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# The Modern ESOP and Fair Market Value After the End of Tax Cuts



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## I. Introduction

Section 1 of this article reviews the general purpose and benefits of employee stock ownership plans ("ESOPs"). Section II discusses the specific tax incentives associated with implementing an ESOP that are available to the company, the selling shareholder(s), and the employees. Section III discusses the fiduciary responsibilities associated with establishing and maintaining an ESOP. Section IV discusses the by-product benefits of an ESOP. Section V discusses the current legal environment facing ESOPs and best practices to avoid common pitfalls. Finally, Section VI discusses the future of ESOPs.

### A. ESOPs—'Baby Boomer' Generation

ESOPs continue to be an increasingly attractive means of transferring ownership in family-owned businesses in a manner which provides fair market value to the owners, but also appeal to several passion points. Aside from receiving fair market value on the sale of the business, many family business owners desire to continue the legacy of the business (and not be absorbed into another business), to keep the business (and jobs) in the community, and to maintain continuity of the business (management—employee control compared to being controlled by the new buyer).

As each year passes, many of the businesses created or operated by the baby boomer generation will be in transition. The options typically considered by a business owner are:

- sell the business to a competitor;
- sell the business to a private equity group;
- transfer the business to the management team for a note; or
- sell the business to an ESOP.

ESOPs provide a financially attractive, tax advantaged, and socially-accepted vehicle to effectuate the transfer of the business.

An ESOP is a stock bonus plan designed to invest primarily in the common stock of the sponsoring company (*i.e.,* "qualifying employer securities" [1] ). From an employee retirement plan standpoint, an

ESOP is similar to other types of employee retirement plans, such as tax code Section 401(k) plans and profit-sharing plans. However, an ESOP has the unique right to borrow money and own up to 100 percent of the common stock of its company sponsor. The assets of an ESOP are held in a tax-exempt trust, and the ESOP must comply with the qualified plan requirements, as well as additional requirements, under the Internal Revenue Code ("Code").

[1] The Internal Revenue Code defines "qualifying employer security" as "common stock issued by the employer (or by a corporation which is a member of the same controlled group) having a combination of voting power and dividend rights equal to or in excess of that class of common stock... having the greatest voting power, and ... having the greatest dividend rights." *See* 26 U.S.C. §409(l). In certain situations preferred stock may also be considered a qualifying employer security. *See* 26 U.S.C. §409(l)(3) (West 2006).

**B. Federal Income Tax Reasons**

At its core, there are some basic motivations for an owner to sell a business to an ESOP. Those basic motivations include certain tax benefits. With the uncertain tax environment facing business owners, many of them are accelerating their business succession plans.

At the end of 2012, the Bush-era federal income tax cuts expire and the long-term capital gains rate increases from 15 percent to 20 percent. In addition, certain provisions of the new health care reform law, which take effect at the beginning of 2013, impose a new 3.8 percent Medicare tax on unearned net investment income (which includes capital gains) for certain individuals. Therefore, the capital gains tax rate will increase approximately 60 percent come Jan. 1, 2013.

But that's not all that will have an impact on taxpayers come Jan. 1, 2013. Beginning in 2013, higher income taxpayers will be subject to the phase-out of certain itemized deductions, namely:

- taxes,
- interest (except investment interest),
- charitable contributions,
- employee job expenses, and
- other miscellaneous itemized deductions (excluding gambling and casualty or theft losses).

If the itemized deductions are subject to the limit, the total of all itemized deductions is reduced by the smaller of: (i) 3 percent of the amount by which the adjusted gross income ("AGI") exceeds the annual limit; or (ii) 80 percent of the itemized deductions that are affected by the limit. The threshold amounts for 2013 have not been announced yet but will be inflation-adjusted amounts from 2009, which were $83,400 for married taxpayers filing separately and $166,800 for all others.

Thus, it is apparent that 2013 will impact a lot of business owners, especially those planning to sell their business, since the sales proceeds will be subject to higher taxes. As the capital gains tax increases, business owners will lose a greater portion of the value of their business that they worked hard to accumulate when they sell the business. Moreover, if business owners live in a state with high capital gains tax rates, such as California or New York, they will be subject to an additional capital gains tax of about 8 to 10 percent.

Business owners can always sell their business to a third party. However, owners will be subject to federal income tax on a large portion of the sales proceeds if the sale occurs after Dec. 31, 2012. Also, beyond tax considerations, a third party sale will prevent business owners from: (i) transferring control of the business to either their children or the company's current management; and (ii) keeping the business in the community.

**C. Benefits Associated With ESOPs**

First and foremost, an ESOP is an employee benefit plan that allows employees to share in the economic benefits of owning equity in their company. In many ways, an ESOP is no different than any of the other broad-based retirement plans, such as 401(k) plans and profit-sharing plans which are qualified under Section 401(a) of the Code. The tax-exempt status of the related trust depends on the

ESOP meeting all the qualification requirements under the Code as is the case with all other tax-qualified plans. These include the requirements for coverage, eligibility, vesting, distributions, nondiscrimination standards, and also the disclosure and reporting requirements under the Employee Retirement Income Security Act. While an ESOP is similar to any other tax-qualified retirement plan, it has distinguishing characteristics. Apart from having to invest primarily in qualifying employer securities, an ESOP is also subject to different distribution rights, diversification rights, and voting rights.

The many benefits associated with an ESOP becoming part of the capital structure of a business are as follows:

• the business owner has a way to transfer and sell his or her business interest (and the business owner may receive some tax benefits);

• the company receives some tax benefits; and

• the employees receive some benefits.

As the baby boomer business owners transition their businesses, they will be faced with a series of important and difficult questions, such as the following commonly referred to as “key planning gateways”:

• Which transition method will maximize the business owner's return on investment?

• What will happen to the business and who will control the company following the transition?

• What will happen to the culture and the quality of its products or services following the transition?

• What will happen to the employees, their families, and the community following the transition?

• What will happen to the legacy of the business?

The answer to the first question can be calculated with some certainty, and the business owner will be able to decide which route to go. However, the answers to the subsequent questions are far more difficult to predict. ESOPs reduce the uncertainty inherent in a third party sale of a business because the current individuals running and working at the business will purchase the business through the ESOP.

***ESOPs also tend to benefit the selling business owners, the employees of the company, the company, and the community.***

In the right situation, a business owner's transition of a business using an ESOP provides both tangible and intangible benefits to the business owner, the company, the employees, and the community. Additionally, the business owner will have significant input on the design of the ESOP and corporate governance (unlike a third-party buyer, the ESOP must abide by certain rules that promote good corporate governance, discussed in more detail below). By establishing an ESOP, a baby boomer business owner can harvest the benefits of his or her investment and have greater certainty regarding who will control the business and how the business will be managed in the future, with some degree of assurance that the business will stay in the community.

## II. Incentives for Companies, Shareholders, and Employees

There are many financial benefits for the company that establishes an ESOP. As discussed later, the benefits are different for a company taxed as a C corporation and one taxed as an S corporation. Generally, company stock can be purchased by the ESOP with tax deductible company contributions or, in the case of a leveraged ESOP, with borrowed funds which can be repaid with tax deductible employer contributions and tax deductible dividends. [2] Additionally, ESOPs provide a source of cash and a willing buyer for the purchase of outstanding or newly-issued corporate stock. [3] When an ESOP is implemented, participants now have an additional benefit, one that is not taxed until they receive distributions (*i.e.*, when they leave the company) – and not even then if it is rolled over into an individual retirement account or other tax-qualified plan. Owning stock through the ESOP allows participants to share in the growth of the company, just as the company's initial owners experienced. Further, dividends paid to employees through the ESOP may provide additional tax deductions for the company to use. [4]

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[2] 26 U.S.C. §§404(a)(9), 404(k).

[3] ESOPs are similar to many other forms of tax exempt retirement plans. The key difference being that an ESOP is required to invest primarily in qualifying employer securities. 26 U.S.C. §§401(a), 4975(e)(7).

[4] 26 U.S.C. §404(k).

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**A. Tax benefits for C corporations**

There are several unique tax benefits available to business owners who engage in an ESOP transaction for their C corporations. These include:

- shareholders who sell stock to the ESOP may elect to postpone the tax on the sale;
- the company will be able to deduct the contributions made to the ESOP for the purpose of paying down the ESOP loan (interest and principal); and
- the company will be able to deduct dividend payments which are used to pay off the ESOP loan.

1. *Tax Deferral on the Sale of Stock to an ESOP.* Provided that the specific requirements of the Code are satisfied by the business owner, [5] the shareholders of a C corporation can sell their stock to an ESOP and elect to defer the long term capital gains recognition ("1042 Transaction"). While the tax benefits of a 1042 transaction only contemplate a tax deferral, shareholders may obtain permanent tax avoidance by reinvesting an amount equal to the sale proceeds in qualified replacement property (*i.e.,* stocks and bonds of U.S. companies), [6] and then later when the qualified replacement property is passed onto the shareholder's heirs, their heirs will receive a stepped-up basis in the property. [7] Thus, if the heir later chooses to sell the qualified replacement property they will realize no gain, and taxation on the initial 1042 transaction will have been permanently avoided.

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[5] Under the terms of 26 U.S.C. §1042, the shareholder will not recognize gain on the sale if (i) the stock that is sold is a "qualified security" (as defined by 26 U.S.C. §409(l)); (ii) the taxpayer purchases qualified replacement property (as defined by 26 U.S.C. §1042(c)(4)) within the replacement period (as defined by 26 U.S.C. §1042(c)(3)); (iii) the taxpayer must have held the stock for at least 3 years; and (iv) the ESOP must own at least 30 percent of the common stock of the corporation after the stock is sold to the ESOP.

[6] "Qualified replacement property" is defined as any security issued by a domestic operating corporation which did not, for the taxable year preceding the taxable year in which such security was purchased, have passive investment income in excess of 25 percent of the gross receipts of such corporation, and is not the corporation which issued the qualified securities which such security is replacing or a member of the same group of controlled corporations as such corporation. *See* 26 U.S.C. §1042(c)(4).

[7] According to 26 U.S.C. §1014, an heir's basis in property that is acquired through testamentary transfer is equal to the property's fair market value at the moment of the testator's death.

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Generally, if any item of qualified replacement property is sold, gain will be recognized in the year of sale in an amount equal to the amount of gain that went unrecognized pursuant to the shareholder's tax-deferral election under Code Section 1042. [8] Gain on the remaining items of qualified replacement property will continue to enjoy tax-deferred treatment. [9] In some instances, the shareholder may borrow against the qualified replacement property and reinvest the proceeds into investments that are managed by a professional investor. Therefore, the shareholder, during his or her lifetime, will have the ability to monetize the investment without recognizing the gain from the initial 1042 Transaction. Given that the capital gains rate is set to increase at the end of 2012, [10] the tax deferral offered by a 1042 transaction may allow businesses and shareholders to sell their stock on a tax-favorable basis. [11]

[8] 26 U.S.C. §1042.

[9] 26 U.S.C. §1042(e)(1).

[10] At the end of 2012, the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs Growth Tax Relief Reconciliation Act of 2003 are set to expire. Therefore, absent intervention by congress, the capital gains rate is set to increase. Additionally, the recently enacted Health Care and Education Reconciliation Act of 2010 is set to add a 3.8 percent Medicare tax on unearned net investment income, which includes capital gains, for higher income individuals.

[11] This type of structure was very popular with business owner's pre-Bush tax cuts.

2. *Deductions for Contributions Made to Leveraged ESOPs.* Both S and C corporations can deduct 25 percent of the value of contributions made to the ESOP to pay off the ESOP loan principal. However, there are additional deductions available to C corporations who sponsor a leveraged ESOP. First, there are no limitations on the value of deductions for company contributions that are used to repay ESOP loan interest. [12] Further, in addition to the 25 percent deduction available for contributions made to pay off ESOP loan principal, C corporations can deduct an additional 25 percent of participant payroll if they maintain a separate defined contribution plan. [13]

[12] Internal Revenue Code §404(a)(9)(B).

[13] I.R.S. Priv. Ltr. Rul. 200436015 (June 9, 2004); I.R.S. Priv. Ltr. Rul. 200732028 (May 16, 2007).

3. *Tax Deductions for the Value of Dividends.* A C corporation is allowed a deduction for any dividend paid with respect to corporate stock held by an ESOP if the dividend:

- is paid in cash to ESOP participants or beneficiaries;
- is paid to the ESOP and then distributed in cash to ESOP beneficiaries not later than 90 days after the end of the plan year in which it is paid;
- is used to repay a loan to the ESOP; or
- at the election of the participant or beneficiary, the dividend is paid back to the plan and reinvested in qualifying employer securities.

[14]

[14] 26 U.S.C. §404(k).

Additionally, dividend deductions are not subject to the 25 percent limitation for ESOP contributions. [15]

[15] It should be noted that S corporation distributions (the equivalent of dividends) are not tax deductible, but they can be used to repay an ESOP loan.

C. *Tax Benefits for S Corporations: No Corporate Income Tax.*

There are some notable tax advantages to S corporation that sponsor an ESOP. Due to the fact that an S corporation is a pass-through entity (meaning that it does not pay corporate income tax), and that ESOPs are tax-exempt retirement plans, if an ESOP is a shareholder in an S corporation, the ESOP's proportionate share of the S corporation's income is tax exempt. [16] Normally, qualified plans are subject to tax on unrelated business taxable income ("UBTI"); however, the Code was amended, effective Jan. 1, 1998, to provide that where an ESOP is a shareholder in an S corporation, the ESOP's proportionate share of the S corporation's income is not considered in computing the ESOP's UBTI. [17] In addition, gain realized from the sale by the ESOP of S corporation employer securities is exempt from UBTI. [18] As you can see, the more shares of the sponsoring corporation that the ESOP owns, the less tax liability exists with respect to corporate income. However, selling shareholders are not allowed to postpone the capital gains tax on the sale in a 1042 transaction.

[16] *See* 26 U.S.C. §1361.

[17] Pub. L. 105-34, H.R. 2014, 111 Stat. 787 (Aug. 5, 1997).

[18] *Id*.

For the S corporation ESOP to be tax exempt, the company that sponsors the ESOP must satisfy certain anti-abuse rules under the Code. [19] Generally, an ESOP is designed to promote broad-based employee ownership. As such, an ESOP that holds shares of an S corporation is prohibited from allocating or accruing a certain percentage of common stock on behalf of a small number of persons.

[19] To make sure tax promoters do not set up S corporation ESOPs so that individual can avoid paying taxes, Congress established rules ensuring that S corporations with a "real business" and a certain minimum number of employees can benefit from an ESOP.

## III. Fiduciary Responsibilities

### A. ESOPs: Proper Structure Versus Poor Structure

1. *The Role of the Board of Directors.* The business affairs of the company are to be managed under the directions of the board. The board is selected by the shareholders, and is expected to act prudently, under a duty of loyalty to act in good faith and in the best interests of the company, and under a duty of obedience to remain faithful to the purpose of the company. [20] Typically, prior to setting up an ESOP, the business owner (*i.e.,* the shareholder) and his or her family also serve on the board. Following the implementation of an ESOP into the capital structure of a company, the shareholder is the ESOP trustee with the board running the business affairs of the company (*i.e.,* interests are not aligned). Because interests may not always be aligned, it is important to understand the duties of the board, since the ESOP trustee (*i.e.,* the shareholder) is looking out for the best interests of the ESOP participants.

[20] Texas Business Organization Code §21.401; *Gearhart Industries, Inc. v. Smith International, Inc.,* 741 F.2d 707(5th Cir. 1984).

The primary responsibilities of the board include the following:

- appointing the trustees (who happen to be the shareholder) and fiduciaries along with monitoring such fiduciaries' performance;
- growing shareholder value;
- governing to ensure the company is achieving its legal purpose and strategic and financial objectives;
- establishing a vision;
- reviewing strategy and business plans;
- appointing, compensating, monitoring, evaluating, and advising the CEO and senior management;
- determining compensation for the management team;
- planning for succession;
- managing risk;
- evaluating and approving transactions from a corporate and shareholder perspective; and
- complying with applicable law (*i.e.,* the ESOP company is subject to regulations).

The board, while not typically responsible as a fiduciary to the ESOP, [21] does fulfill a fiduciary role when selecting the ESOP's trustee as the fiduciary of the ESOP. [22] Given the breadth of ERISA's fiduciary obligation, and the dichotomy of loyalties that the board owes to both its shareholders and the ESOP, careful consideration of potential conflicts must be made when selecting each member of the managing structure.

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[21] An important limitation on fiduciary status is that a person is a fiduciary only "to the extent" he performs one of the defined fiduciary functions. *See Id.*; *Pegram v. Herdrich*, 530 U.S. 211, 24 EBC 1641 (2000)(118 PBD, 6/19/00; 27 BPR 1519, 6/20/00). ("In every case charging breach of ERISA fiduciary duty, the threshold question is not whether the actions of some person employed to provide services under a plan adversely affected a plan beneficiary's interest, but whether that person was acting as a fiduciary (that is, was performing a fiduciary function) when taking the action subject to complaint.").

[22] ESOPs are governed by the Employee Retirement Income Security Act. ERISA defines a fiduciary as a person who:

- (i) exercises discretionary authority or discretionary control with respect to the management of a retirement plan or exercises any authority or control with respect to the disposition of plan assets,

- (ii) renders investment advice for a fee with respect to the money or other property of the retirement plan, or

- (iii) has any discretionary authority or discretionary responsibility in the administration of the retirement plan. 29 U.S.C. §1002(21).

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a. *Selection of a Trustee*. An ESOP fiduciary is a person or entity that makes decisions affecting the operations of the ESOP. Typically, due to the board's desire for accountability so that the board satisfies its duty to monitor the ESOP trustee, the appointed ESOP trustee will be a person or entity selected by the board. In many cases, the board selects the trustee with whom they are comfortable, and believes that such a trustee has a certain level of loyalty to the board. The dual responsibility associated with such an appointment, in many circumstances, creates a conflict of interest under ERISA. [23] However, this duality of service is expressly authorized and will not be viewed as a breach of fiduciary duty. [24]

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[23] Typically, ERISA requires that the named fiduciary act solely in the interest of plan beneficiaries for the exclusive purpose of providing benefits to participants and defraying the expenses of plan administration. 29 USC §§1103, 1104(a)(1).

[24] 29 USC §§1108(c)(3) of ERISA expressly exempts from the definition of a "prohibited transaction" "serving as a fiduciary in addition to being an officer, employee, agent or other representative of a party in interest."

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Regardless of legality, it is critical that all fiduciary appointments take their roles seriously and engage in the levels of scrutiny required by law. While courts will initially give the benefit of the doubt to the discretionary actions of plan fiduciaries, this presumption may be overcome if their actions fail to reveal a clear understanding of their responsibilities to the trust. [25]

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[25] *Moench v. Robertson*, 62 F.3d 553, 572, 19 EBC 1713 (3rd Cir. 1995), rehearing denied, 1995 U.S. App. LEXIS 26141, cert. denied, 516 U.S. 1115, 116 S. Ct. 917, 19 EBC 2888 (1996). ("Courts should be cognizant that as the financial state of the company deteriorates, ESOP fiduciaries who double as directors of the corporation serve two masters. And the more uncertain the loyalties of the fiduciaries, the less discretion it has to act. Indeed, when a fiduciary has dual loyalties, the prudent person standard requires that the fiduciaries make careful and impartial investigations of all ... decisions.")

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In selecting a fiduciary, the board should consider the following factors, among others, depending on the situation:

- The independence (and conflict of interests) of the person or entity being considered as the fiduciary (as what should have occurred early on in the *Alliance* case discussed below);

- The knowledge and experience of the person or entity being considered as the fiduciary;

• The size of assets of the person or entity being considered as the fiduciary;

• The amount of fiduciary insurance, and the insurance company underwriting such insurance, covering the person or entity being considered as the fiduciary;

• The reputation of such person or entity being considered as the fiduciary;

• The amount of litigation and Department of Labor investigations the person or entity being considered as the fiduciary is involved in;

• The Madoff perception risk if an individual is selected over an entity as the fiduciary; and

• The resources ("back office support") of the person or entity being considered as the fiduciary.

b. *Outside Trustee Compared to Inside Trustee*. When selecting a trustee, the board may select either an inside trustee (*i.e.*, an employee, officer, director, or board member) or an outside trustee (generally, a corporation with trust power, *i.e.*, a bank or trust company).

An outside trustee will generally have sophisticated knowledge of ERISA duties, ESOP regulations, and case law; thus, there will be a higher level of autonomy in their decision making. In addition, it may be easier to support the above factors if there is an allegation made against the board. Further, the outside trustee will be less likely to experience a conflict of interest. Conflicts of interests are common with inside trustees because they are required to serve as an employee of the company while acting in a manner that is in the best interests of plan participants and beneficiaries. [26] An individual inside trustee tends to get pulled into the conflict since the individual is getting paid by the company and such individual may be relying on such compensation.

[26] *See Chesemore v. Alliance Holdings, Inc.,* 52 EBC 1703 (W.D. Wisconsin 2011)(186 PBD, 9/26/11;38 BPR 1764, 9/27/11).

In the short run, an inside trustee may be cheaper since an insider will not charge a fee. However, the company may be subjecting itself to substantial liability exposure. An outside trustee will charge a fee. This fee will be used to compensate the outside trustee to serve as the trustee. Additionally, the company will need to spend time informing the outside trustee about the company and its markets in order for the outside trustee to learn about the company (*i.e.,* the outside trustee is an investor).

On the other hand, an inside trustee will have the benefit of personal relationships and knowledge of the company's inner workings. Unfortunately, inside and independent individual trustees will likely be more susceptible to the persuasion of parties with interests which are adverse to the ESOP. For example, if the inside trustee is forced to negotiate with a superior, he or she may be fearful of damaging his or her career. Therefore, the inside trustee may negotiate from a weaker position than would an outside trustee.

However, many inside trustees may lack the knowledge and sophistication necessary to negotiate and administer an ESOP. They will therefore need to seek the assistance of outside counsel and other advisors. Any outside advisors will generally be selected by the fiduciary, which may create divided loyalties.

c. *The Trustee's Role.*

i. *Valuation of ESOP Company Stock*. Valuation of the company stock being sold by the business owner to the ESOP is a cardinal concern for all parties involved in the transaction. The fiduciary for the ESOP has the burden of proving that the ESOP did not pay more than adequate consideration for its purchase of the company's stock from the business owner. [27]

[27] 29 U.S.C. §§1002(18), 1108(e); *Henry v. Champlain Enterprises*, 445 F.3d 610, 620, 37 EBC 1941(2d Cir. 2006)(83 PBD, 5/1/06;33 BPR 1111, 5/2/06). ("Under ERISA, the fiduciary bears the burden of proving by a preponderance of the evidence that the ESOP received "adequate consideration" for its purchase of company stock ... . The role of courts in reviewing the adequacy of consideration in an ERISA case is to determine whether the fiduciary can show that the price paid represented a good faith determination of the fair

market value of the asset....").

Under ERISA, determination of adequate consideration is based on whether or not the plan is purchasing a security for which there is a generally recognized market. [28] If the ESOP is purchasing a security for which there is a generally recognized market, adequate consideration is equal to the current price of the security on a national exchange. [29] However, if the ESOP is purchasing a security that does not trade on a generally recognized market, adequate consideration is defined as the fair market value of the asset being purchased, as determined in good faith by the trustee or fiduciary of the ESOP. [30] Good faith is an "objective, rather than a subjective, standard of conduct." [31] Since most ESOP transactions involve privately-held family types of businesses, the company stock is not publicly traded. [32] The ESOP Trustee will engage an independent appraiser to value the company stock. The ESOP trustee will (approve and) set the value of the company's stock. Courts will examine whether a fiduciary has met his obligations to the ESOP by asking whether, at the time of the transaction, the fiduciary employed the appropriate methods to determine the value of the securities being purchased. [33] Further, a proper determination of fair market value by the ESOP fiduciary depends on whether the parties involved in the transaction are well informed about the assets and the markets for the assets. [34] Typically, the ESOP trustee will obtain from the independent appraiser the range of value and will negotiate a price in between such range that will represent the purchase price.

[28] 29 U.S.C. §1002(18).

[29] *Id*.

[30] *Id.*; Fair market value is defined as "the price at which an asset would change hands between a willing buyer and a willing seller" when neither party is under any compulsion to buy or sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset." Prop. Department of Labor Reg. §2510.3-18 (b)(2)(i).

[31] Prop. Department of Labor Reg. §2510.3-18(b)(3)(i).

[32] Under ERISA, determination of adequate consideration is based on whether or not the plan is purchasing a security for which there is a generally recognized market. If the ESOP is purchasing a security for which there is a generally recognized market, adequate consideration is equal to the current price of the security on a national exchange. However, if the ESOP is purchasing a security that does not trade on a generally recognized market, adequate consideration is defined as the fair market value of the asset being purchased, as determined in good faith by the trustee or fiduciary of the ESOP. Good faith is an "objective, rather than a subjective, standard of conduct."

[33] *Champlain*, 445 F.3d at 620.

[34] *Id*. at 619.

d. *Valuation Process.* Though the Department of Labor has not released official guidelines for the appraisal of fair market value, the Department of Labor's proposed regulations [35] are consistently looked to for guidance when determining the value of company stock held in an ESOP. According to the proposed regulations, when determining the fair market value of the stock, the valuation must be reflected in written documentation. The documentation must contain, at a minimum, the following information:

- a summary of the qualifications of the person or persons making the valuation [36] to evaluate assets of the type being valued;

- a statement of the asset's value, a statement of the methods used in determining that value, and the reasons for the valuation in light of those methods;

- a full description of the asset being valued;

- the factors taken into account in making the valuation, including any restrictions, understandings, agreements, or obligations limiting the use or disposition of the property;

- the purpose for which the valuation was made;

- the relevance or significance accorded to the valuation methodologies taken into account;

• the effective date of the valuation; and in cases where a valuation report has been prepared, the signature of the person making the valuation and the date the report was signed.

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[35] Prop. Department of Labor Reg. §2510.3-18(b)(4).

[36] Qualified appraiser must make a declaration in the appraisal summary that the appraiser: (i) holds himself out to the public as an appraiser or performs appraisals on a regular basis, and (ii) is qualified to make appraisals of the type of property being valued and provides a description of his qualification. 26 CFR §1.170A-13(c)(5).

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The proposed regulations contain special requirements for securities that are not traded on a generally recognized market. These requirements are modeled after Internal Revenue Service Rev. Rul. 59-60, 1959-1 C.B. 237 (which deals primarily with the valuation of closely-held property for the purpose of gift and estate taxes). [37] The proposed regulations provide that, in addition to the factors listed above, the valuation report must include a detailed assessment of the following factors:

• the nature of the business and the history of the enterprise from its inception;

• the economic outlook in general, and the condition and outlook of the specific industry in particular;

• the book value of the securities and the financial condition of the business;

• the earning capacity of the company; the dividend-paying capacity of the company;

• whether or not the enterprise has goodwill or other intangible value;

• the market price of securities of corporations engaged in the same or a similar line of business, which are actively traded in a free and open market, either on an exchange or over-the-counter;

• the marketability, or lack thereof, of the securities; and

• whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued, provided that, in cases where a control premium is taken into account: (a) actual control (both in form and in substance) is passed to the purchaser upon the sale, or will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the sale; and (b) it is reasonable to assume that the purchaser's control will not be dissipated within a short period of time subsequent to acquisition.

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[37] It should be noted that Internal Revenue Service Rev. Rul. 59-60, 1959-1 C.B. 237 goes into further detail regarding the requirements for all of the listed factors.

[38] Prop. Department of Labor Reg. §2510.3-18(b)(4)(ii).

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e. *Selection of an Appraiser*. In all cases, both an inside and outside trustee will engage an independent appraiser to assist the ESOP trustee in determining the fair market value of the company stock. However, the regulations require that valuations must be made by an independent appraiser if: (i) the ESOP securities are not readily tradable on an established securities market; or (ii) if the ESOP has an "inside" fiduciary. [39] Again, best practice requires an ESOP trustee to retain an independent appraiser to perform a valuation. It is important to note that an appraiser is not independent if the appraiser:

• is the company sponsor that maintains the ESOP (or in the controlled group);

• is a party to the transaction in which the ESOP acquired the property;

• is employed by the taxpayer maintaining the ESOP, by a member of the controlled group of such person, or by a party in interest to the acquisition by the ESOP; or

• is regularly used by any of the entities described above and does not perform a majority of his or her appraisals for entities other than those described above.

[40]

[39] *Id*. at §2510.3-18(b)(3)(ii).

[40] *Id*.

f. *Ongoing Valuation*. Given that the ESOP trustee is required to make prudent investment decisions based on an ongoing obligation to monitor the plan's investments, [41] it would be difficult if not impossible to fulfill these obligations without first obtaining accurate information concerning the value of the ESOP's assets. Under the Code, ESOPs must value participants' accounts at least once a year. [42] According to Rev. Rul. 80-155, 1980-1 C.B. 84:

[41] 29 U.S.C. §1104(a)(1)(B) provides that a fiduciary must act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

[42] 401(a)(28)(C).

Because [defined contribution plans] are required to provide for distributions in accordance with amounts stated or ascertainable and credited to participants, the funds under such a trust must be allocated to participants' accounts in accordance with a definite formula … .

Furthermore, if the amounts to be allocated or distributed to a particular participant are to be ascertainable, such plans must provide for a valuation of investments held by the trust, at least once a year, on a specified inventory date, in accordance with a method consistently followed and uniformly applied. The fair market value on the inventory date is to be used for this purpose. The respective accounts of participants are to be adjusted in accordance with the valuation.

In the case of a plan in which trust earnings, unrealized changes in the value of trust investments, and losses realized on the sale of trust assets may be valued and allocated to participants' accounts at infrequent or irregular intervals or different valuation methods may be used for different participants, the plan does not provide a definite formula for allocating and distributing the funds, as required by the regulations.

## IV. Other Benefits of an ESOP

### A. The By-Products of an ESOP

The individual benefits that accrue to each of the aforementioned constituencies are not the end of the story. The direct benefits of an ESOP foster an environment that creates synergy and promotes above average business performance. ESOPs align the interests of a company's employees, managers, and shareholders and provides them with the incentive to behave in ways that maximize the company's value. In addition, the biggest benefit is the business that continues to provide current and future jobs in the community.

It is well documented that employees who have an ownership stake in a business behave differently than those who do not. As an employee's level of ownership increases, so does his or her level of motivation, engagement, commitment and satisfaction. [43] However, a company will not experience superior performance if its employees are owners in name only. To realize the full potential of increased employee ownership, all employees must be able to meaningfully participate in making important business decisions. In short, they must actually feel like owners. This means that managers must actively seek employee input and challenge employees to think of ways the business can operate more efficiently or create more value for the customer.

[43] *See* Rosen C. Klein Et. Al., Employee ownership in America: The equity solution (1986).

Companies that combine an ESOP with participative management tend to grow faster and operate more profitably than their peers. A study conducted by researchers at Rutgers University found that implementing an ESOP causes sales, employment, and sales per employee to be 2.3 percent-2.4 percent higher than what would have been expected absent an ESOP. [44] This should not be surprising. The most innovative and adaptable companies are often the most successful. If every person within an organization is engaged and highly motivated then it is likely that the business as a whole will react to emerging trends more readily than a business whose employees are only marginally engaged. If a company is reacting quickly and effectively to new information then it will tend to grow and generate profits at an above average rate.

[44] National Center for Employee Ownership, *Largest Study Yet Shows ESOPs Improve Performance and Employee Benefits*, Articles, NCEO.org, http://www.nceo.org/library/esop_perf.html (last visited 8-10-2012).

**B. General Observations**

The employees in companies that establish ESOPs tend to earn higher compensation and have more retirement assets than employees in companies that do not establish ESOPs. [45] A comprehensive study of companies located in the state of Washington found that “ESOP companies” (companies that had established some type of ESOP) paid 5 percent to 12 percent more in wages to their employees than “non-ESOP companies” (companies that had not established an ESOP). [46] The same study found that employees in ESOP companies had more than twice as much in total retirement benefits than those in non-ESOP companies. [47] The average non-ESOP company employee had $12,735 in total retirement benefits while the average ESOP company employee had $32,213 in total retirement benefits. [48] These numbers are averages and therefore should be taken with a grain of salt. Nonetheless, this study as well as many others, offer compelling evidence that employees can be directly and materially benefited by a properly implemented ESOP.

[45] Peter Kardas et al., Wealth and Income Consequences of ESOPs and Employee Ownership: A Comparative Study from Washington State, Journal of Employee Ownership Law and Finance 10 No. 4 (Fall 1998).

[46] *See Id.*

[47] *See Id.*

[48] See *Id.*

## V. Best Practices for an ESOP

By now it should be apparent that successfully creating and managing an ESOP requires compliance with a myriad of laws and regulations. But this should not deter a business owner or its management team from implementing an ESOP. Sometimes being a regulated entity is a good thing. Regulation can encourage better corporate governance and decision making. More importantly, the laws governing ESOPs promote good solid corporate governance and help prevent unscrupulous persons from engaging in self dealing that may jeopardize the business and hurt its employees.

There are several court cases that highlight the fallout that occurs when key corporate officials fail to satisfy their legal duties to the ESOP and hurt the company. The purpose of reviewing these cases is twofold. First, we hope that, by discussing the cases, business owners who are considering an ESOP can see that a good ESOP structure promotes good corporate behavior. Second, the cases can be instructive to help owners and managers avoid critical mistakes if they decide to implement an ESOP.

A closely-held business, by definition, is owned and controlled by a small group of people and is not subject to external oversight. Unfortunately, added with significant tax savings, this makes it easier for a small group of individuals who control the business to engage in unethical or unlawful behavior solely to do things to benefit themselves. The regulations governing ESOPs promote good corporate governance, which has the effect of curbing abuses by making it particularly costly for these types of individuals to engage in blatant self dealing.

There are two seminal cases that demonstrate the importance of good corporate governance. In *Johnson v. Couturier*, the company's president (who was also the ESOP trustee (*i.e.,* inside individual trustee)) faced severe penalties for enriching himself at the expense of the company, the ESOP, and its employees. [49]

[49] *See Johnson v. Couturier*, 572 F.3d 1067, 47 EBC 1449 (9th Cir. 2009)(142 PBD, 7/28/09;36 BPR 1825, 8/4/09).

Noll Manufacturing Company ("Noll") was a closely-held corporation that produced galvanized sheet metal products. [50] Noll's founder established an ESOP in 1977 and, by 2001, the ESOP fully owned the company. [51] After the ESOP was created, Clair R. Couturier ("Couturier") was the president of Noll, the ESOP's sole trustee, and one of only two members on Noll's board of directors. [52] Shortly after gaining control of the board, Couturier created and approved massive deferred compensation packages for him that were tied to the value of the company's stock. [53] He took Noll through reorganization with N & NW Holding Company ("N & NW") being the operating entity. N & NW borrowed money to purchase extravagant luxury items for Couturier, such as a $5.5 million mansion in Palm Desert, Calif., and a $300,000 private golf club membership. [54] By 2004, Couturier's total compensation package and benefits equaled about 80 percent of the company's assets and was worth two times the value of its stock. [55] In 2003, a compensation advisory firm had recommended that Couturier be given between $6 million to $9 million in compensation. [56]

[50] *Id.* at 1072.

[51] *Id.*

[52] *Id.*

[53] *Id.* at 1073.

[54] *Id.*

[55] *Id.* at 1074.

[56] *Id.* at 1079.

In late 2005, several ESOP participants brought a lawsuit against Couturier under ERISA. [57] They believed that Couturier was over compensated and sought to hold him personally liable for all the ESOP's losses that resulted from his lavish compensation package. [58] But prior to the filing of the lawsuit, Couturier had executed several indemnification agreements that purported to require the company (and ultimately the ESOP) to cover any liabilities that may be incurred in his service as a director, president, or ESOP trustee. [59] The plaintiffs filed and received a preliminary injunction in federal district court that prevented Couturier from using company and ESOP assets to fund his defense efforts. [60] The Ninth Circuit affirmed the district court. [61] It held that the indemnification agreements were invalid because there was a high probability that Couturier had breached his fiduciary duties toward the plan. [62] Section 410(a) of ERISA states that "any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation or duty under this part shall be void as against public policy." [63] The court's ruling meant that Couturier would be responsible for paying his own attorneys' fees. Although the case was settled, the plaintiffs alleged that Couturier was personally liable for all of the ESOP's losses that resulted from his actions.

[57] *Id.* at 1074.

[58] *Id.*

[59] *Id.* at 1073.

[60] *Id.*

[61] *Id.* at 1081.

[62] *See Id.* at 1079 ("It is difficult to understand how an ERISA fiduciary exercising the requisite care, and acting exclusively in the ESOP's interest, could have acquiesced to a buyout package for Couturier that apparently exceeded the fair market value by some $25 million.").

[63] 29 U.S.C. §1110(a) (West 2012).

Again, in a recent decision, the court encouraged the adoption of best corporate practices as it relates to ESOP structure. In the *Alliance* case, [64] Alliance sponsored an ESOP whereby the sole board member and sole trustee were the same individual. In addition, Alliance owned a subsidiary that it attempted to sell. However, Alliance was unsuccessful in obtaining an acceptable price. As a result, the board and the trustee of Alliance spun off the subsidiary in a transaction whereby the spinoff company set up its own ESOP, which became the buyer of the subsidiary at a price that was above what the market reflected. The trustees of the spinoff company ESOP were management employees of the spinoff company who also worked for Alliance. The valuation firm that worked for the Alliance ESOP also permitted the spinoff ESOP company to use such valuation in generating its fairness opinion. As a result, the court held that there were a number of "conflicts of interest" and that there were breaches of fiduciary duties. This case demonstrates the importance of:

- implementation of best practices;
- the elimination of any conflicts of interest;
- engaging knowledgeable professionals; and
- proper structure of the transaction.

[64] *See Chesemore v. Alliance Holdings Inc.,* 52 EBC 1703 (W.D. Wisconsin 2011)(186 PBD, 9/26/11;38 BPR 1764, 9/27/11).

*Johnson v. Couturier* and the *Alliance* case demonstrate the importance of separating control of the company from control of the ESOP, and implementing a system of checks and balances. In both cases, one person was in total control of the ESOP, as well as the company itself, and was not subject to oversight. Best practices would suggest that the same person should more than likely not hold multiple positions of high responsibility at the same time. This is especially true when the interests of those positions are diametrically opposed. For example, Couturier's primary interest was being paid as much as possible and the board member/trustee in *Alliance* wanted to receive the highest sales price.

As ESOP trustees, both individuals were responsible for making sure that they acted in the best interests of the participants and beneficiaries. As members of the Board, they were responsible for taking actions that are in the shareholder's best interest (*i.e.,* increasing stock value). It is impossible for one person to make an ethically responsible decision regarding executive compensation while operating under so many conflicts of interest. Not surprisingly, Couturier's personal interests ended up taking precedence over the employees' interests, the ESOP's interests and the company's interests. Good corporate governance would dictate that the individual or institution selected to be ESOP trustee should not also sit on the board of directors.

Federal regulation also ensures that important decisions are made with care. ESOP trustees may breach their fiduciary duty to the plan if they make important decisions without the appropriate amount of consideration. [65] Amsted Industries Inc., ("Amsted") was a manufacturer of railroad and other transportation equipment that was entirely owned by an ESOP. [66] LaSalle Bank ("LaSalle") was the named trustee of that ESOP. In 1999, Amsted bought Varlen Corp., a manufacturer of trucking equipment, for $800 million. [67] It financed the acquisition with an unsecured bank loan for $1 billion. [68] After the acquisition, LaSalle hired an independent appraisal firm ("Appraiser") to value Amsted's stock. [69] The Appraiser estimated that the stock was now worth $182 per share. [70] This was a 32 percent increase over the prior year's valuation. [71] Historically, the Amsted ESOP had a redemption rate of about 10 percent per year. [72] However, after management announced the new stock valuation, the redemption rate tripled. In 2000, Amsted's total redemption cost was 330 million dollars. [73] This caused major liquidity problems and forced Amsted to take remedial measures. [74] Specifically, it amended the ESOP document to eliminate the right to lump sum distributions and defer eligibility for distributions generally by five years. [75] Over the course of the next two years, Amsted's stock was valued at $90 and $44 per share respectively. [76]

[65] *See Armstrong v. LaSalle Bank Nat. Ass'n*, 446 F.3d 728, 37 EBC 2256 (7th Cir. 2006) (88 PBD, 5/8/06;33 BPR 1181, 5/9/06).

[66] *Id.* at 730.

[67] *Id.*

[68] *Id.*

[69] *Id.*

[70] *Id.*

[71] *Id.*

[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] *Id.*

[76] *Id.*

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Many Amsted ESOP participants brought an action against LaSalle under ERISA. They claimed that LaSalle should have foreseen the fact that relying on such a high stock valuation would cause a stock-run and put the company's financial health in jeopardy. At the time of the valuation, many Amsted employees were near retirement age and had a substantial amount of company stock. [77] The issue the court had to decide is whether LaSalle breached its fiduciary duty by accepting such a high valuation price without realizing that doing so may negatively affect many participants. The Ninth Circuit did not provide a direct answer but it did provide an analytical framework that trustees can follow when evaluating their decision making process. [78] It held that ESOP trustees must be particularly rigorous in their analysis of valuation figures because ESOP participants only hold one type of security. [79] If the trustee fails to engage in any analysis or only engages in a superficial analysis then it has likely breached its fiduciary duty. [80] But if the analysis was rigorous then it is likely that the trustee did not breach its fiduciary duty. [81]

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[77] *See Id*. at 731 (“Of Amsted's 3,000 employee-shareholders, 735 owned in the aggregate $560 million worth of Amsted stock at $184 redemption price set in September of 1999. And the 800 employee-shareholders who were at least 55 years old or had more than 30 years of service with the company had amassed Amsted stock worth almost $300 million.”).

[78] *Id.* at 734 (Noting that facts concerning LaSalle's analysis of the potential effects of the $184 valuation were unavailable because this case was appealed from a grant of a motion for summary judgment).

[79] *Id.* at 732 (“The ESOP setting does not eliminate the trustee's duty of prudence. If anything, it demands an even more watchful eye, diversification not being in the picture to buffer the risk to the beneficiaries should the company encounter adversity.”).

[80] *See Id.* at 733-34.

[81] *Id.*

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The Amsted case demonstrates that sometimes procedure can be just as important as outcome. ESOP trustees do not have to make perfect decisions regarding the plan. However, the trustees must have ample evidence that every fiduciary decision they make is a fully informed one. Judge Posner notes that LaSalle had “a true balancing act to perform.” [82] If it slashed the redemption price, then participants may still have sued, claiming that it unnecessarily decreased the value of their retirement assets. If it raised the valuation, then it risked a stock-run and potential liquidity issues. In a no-win situation like this, the only wrong action is one undertaken without analysis. “A trustee who simply ignores changed circumstances that have increased the risk of loss to the trust's beneficiaries is imprudent.” [83] Therefore, when operating a regulated entity it is imperative that a trustee assemble a team of credible and independent advisors that will provide it with a range of options for any given fiduciary decision. This will protect the trustee from liability and most likely increase the quality of decision making within the ESOP and the company as a whole.

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[82] *Id.* at 733.

[83] *Id.* at 734.

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A more recent case, *Neil v. Zell,* underscores the duty of an ESOP trustee in ensuring that the valuation of the ESOP shares reflects the actual value of the shares. [84] This case involved a very complex ESOP transaction whereby an institutional ESOP trustee used the ESOP to buy back $250 million in shares of company stock. The company was also converted from a C corporation to an S corporation, allowing for the attendant tax advantages. Less than a year after the buyout, the company filed for bankruptcy and plaintiffs filed an action against the company and the trustee, alleging breach of fiduciary duty and that prohibited transactions occurred. Again, good best practices would suggest that this company was not a suitable company for an ESOP.

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[84] *See Neil v. Zell,* 677 F.Supp 2d 1010, 48 EBC 1462 (N.D. Ill. 2009)(242 PBD, 12/22/09;36 BPR 2939, 12/29/09).

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As you can see, there are some principles to follow when implementing an ESOP, since establishing an ESOP, much like completing an estate plan or a sale of a business, involves:

- transition of stock ownership to an entity (*i.e.,* the ESOP) subject to regulation that provides significant income tax benefits;

- constructing corporate governance that implements best practices and separates the decision making process and stock ownership concerns by making the Board an important body that focuses on the operations of the company, and the ESOP trustee a quasi-passive investor;

- constructing an economic environment for the company that needs to plan to meet repurchase liability obligations; and

- constructing a situation where management will need to focus and make plans for the ESOP as it matures.

The biggest pitfall deals with an ESOP that has been set up without proper advice on the legal areas touched by an ESOP transaction (*i.e.,* employee benefit advisor focused solely on the benefits, or advisor solely focused on shareholder benefits). In these situations, the company has no leadership because of the inadequacies of corporate governance and financial assessment. The other situation involves a mature ESOP with repurchase liability obligations claiming 60 percent of the company's cash flow. Both situations arise because of poor structuring by advisors that are single focused or not experienced.

## VI. The Future of ESOPs

The future is bright for ESOPs and the companies that decide to implement them. Contrary to common perception, the current economic downturn is an opportunity. It is an opportunity because widespread uncertainty has caused the market to undervalue many asset classes. If the underlying business is stable and has integrity, then buying a business right now is a highly prudent decision. This is especially true if the business can be purchased in a way that provides substantial tax benefits and inherently increases productivity. Therefore, in this environment, a closely-held business that implements an ESOP can have its cake and eat it, too.

The ESOP will purchase a valuable asset (*i.e.,* the company's equity), at an ideal time, and can apply a best practices governance model to execute on a well thought out strategic plan. If the ESOP is properly managed the business should have an ongoing competitive advantage.

ESOPs offer unique advantages to shareholders to transition control and ownership of their company. The tax advantages make ESOPs attractive, not only as a form of employee benefit, but also as a technique of corporate finance and as a business succession tool. Because tax rates are anticipated to increase significantly next year, an ESOP can be an even more useful tool for the selling shareholders today.

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