per se, but how fluctuations in company stock values are handled. The valuation process raises fiduciary and management issues, including employee communications, benefits calculations, procedural prudence, and strategic planning. That's why it's important to:

- **Look closely, communicate clearly.** Projections prepared by management may need closer examination and documentation of those assumptions. Assumptions about growth that were realistic for some industries in the near past may be viewed in hindsight as overly optimistic or pessimistic. This and other factors affecting value may create difficult employee communication issues, especially if valuation methods have not been explained to participants or fully understood by all co-fiduciaries. Consider having your ESOP appraiser get more involved in supporting your efforts to communicate to employees. Do your employees know how the appraisal is calculated? Do they know what makes their stock go up or down?
- **Calculate realistically.** Valuation methodologies that made sense under a growth trend may produce anomalous results as business conditions change. Efforts to contain value increases, or to "manage" value fluctuations in a volatile economy, may create problems if valuation reports are examined by third parties. Appraisal reports that search for acceptable values may be doing so at the risk of inconsistent analysis. Historical earnings or asset-based methods that are relied on or which are weighted in the conclusion may not fully reflect the downturn in the company's revenues, resulting in potential overpayment of benefits to participants. Take the time to do a comprehensive review of the reports and methods that are being used over a period of years. Consider getting additional help in this area.
- **Think "demonstrable prudence."** Potential significant shifts in annual valuations or strategic transactions may call for second opinion reviews to ensure that fiduciaries are demonstrating thorough procedural prudence. This can come up if trustees change appraisers or if strategic transactions call for scrutiny or second opinions. The case law may require fiduciaries to review or get second opinions in certain circumstances. Do you know what the forks in the road are that may trigger the need for additional assistance, or a

reinvigoration of the valuation process? Are all the right parties involved in the valuation process, and are they wearing the right hats?

- **Know Your Corporate Duties Too.** With all the talk of corporate governance, are the right parties doing the planning? Consider for example, ESOP repurchase liability. Is it being handled by ESOP fiduciaries, or the board's finance committee? Are you changing the terms of the ESOPs distribution provisions in response to this liability? Be sure your parties and their process, and the plan document optimally protect the company and the ESOP fiduciaries. Additionally, corporate planning may require opinions to be obtained by management in addition to those annual ESOP update opinions. For example, recapitalizations or transactions may require corporate level fairness opinions that would be inappropriate for the ESOP advisors to prepare.
- **Don't wait until the last minute.** Overall, ESOPs fiduciaries must be careful and even more vigilant throughout the valuation process. Delays in valuation reports due to uncertainties, and delays in producing company financial statements, may also cause participant communication and benefit claims that must be carefully handled. Boards of directors should examine the inter-relationship of company financial reporting and the ESOP valuation process. If there are significant accounting anomalies, get them resolved. Consider keeping your appraiser more proactively in the loop with your other advisors in order to streamline the process. How tight is your circle of advisors?

Political Change

This year promises political change in one direction or another and looming budget deficits – a perfect storm that will roil the Internal Revenue Code. The most significant political wrangling over tax policy will likely begin in earnest in early 2009. Major tax legislation following an election year is typically introduced in the first quarter of the following year. Consider:

- **A resurgence in tax deferred sales of companies to ESOPs?** Capital gains rates have been at an historical low for approximately eight years now. To some extent this has affected how ESOP transactions have been structured. A raise in the capital gains rates may cause a resurgence in tax deferred sales of companies to ESOPs as the Code section 1042 rollover once again becomes more compelling.
- **Your ESOP voice counts!** No matter who is elected, the fact that there are multiple seats on the House Ways and Means Committee that are open in this election portends a need for an active effort in educating policy makers. Many politicians in Washington might not even know how an ESOP works if it were right in their backyard; and surprise, there you are! Many ESOP experts recommend that the most important lobbying effort for ESOP companies to protect their tax benefits will be to invite their representatives to visit their companies and become acquainted with what a successful ESOP is. Sending letters to Washington without having educated their representatives on the benefits of ESOPs, may be less than effective.
- **The S in revision?** Subchapter S corporation ESOPs, which were attacked in 2001, may be subject to revision. S corporations contemplating ESOPs or companies contemplating an S corporation election should seriously examine those alternatives in 2008. The 2001 Tax Act brought technical changes and anti-abuse rules after significant lobbying and pro-active participation by S corporations ESOPs. We expect ESOP companies to be particular

active again. S corporation ESOP companies should be ready to outreach to their elected representatives.

Changes In The Law - C'est *LaRue*?

In 2008, the Supreme Court's *LaRue* decision was arguably the most notable retirement plan case to be reported. While you may have read multiple articles on the subject, in short, *LaRue* validated a participant's ability to singularly bring suit against a plan fiduciary for fiduciary breach without suing on behalf of the entire plan. A participant may now sue seeking a restoration of his or her individual account.

Will this mean significant benefit claims or fiduciary breach of litigation? Only time will tell. What this means for all of our retirement plan clients, and in particular ESOPs, is plan sponsors should review their fiduciary structure and ensure their processes involving their transactions, administration valuation and other service providers are up to snuff (OK, now re-read all of our general admonitions, above). Also, for example, ESOP companies should ensure that the employer does not become the plan administrator by default or by terms of the plan. This is particularly important for corporations with outside independent directors who may not wish to be unwittingly legally responsible for fiduciary decisions. Similarly, independent fiduciaries may be advisable for many ESOP companies.

Even though the *LaRue* case involved a drop in the value of a 401(k) account, the impact of the case can be significant in any context where a plan participant believes that by fiduciary action or inaction, his or her individual benefits were negatively impacted. This means that a participant may directly and immediately bring suit for breach of fiduciary duty without moving through the benefit claim and appeal process. The presumption of correctness for fiduciary defendants and the requirement that plaintiffs prove that a benefit denial was "arbitrary and capricious," simply does not apply in a breach of fiduciary duty claim.

A Resurgence of ESOPs?

Some commentators believe that even though the growth in ESOPs has been merely incremental in recent years, it will significantly increase due a growing need for succession planning. Experts in this area point to the "generational" shift of companies owned and operated by baby boomers that will need a mechanism for succession. The growth of closely held businesses over the last 20 years has been the most significant sector of our country's economy. ESOPs should continue to be a meaningful vehicle for private companies. If this is coupled with an increase in income tax and capital gains rates, the experts may be right.

What To Do?

ESOP sponsors should take pause in 2008 as they handle their routine annual compliance and fiduciary matters and periodic plan amendments to assess their entire ESOP situation and look to their future plans. Note though, there really are no "routine" matters involving ESOPs. With great tax and benefits advantages, comes complexity. So, as lawyers, we actually do not like to say "beware." We do recommend to "be aware."

Editor's Note: We did the best we could to make sure the information and advice in this article were current as of the date of posting to the web site. Because the laws and the government's rules are changing all the time, you should check with us if you



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