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“THE FABLED ESOP”

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Most persons are familiar with Aesop's Fables. On the other hand, not many tax practitioners know the value of the fabled ESOP. ESOP stands for Employees Stock Ownership Plan. It is also called ESOT, or Employee Stock Ownership Trust. This type of employee benefit is by no means the dreamchild of tax-conscious lawyers. As far back as 1926 the Sun Oil Company established a stock bonus plan for its own employees and those of its numerous subsidiaries. Similarly, other companies have established and maintained for as long as forty and fifty years employee stock bonus programs. The purpose of such a plan is to give employees a stake in the company through stock ownership. ESOPs or ESOTs resemble profit-sharing plans in that deductions are limited to 15% of payroll; distributions may be paid other than at retirement or other termination of employment; allocation of contributions is made according to compensation of participants; forfeitures are reallocated to participants; and contributions may be at the discretion of the employer. The contributions of the employer can, but do not have to be related to profits. Benefits are distributed in the form of company stock.

With the introduction of special tax treatment for the “Qualified Benefit Plan” under the Internal Revenue Code, this type of employee plan took on a new and additional meaning. Employees and employers became eligible for tax-favored treatment under the aegis of the qualified plan.

Regulation 1.401-1(b)(1)(iii) of the Internal Revenue Code of 1954 provides a definition as follows: “A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. For the purpose of allocating and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, such a plan is subject to the same requirements as a profit-sharing plan.”

Thus, we see that Congress specifically related the employee stock ownership plan to the employee profitsharing plan. Nevertheless, it was the pension plan and the profit-sharing plan that received most if not all of the attention of tax planners in the last thirty years. In fact, after the 1954 Code was enacted, many Revenue Rulings were issued to clarify points with respect to pension and profit-sharing plans. The first reference to an employee stock ownership plan did not appear in the Revenue Rulings until late in 1956 when Revenue Rule 56-656, relating to a profit-sharing plan, stated in its last sentence that “it is also held that the above principles are equally applicable to employees pension or stock bonus plan.” In an economy which has seen a

substantially declining stock market, and reduced company profits, profit-sharing plans have been in declining favor. Similarly, with the advent of ERISA, and its stringent requirements, pension plans have become apparently less attractive. Accordingly, all paths now lead to the Employees Stock Ownership Plan. This type of plan offers a wealth of benefits for both employers and employees. In the first instance, a qualified stock bonus plan offers more flexibility than either the pension or profit-sharing plans. This is true both as to contributions and investment of funds. Unlike both the pension and profit-sharing plans, which severely limit plan fund investment in employer-connected assets, the very basis of the stock bonus plan is investment in employer stock. It provides the most direct incentive to employees as they are given a participation in the equity of the employer. It also provides a market for company stock. For example, when a stockholder of a closely-held corporation dies, it is usually difficult to market his stock. The stock is counted in his estate for estate tax purposes and, without a market for said stock, leaves the estate without the liquidity to pay the taxes on the estate. A stock bonus or profit-sharing trust operating under a unilateral stock selling agreement on the part of stockholders and a unilateral stock purchase option held by the Trustee could well provide a market for the stock, provided the terms of the arrangement are entirely favorable to the Trust.

A third type of benefit for the employer is that should the employer be strapped for cash, he can contribute stock to the plan. The value of the stock is deductible, which should free up tax dollars for him for purposes other than employee fringes. It is important to note that the employer's contribution does not have to be in stock; the employer can contribute cash with which stock is purchased from different sources. This will be further expanded upon *infra*.

ERISA is primarily dedicated to the improvement of pension plans from an employee security program. Only some of its provisions are relevant to employee stock ownership plans. Such references are made under the umbrella of the reference in ERISA to "qualified plans." For example, under ERISA, a plan will not qualify for exemption if it requires, as a condition to plan participation, that an employee have a period of service with the employer which extends beyond (a) one year of service or (b) the date which the employee reaches age twenty-five, whichever occurs later. However, a plan which provides for 100% vesting after three years of service can defer participation until an employee has put in three years of service. A "year of service" is now defined to mean a twelve-month period during which the employee has not less than 1,000 hours of service. Computation of any twelve-month period shall be made the reference to the date on which the employee's employment commenced, except that, under Regulations subscribed to by the Secretary of Labor, such computation may be made by reference to the first day of a plan year in the case of an employee who

did not complete 1,000 hours of service during the twelve-month period beginning on the date his employment commenced. A key advantage to employers under ERISA is found in Section 410(b)(2) of the Code which permits there to be excluded from consideration of minimum participation standards for qualification, employees not included in the plan who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be collective bargaining agreement between employee representatives and one or more employers, if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers.

ERISA provides a new tax treatment for lump-sum distributions from all qualified plans. Accumulations attributable to years of participation before 1974 will be all capital gain and accumulations attributable to years of participation after 1973 will be all ordinary income. However, there is now a special elective ten-year forward averaging rule and a \$10,000 minimum distribution allowance for taxing the ordinary income portion of the distribution. The minimum distribution allowance is computed as follows: there is an exclusion of 50% of the first \$20,000 of a distribution, reduced, however, by 20% of the amount by which the distribution exceeds \$20,000. To compute the ten-year forwarding average, the entire distribution which is subject to tax (including 100% of any capital gain) is divided by 10; a tax on this amount is computed by using the rates for single taxpayers and this tax is multiplied by 10. Finally, this result is multiplied by the percentage of the taxpayer's plan participation after 1973.

If an employer receives more than one lump-sum distribution in one tax year, the new law applies a special "look back" provision. All lump-sum distributions received in the current year and during the five years preceding the year of the current distribution are included for purposes of computing the tax under the ten-year rule. The tax on the prior distribution is then subtracted from the tax thus computed to find the tax on the current distribution. The net result, of course, is a higher tax under the ten-year rule on the ordinary income element of the current distribution. The look back rules do not apply to lump-sum distributions made prior to 1974.

Finally, if none of the above rules are applicable to a particular taxpayer's distribution, he can always fall back upon the regular five-year income averaging. As can be seen by the above, the new rules are quite complicated. The big exception to these rules apply to stock payouts. When the employee receives a lump-sum distribution of stock following his termination of employment, he is taxed only on the value of stock equal to the employer's original contributions—even if the stock is worth much more. Furthermore, the amount he is taxed upon is taxed on the same favorable basis as lump-sum distributions from other qualified plans. The unrealized appreciation is not

taxed until sale of the stock. If stock is then held by the employee for at least six (6) months, gain upon sale are taxed at long-term capital gain rates.

In order to qualify, a plan must benefit either (a) 70% or more of all employees, or 80% of all eligible employees, if at least 70% of all employees are eligible to benefit under the plan, or (b) such employees as qualify under a classification which does not discriminate in favor of officers, shareholders, or highly compensated employees.

There are now minimum vesting standards required (found in Code Sec. 411) which provide that there will be complete vesting of a normal retirement benefit on attaining normal retirement age, complete vesting of all accrued benefits derived from an employee's own contributions to a qualified plan, and complete vesting of all accrued benefits derived from the employer's contributions under one of the following three alternatives: (a) full vesting on a prescribed graduated basis after fifteen years of service; (b) full vesting after ten years of service, or (c) full vesting under the so-called "Rule of 45", which is that an employee with at least five years of service must have a non-forfeitable right to at least 50% of his accrued benefit derived from his employer's contributions when the sum of his age and the number of years of service totals 45. For each succeeding year of service required, the percentage goes up ten points so that, after an additional five years of service, the employee has 100% vested interest in his accrued benefit.

It becomes obvious that in considering the establishing of an employees stock ownership plan, the attorney first must consider the requirements of Code Secs. 401 through 415. Having become an expert in the meaning of these Sections, including the Regulations thereunder which should be forthcoming in the near future, the attorney will take the next step, which is consideration of the more sophisticated aspects of employees' stock ownership plans. The first benefit is the tax-favored financing for a corporation. The typical situation would involve a closely-held company in need of financing. It would establish an ESOP for the benefit of its employees. The ESOP Trustees would apply to a financial institution for a loan, to be guaranteed by the employer. Then the ESOP Trustees would purchase from the employer stock of the employer (possibly created just for that purpose) and these shares of stock would form the trust res for the benefit of employees.

Thereafter, the employer would make its contributions to the stock ownership plan every year in cash, said contributions being fully deductible, and the Trustees of the plan would use the contributions to repay the bank under its loan agreement, including interest payments and amortization of the loan itself. In this manner, the employer is able to complete a financing arrangement and obtain a deduction for

paying off the loans thereunder. The employees benefit by having a stock interest in the employer and everybody is happy.

An alternative situation would arise where in a closely-held corporation, the shareholders are anxious to realize cash from the corporation in other than dividend form. They cannot unreasonably increase their compensation or the corporation will have a dividend treatment attributed to the portion of compensation deemed unreasonable by Internal Revenue. There is no market for the corporation's stock. Thus, the shareholders look to the creation of an ESOP whereunder, the corporation will contribute cash to the ESOP and receive a deduction therefor, and the ESOP will purchase stock in the corporation from the shareholders themselves. This would be a capital gains transaction for the shareholders. This could be accomplished in one year or over a period of years.

Finally, from the employee's point of view, should the employee receive a distribution from the ESOP of the employer's stock and die with said stock, his estate would pay no income taxes whatsoever and arguably receive a stepped-up basis in the stock for future sales purposes.

In addition, ESOPs may include life insurance benefits if incidental to the primary purpose of the plan. This can include keyman insurance and stock purchase insurance on the life or lives of current stockholders.

Just recently Congress "iced the cake" by offering a 1% investment credit to corporate taxpayers which contribute an amount equal to 1% of the qualified investment to an employee stock ownership plan. This is found in Sec. 301(d) of the Tax Reduction Act of 1975.

In order to take advantage of the investment credit under the Tax Reduction Act of 1975, shares must be allocated to employees who participated at some time during the plan year even if they were not participants on the last day of the plan year; contributions to the ESOP may not be integrated with social security benefits; only the first \$100,000 of compensation may be taken into account; immediate full vesting is required; participants must be entitled to vote the shares allocated to the respective accounts; and only common stocks or securities convertible to common stock may be contributed.

Because of these restrictions, it may be worthwhile to consider establishing a separate one time ESOP for this additional investment credit benefit.

Recently, the Employees Stock Ownership Plan concept was used in an unusual financing whereunder a private company was "taken public". Amsted Industries, Inc. had been seeking to divest itself of its South Bend Lathe Company unit and had not met with much success. A logical alternative was to merely close down the unit. Rather than do so, Amsted used the ESOP to solve its problem. It established a

South Bend Lathe ESOP, which borrowed \$10 million, \$5 million from the Federal Economic Development Administration to the City of South Bend and \$5 million from two Indiana banks and Heller International, Inc. The ESOP then purchased all of the stock of the South Bend Company, which company will remain intact and business operations will be unaffected. Ultimately, the South Bend unit itself will make enough contributions to the ESOP in cash to pay off the loans and the employees will, in the end, own the stock of the South Bend unit.

The Internal Revenue Service has considered the distribution of stock from an ESOP to employees, with respect to tax consequences. It has long been believed by many tax practitioners that should an employee receive stock with unrealized appreciation from an ESOP, and should the employee die and that stock become part of the employee's estate, the beneficiary receiving the stock would also receive a stepped-up basis in the stock, being the fair market value on the valuation date of the stock in the estate. Now the Internal Revenue Service, in Revenue Ruling 75-125 has stated that it does not go along with this theory. Rather, it takes the position that the unrealized appreciation, which was not taxed when the stock was distributed from the ESOP to the employee, is income in respect of the decedent in the above-mentioned situation. The Ruling gives an example whereunder an employee retires in 1969, receives employer securities from a qualified plan with a basis of 5x (1x of employee contributions + 4x of employer contributions) and with a fair market value of 10x. At that point, the employee would have to pay tax on 4x (the employer contribution). The employee then dies in June of 1974 leaving the aforementioned securities to his wife. At the date of death, the fair market value of the securities is 12x. The securities are sold three months later for 13x.

The wife's basis in the securities is the fair market value at date of death minus the unrealized appreciation. This works out to be 12x minus 5x equals 7x. The 5x, which is the unrealized appreciation, is income in respect of a decedent under Section 691(a) of the Internal Revenue Code of 1954, as amended.

The tax treatment of the above transaction would be as follows: the amount realized from the sale is 13x; from this we subtract the wife's basis as computed under Section 1014(a) of the Code, which is 7x, arriving at a taxable gain of 6x. This gain is further broken down into gain attributable to unrealized appreciation of 5x and the excess gain over the unrealized appreciation of 1x. The 5x is long-term capital gain since the gain retains the same character as it would have in the hands of the decedent had he lived. Due to the operation of Section 1223(11) of the Internal Revenue Code of 1954, as amended, the gain of 1x gets long-term capital gain treatment even though the wife held the securities for only three months. Section 1223(11) states that in case of a person acquiring property from a decedent dying

after December 31, 1970, if basis is determined under Section 1014(b) of the Code and the property is sold within six months, then the property is to be considered as being held for more than six months. Under the normal rules with respect to the excess appreciation, the property must be held for at least six months to receive long term capital gain treatment.

Furthermore, a deduction is allowed to the wife under Section 691(c) for the portion of Federal Estate Tax attributable to the amount of net unrealized appreciation included in the decedent's estate, even if none of the unrealized appreciation is included in the decedent's estate because of Section 2039(c) of the Code. It may be noted that if the stock went from the Trust directly to the wife after the death of the employee, Section 1223(11) would not appear to apply since the property would not have "passed from the decedent" within the meaning of Section 1014(b). Thus, the holding period of the wife would be the key to the tax treatment of the 1x.

Revenue Rule 75-125 is very important when doing estate planning with respect to death benefits received from a qualified plan. On top of the adverse implications of this Ruling, proposed Regulation 1.402(e)-2(d)(2)(iii) states that a distribution made to more than one person (except a payment made solely to two or more Trusts) is not treated as a lump sum distribution. Therefore, should a death benefit under a qualified plan be left to a wife and should she predecease her husband, to their children in equal shares, and should this benefit devolve down to the children, they would lose the capital gain treatment. An obvious way to avoid this is to set up Trusts for the children, but this is cumbersome and they have other adverse tax consequences.

Another problem area in connection with ESOPs made itself known in the *Aero Rental v. Commissioner* decision, 64TC33 (5/29/75). In this case, it was determined that while a requirement that the participants sell their shares to the Company (or the Company have a call on the shares) upon distribution by an ESOP would not be acceptable to the Internal Revenue Service, a provision that the Company has a right of first refusal and/or that the employees may put the shares to the Corporation will be acceptable. This case clearly points out that the employer may not keep control over its stock once the stock is distributed by the ESOP to the employees.

It would seem that as tax planners and the Internal Revenue Service become more aware of the facts of ESOPs, there will be additional restrictions and limitations in connection therewith. Accordingly, it is recommended that serious consideration be given to all facets of utilizing an ESOP before one recommends it or uses it.

There are many non-tax aspects involved with respect to the ESOP. These go right to the basic question of whether a corporation can even legally establish an ESOP. Under the holding of *Murrell v. Elder-Beerman Stores Corp.*, 239 NE 2d 248 (1968), the general rule has been reaffirmed that even though a corporation may not be expressly

authorized to adopt and pay employee benefits, such authority is said to reside in the implied powers of the corporation. Most certainly a statute, charter or by-laws could prohibit a corporation from undertaking such a project, or provide that consent of the stockholders must be obtained before putting a Plan into effect. Therefore, the first place one must look in considering an ESOP is to the state statutes. There are practically no statutes on the books in the fifty states dealing with the right of a corporation to establish a fringe benefit program such as an ESOP for employees. There are numerous cases in the various states, all of which affirm the general right of a corporation to so provide benefits for its employees. In fact, in *Holmes v. Republic Steel Corporation*, 84 NE 2d 508 (1948), the Court stated that "a corporation would be short-sighted which sought to make its laborers and clerks satisfied and happy employees, and neglected its key men and executives." This was dealing with the power of a corporation to allow its executives to participate in a Pension Plan.

The next step is to review the corporate charter and by-laws. Most corporate charters merely contain a specific power of the corporation to enact the particular business that it is in and then add general powers to enact all other legal business that a corporation can enact. This would fit in with the general principles just discussed.

The by-laws of the corporation, which are really the operating tools, must be reviewed to see if they specify whether or not Directors alone can enact an ESOP and whether or not Directors alone have the right to make the ESOP allocations and valuations, and how minority stockholders' rights are affected. If the by-laws are silent, it would be wise to amend the by-laws (and this may require stockholder approval) to lay down ground rules for the establishment and operation of an ESOP.

Generally, the state statutes entrust the total business management of a corporation to the Board of Directors. Stockholders rarely, if ever, participate directly in the management of the business. Thus, the establishment of an employees' benefit program would seem to be solely within the authority of the Board of Directors as one of its implied powers. Nevertheless, as a relatively conservative attorney, it would be my recommendation that stockholder approval be sought before an ESOP is established. This may be accomplished by proposing a plan for stockholder approval, by adopting a plan conditioned upon subsequent approval of stockholders, by adopting a plan and seeking subsequent ratification and approval of the Board's action by the stockholders, or by proposing an amendment to the by-laws which would authorize the Directors to establish such a plan. The obtaining of approval of stockholders would most certainly lessen the force of any minority objections.

Some states, such as New Jersey, require stockholder approval in certain circumstances. New Jersey requires approval only when the

plan permits the use or issuance of Treasury shares or authorized but unissued shares. In all other cases, the Board of Directors alone can adopt a plan by majority vote if the Certificate of Incorporation or by-laws do not provide otherwise. This is found in Section 14A:8-2 of the New Jersey Business Corporation Law.

The adoption procedures are relatively simple. The first step is for the Directors to decide upon the plan they want the corporation to install. After all the details have been worked out and the plan formulated, the Directors formally adopt a resolution approving the plan. The resolution may state that ratification is required or shareholder approval is required. Such approval may be accomplished at the Annual Stockholders' Meeting or at a special meeting called for this purpose.

Minority stockholders have not been successful in limiting the establishment of such a plan. The general rule is that an employee benefit plan may be established over the objections of minority stockholders if the payments bear some relationship to the value of services rendered by the employees. There have been some cases such as *Moore v. Keystone Macaroni Company*, 87A2d 295 (1952), wherein minority stockholders have been successful in defeating fringe benefit payments where the Court failed to find a relationship between the payments and the value of services rendered. It might be noted that in that case there was no stockholder approval called for by the Board, but merely Board action. The area where minority stockholders have been most successful in preventing the payment of employee fringe benefits is when the benefits are related or measured by past services. Here, case law in the particular state involved should be studied.

The next area to consider is the rights of the employer's creditors. Where the employer has no control over the funds of an irrevocable qualified plan which has been created in good faith, it does not seem that the employer's creditors can reach amounts paid into the Trust prior to the employer's insolvency. Trust Law would seem to indicate that monies irrevocably contributed to a Trust Fund for the exclusive benefit of employees and their beneficiaries are no longer assets of the employer and, as such, not subject to creditors' claims. It might be noted that a question can arise when an employer has determined that a contribution to an ESOP should be made for a given year and then the employer goes into bankruptcy. The Bankruptcy Act provides in Section 64 that "wages due the workmen" shall "have priority in advance of the payment of dividends to creditors, and are to be paid in full out of bankrupt estates." The Supreme Court of the United States, in a split decision has indicated that plan contributions are not "wages due the workmen". (*United States v. Embassy Restaurant, Inc.*, 359 US 29 (1959)).

A number of states have passed statutes which specifically grant preferred status to claims of employee benefit plans. For example, in Michigan, employer obligations to pension, profit-sharing, health or

welfare plans for the benefit of non-salaried employees are preferred claims when an employer's business is suspended by action of creditors or is placed in the custody of a Receiver or Trustee. The law is similar in Illinois. On the other hand, a New York Court has refused to order a Receiver in foreclosure of real property to pay accumulated unpaid contributions due a Union Pension and Welfare Fund under a collective bargaining agreement between the Union and prior owners of the property. The Receiver need only pay contributions due from the date of his appointment (*Bradford Financial Corp. v. Clark West Realty Corp.*, 252 NYS 2d 580 (1964)).

All states permit the establishment of a Qualified Trust. In addition, the general rule is that the Qualified Trust is not subject to the rule against perpetuities. This rule requires that all future interests vest within a period measured by a life or lives of persons in existence at the start of the Trust plus twenty-one years thereafter, and gestation periods. Most States specifically exempt trusts set up as part of a stock bonus, pension, profit-sharing, disability, or death benefit plan from the ordinary requirements as to duration of trusts and accumulation of income. In New York this exemption is found in the Personal Property Law, Section-C.

It might also be worthwhile to mention that many states have their own laws dealing with fringe benefits and qualified plans. Therefore, compliance is required not only of ERISA but of the particular requirements of the various states. For example, in Michigan, under Public Act 45, Laws of 1966, an employer who fails to make promised payments to an employee benefit plan within three weeks after they become due and payable is guilty of a misdemeanor. In Missouri, the employer has sixty days to make payment before he goes up for a misdemeanor. In New Jersey, the period of payment is thirty days after they are due and an employer who knowingly and wilfully fails or refuses to make such payments is a disorderly person, and upon conviction, is punishable by a fine up to \$500.00 or imprisonment up to one year, or both. The states also have rules on vesting, on filings and reporting, as well as other aspects of employee fringe benefits. Thus it becomes absolutely essential for the Board of Directors of a corporation to be given the full specifics of state law relating to the ESOP as well as the Federal rules.

That brings us to the question of regulation for purposes of Securities' Acts. The Securities Act of 1933 requires securities issuers to make full and fair disclosure of information about their securities to their prospective purchasers. This is accomplished in two ways: (1) by requiring the filing of a Registration Statement with the SEC disclosing details deemed necessary to enable the buying public to form an accurate judgment of the value of the security offered, and (2) by requiring the use of a prospectus containing information similar to that required in the Registration Statement but in a condensed form.

Jurisdiction over pension and profit-sharing plans arise from the provisions of the Securities Act of 1933, which require registration with the SEC in the event of a public sale of, or offer to sell, a "security". The term "security" is defined by Section (21) of the Act to include "certificate of interest or participation in any profit-sharing agreement, . . . or investment contract, . . . or, in general, any interest or instrument commonly known as a "security", or any certificate for, receipt for, guarantee of, or warrant or right to subscribe to, or purchase, any of the foregoing."

For years this gave the SEC the right in its own opinion to look into Qualified Plans with respect to security sales. However, the Investment Company Amendments Act of 1970 added the following to the classes of securities that are exempt from registration under Section 3(a)2 of the Securities Act: Any interest or participation in a single or collective Trust Fund that is issued in connection with (1) a qualified stock bonus, pension or profit-sharing plan or (2) an annuity plan which meets the requirements for the deduction of employer's contributions (under Internal Revenue Code Section 404(a)(2)).

Thus, at present, registration is only required in two cases: (1) when an amount in excess of employer's contribution is allocated to the purchase of securities issued by the employer or by any company directly or indirectly controlling, controlled by or under common control with the employer. (2) When a plan covers self-employed individuals and owner employees within the meaning of Internal Revenue Code Section 401(c)(1). However, the SEC may exempt self-employed plans (if and to the extent that the Commission determines this to be necessary or appropriate in the public interest and consistent with the protection of investors . . .).

There are also certain private letter rulings in the field that indicate that ESOPs are not required to register with the SEC. Should the SEC ever determine that a particular ESOP is being used for a financing vehicle that should require public disclosure, such as "going private" or "going public", then and in such event in order to seek exclusion from registration the company must look to the regular exemption from registration requirements under the SEC rules. The courts have gone along with this. For example, in *SEC v. Ralston Purina Company*, 346 U.S. 119 (1953) the Supreme Court ruled that even though an offering of securities is limited to employees of the company, if all employees offered the stock do not have access to the same information that would be disclosed in registration, the offering is public.

The 1970 Act would imply that contributory ESOPs must be registered unless exempt under the normal exemption for registration rules. In that case a Form S-8 may be required.

It is worthwhile to mention that even if a securities issue is exempted because it is a qualified ESOP, these exempted securities are still subject to the anti-fraud provisions of the securities act.

Most states have "blue sky" laws, which have been enacted to prevent the fraudulent sale of securities in the particular state. Definitions under most of the statutes are so broad that pension, profit-sharing and stock bonus plans may be readily held to fall under the requirements of registration. Many states exempt qualified plans from blue sky registration. For example, the New York law provides that "the Attorney-General may upon application, in writing, grant exemptions . . . to any person, partnership, corporation, company, trust or association which is a dealer . . . , solely by reason of the fact that it is offering to sell or selling or offering to purchase or purchasing to or from the public, within or from the state . . . securities issued in connection with an employees' stock purchase, savings, pension, profit-sharing, or similar benefit plan." (New York General Business Law, Section 359-F(2)(e)). The caveat here is to know your state law and be aware that it exists.

There are also the miscellaneous state laws that relate to ESOPs. State laws relating to contracts, etc. must be studied when formulating your ESOP concepts. You cannot overlook them as they most certainly may have bearing. For example, under the laws of many states it is possible to protect the benefits payable to employees from claims of their creditors by inserting appropriate language in the trust instrument. In other states, this type of spendthrift clause does not work. States with such spendthrift statutes include Massachusetts, Minnesota, Mississippi, New York, Oklahoma, Pennsylvania, Rhode Island, Texas and Wisconsin.

In addition, every state has special laws dealing with minors and their right to enter into legally enforceable contracts, which generally allow a minor to disaffirm the contract upon attaining maturity. These laws must be checked when an employer establishes a contributory employee benefit plan, as well as for the implications of a minor being a secondary beneficiary under a plan.

The final thought with respect to the state law implications of an ESOP goes to the capitalization of the corporation. Before structuring an ESOP, the corporate capitalization must be reviewed, first and most importantly to make sure there is stock available for the ESOP, and secondly to consider on a long-range basis just how much control should ultimately be taken out of the hands of the majority stockholders by the ESOP, whether the stock going to the ESOP should be voting stock, or a type of special stock, and in general all of the other implications of corporate capitalization should be reviewed.

The next area under discussion is the plan administration, and more particularly fiduciary responsibility. One of the most important aspects of ERISA is its fiduciary responsibility requirements. Both corporate and individual trustees may be subject to the same duties and obligations prescribed by trust instruments. Therefore they are governed by the same general principles of trust law. The laws of the various states

as to trust investments and behaviour are not uniform. A trustee must look to the laws of his own state for guidance. In addition, the trustee must be aware of the overriding Federal rules of ERISA.

The New York rule, broadly stated is that the trustee is given power "to invest in such securities as would be acquired by prudent men of discretion and intelligence in such matters who are seeking a reasonable income and the preservation of their capital". This is found in EPTL Section 11-2.2(a)(1). ERISA also seems to adopt the "prudent man rule".

Part XVI of ERISA contains the fiduciary responsibilities and prohibitive transaction section. It directs that each plan must be in trust form and must specifically name the fiduciary or fiduciaries who will manage, control and operate the plan. In addition, each plan must specify a procedure for establishing and carrying out a funding policy in line with the requirements of the new law; must provide a procedure for amending the plan; must set forth a procedure for the allocation of responsibilities for the operation and administration of the plan; and must specify the basis on which payments will be made to and from the plan. In addition, each plan may provide that any person can serve in more than one fiduciary capacity, that a fiduciary can employ others to advise him and can appoint an investment manager to handle any of the plan's assets.

ERISA emphasizes that the assets of the plan must be held exclusively for the benefit of employee beneficiaries and to defray the reasonable expenses of administering the plan. A fiduciary is defined as any person who has any power of control, management or disposition over the funds or other property of any employee benefit fund. In addition to being prudent in his actions, a fiduciary may not deal with the assets of the plan for his own account; act in any capacity in any transaction involving the plan, on behalf of a party whose interests are adverse to the plan or its participants; or receive any consideration from any party in connection with a deal involving fund assets. Except as permitted by the Secretary of Labor, no fiduciary may maintain indicia of ownership of any plan assets outside of the jurisdiction of U.S. District Courts.

Subject to certain exceptions, ERISA specifically spells out certain activities which are out of bounds for fiduciaries. Most of these prohibited transactions involve a "party in interest". A "party in interest" is defined as: (a) an administrator, officer, fiduciary, trustee, custodian, counsel or employee of the plan; (b) a person providing benefit plan services to the plan; (c) an employer whose employees are covered by the plan and its employees, officers, directors and 10 percent shareholders; (d) a person controlling, controlled by or under constant control with, an employer whose employees are covered by the plan; (e) an officer, employee or agent of the plan's employer or any person controlling or controlled by the employer and its employees, officers,

directors and 10 percent shareholders; (f) an employee organization having members covered by the plan and its employees, officers and directors and affiliates; (g) a relative, partner or joint venturer of any of those previously enumerated.

A fiduciary who participates in a prohibited transaction or breaches any of its responsibilities or duties as fiduciary is personally liable to the employee benefit fund involved for any losses his act occasioned and for any profit he realized in the transaction. In addition, such conduct could result in the removal of the fiduciary by a court.

A fiduciary may not engage in a transaction which constitutes a direct or indirect sale or exchange between the trust and a party in interest. An exception to this rule is that acquisition and sale of a qualifying employer's security between a plan and a party in interest is okay if on an arms-length basis, for adequate consideration and no commission is charged.

A fiduciary may not engage in a transaction which constitutes the direct or indirect leasing of property between the trust and a party in interest.

A fiduciary may not engage in any transaction which constitutes the direct or indirect lending of money or extension of credit between the trust and a party in interest.

In addition, a fiduciary cannot engage in any transaction which constitutes the direct or indirect furnishing of goods, services or facilities between the trust and a party in interest, or transfer to, or use by or for the benefit of a party in interest of any of the trust assets, or the acquisition by the plan of any employer security or employer real property in excess of that permitted by the new law.

Finally, and most important from the standpoint of ESOPs, a fiduciary who has the authority to manage the assets of a plan cannot permit the plan to hold an employer's security or employer real property if he knows or should know that such holding is not permitted.

Penalties for fiduciary breach of obligation include non-deductible excise taxes varying between 5% on the amount involved for each year or part thereof up to 100% of the amount involved if the prohibited transaction is not corrected within certain time limits; in addition, there are fines and jail sentences applicable, as well as normal trustees' legal liability.

How then does the fiduciary responsibility law affect the ESOP itself? Section 404 of ERISA provides that the fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and: (a) for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administration; (b) 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 his similar enterprise; (c) by diversifying investments

so as to minimize the risk of large losses; (d) in accordance with the plan's documents insofar as they are consistent with the Act.

While ESOPs are exempted from the diversification requirements in (c) above and from the prudence requirement of (d) above insofar as prudence requires diversification, ESOPs are not exempted from the other requirements of Section 404. The question thus arises as to whether the ESOP has been established and is operated for the exclusive benefit of the participants and their beneficiaries. This has great significance where the ESOP is established for some of the "fancy" financing purposes such as the going public or going private concepts or raising capital for expansion or permitting a large stockholder to dispose of all or a portion of his shareholdings.

The Internal Revenue Service has long taken the view that the exclusive benefit rule, which existed prior to ERISA, did not prohibit other incidental benefits to non-participants. Thus, it would not appear that the above benefits are per se improper if in fact, the plan is being run in such manner that the participants receive real benefits therefrom. If the company establishing the ESOP is a profitable, growing company, there would not appear to be much of a problem. However, if the company is deficit-ridden or close to bankruptcy, questions as to the propriety of the ESOP could easily arise.

Another serious situation would arise if the fiduciaries of the ESOP perceive that the value of the company stock is declining because of its diminished prospects. Do they have a fiduciary obligation to sell the stock in order to prevent further losses in market value? On the other hand, such sales may themselves create a crisis if confidence with respect to the company and thus intensify its problems.

If the fiduciaries of the ESOP are also the directors of the company, they may have a conflict of interest between their obligations to the participants of the ESOP and responsibilities to the shareholders of the company. From my point of view, I would never make a director a fiduciary of an ESOP.

Questions as to the valuation of the stock of the company are always critical in the ESOP situation, especially where the shares of the company are not publicly traded. The fiduciary has an affirmative obligation to see that the valuation is proper. Fortunately, the Labor Department recently issued ERISA I B 75-4 in which it interpreted Section 410a of the Act, which prohibits exculpatory provisions in pension plans, so as not to prohibit an employer from indemnifying the fiduciaries of a plan established by it, or a plan fiduciary from indemnifying its own employees who actually perform the fiduciary services. This is fine from a federal standpoint but once again, we must look to the particular state law in which the company operates to see if it's also fine from the corporate point of view. In New York, a corporation cannot indemnify a third party, though it may indemnify its officers, directors and employees as fiduciaries.

One of the main points raised by people who favor the ESOP is the utilization of a "friendly" fiduciary so that the fiduciary will vote the stock under its control in accordance with the wishes of management, etc. This, in and of itself is a clear violation of fiduciary responsibility, which is primarily the job of acting as guardian of the participants' and beneficiaries' rights under the particular plan. It is well and good to talk about the mutual interest theory between the fiduciary and management and employees, but in reality the fiduciary runs a real risk in its actions.

We finally arrive at the ESOP itself and the drafting thereof.

The ESOPs can be prepared under a one or two-document structure. If you do it as a single document, it is a plan with the trust provisions built in; in the alternative, you can separate the plan and the trust. Since ERISA contemplates simplifying the Plan concept so that employees can readily understand it, I recommend using a single document. In Article 1 of the document, known as the Employees Stock Ownership Plan, there should be an explanation of the nature of the plan. Thus, it would begin with a purpose statement in Section 1 as follows:

"The purpose of this Plan is to assist you over the course of your years of employment with your employer to accumulate capital ownership and through that ownership to share in the future of company and provide you economic security and an independent income. The plan is intended to do this without any deductions from your paychecks or without calling upon you to invest your personal savings. A primary purpose of the plan is to enable you to acquire a proprietary interest in company and consequently a major portion of the cash payments made by your employer to the trust for your account will be invested in company stock."

The Plan would then set forth its effective date and go on to explain the way it operates. It would set forth the various definitions that the plan will operate under, such as "anniversary date," "beneficiary," "capital accumulation," "covered compensation," "employee," etc. Other matters to be discussed include eligibility, participation and the rules for allocation, whether it be based upon percentage of an employee's compensation to all covered compensation or years of service and compensation or just years of service. There would also be discussed breaks in service, employer contributions (usually indicating that the amount of the contributions will be determined by the Board each year), payment of contributions (usually indicating how contributions shall be paid to the trust), investment of trust assets (usually indicating that purchases of company stock will be made at a price or prices which in the judgment of the Committee does not exceed the fair market value of shares of company stock), allocation to the

employee's account (usually indicating how it's allocated and when it's allocated. This includes discussion as to forfeitures and the net income or loss of the trust), who pays the expenses of the plan in trust, (in most cases the employer will bear that full cost), how voting company stock will be handled (usually indicating that the trustee will vote all company stock held by it as part of trust assets), the annual statement which is provided as soon as practicable after each anniversary date to each employee. (Such a statement will indicate the balance employee's account, any adjustment to the employee's account reflecting share of income or loss of the trust for the year, and the new balances in each of the employee's accounts, including the number of shares in the company stock account).

The Plan would also discuss what the employee will receive, the capital accumulation in general, (the capital accumulation at retirement or death and disability) and at other termination of service setting forth a vesting scale. (The most recent vesting scale we have used is 30% after three years and 10% a year thereafter until 100% at ten years.)

The Plan goes on to discuss how the capital accumulation will be distributed and sets forth certain options which the employee may indicate to the trustee he would like, the final decision being in the trustee at all times. It is to be remembered that distributions will be made in employees' stock. The employer has no right to insist on redemption of stock when the employee retires and receives his distribution. The Plan covers provision for intermediate and partial distributions. This is usually to mitigate financial hardship for employees.

The Plan then goes into the general provisions, such as guarantees, the future of the plan (indicating that it is subject to initial approval by the Internal Revenue Service and that it may be amended or terminated by the company), which law is to govern plan, and the execution of the plan.

The plan itself is structured in legal, technical language. Sometimes employees do not really understand this type of language and so I have always believed in adding a second document to the plan, that being an employees' stock ownership plan accounting procedures manual. Under ERISA, employers are required to furnish explanations of the plan to employees in language that they can understand. Our accounting procedural manual goes through the explanation of the Plan in the most simple terms. Some of the troublesome areas are found in the unallocated company stock accounts, those being accounts before employees are vested; how forfeitures are handled; how net income or loss of the trust is handled; what happens in respect of stock splits and capital reorganizations and fractional shares; and, in general, how the plan operates to the employees' benefit. In some cases it is useful to provide cartoon-like character drawings to help explain the plan or put the employees' manual in the form of simple questions and

answers. The best type of manual may well be a looseleaf structure; thus, amendments to the plan can be added and annual statements can be kept together with the plan in the manual by the employees. In addition, the corporation can even sectionalize the looseleaf book so that all the employees' benefits can be kept under the same looseleaf binder. It is to be noted that on many occasions the employees' manual has been of more help in obtaining stockholder approval than the plan itself.

As you can see by the above, ESOPs are potentially wonderful benefit programs with all sorts of ancillary implications which are helpful to almost everybody involved. However, before entering into an ESOP program, the Board of Directors of the company must be well versed in federal and state law not only covering the tax implications but covering all of the other ramifications just discussed.

It becomes obvious that the employees stock ownership plan is not only an excellent employee benefit program, but may also serve the purpose of a financing device for a corporation, an estate planner's tool, and a bail-out device in a closely-held corporation. The key here is that whatever the program, it must be found to be primarily for the benefit of employees.