

# CLIENT ALERT

## LEGAL STRATEGIES FOR ESOP COMPANIES IN HARD ECONOMIC TIMES

Written by: Margaret Steere, Esq.

**W**hen a company decides to put an ESOP in place, and an existing shareholder sells stock directly to the ESOP, the purchase price for the stock can be financed in one of two ways: with cash lent to the ESOP by the company to pay the selling shareholder, or with a loan directly to the ESOP from the selling shareholder. In hard economic times, the latter structure may place a strain on the company's cash flow, but there are possible solutions to this problem.

### Comparing the Methods of Financing the ESOP Stock Purchase

#### **Company** **ESOP**

If the ESOP purchases shares directly from a selling shareholder with cash that it has borrowed from the company (the company either gets this cash from a bank loan or uses cash it already has on hand), the selling shareholder receives the full amount of the purchase price for his shares. The ESOP then repays the company using contributions it receives from the company. Thus, money essentially moves in a circle: the company makes a contribution to the ESOP equal to the amount of the loan payment that is due, and the ESOP immediately returns that money to the company as a loan repayment.

The company is a "friendly lender" in that the ESOP can only make payments on the loan if the company makes adequate contributions to the ESOP. While the company may have to part with the cash to make the contribution initially, it is only temporary - the ESOP pays it right back to the company and the net effect on the company's cash is zero.

#### **Selling Shareholder** **ESOP**

If the ESOP purchases the shares directly from the selling shareholder in exchange for a note, the stock sold to the ESOP is pledged back to the seller as collateral to secure the note. The company makes contributions to the ESOP in cash, which the ESOP then pays to the selling shareholder in repayment of the note. Payments on the note may also be guaranteed by the company, and this guaranty is often secured with a lien on the company's assets.

When credit is extended to the ESOP by a third party - namely, the selling shareholder - there is less flexibility than when the company is the lender. The company still makes a cash contribution to the ESOP, but rather than that cash coming back to the company, the ESOP pays it to the selling shareholder to repay his note. Consequently, the company's cash position is reduced by the amount of the contribution to the ESOP to repay the loan to the selling shareholder.

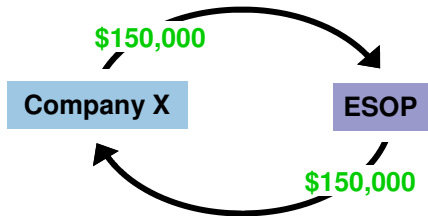
### An Example

By way of illustration, let's say that in 2007 Company X puts an ESOP in place, and the existing owner of 100% of the outstanding stock (Y) sells his 100,000 shares of stock to the ESOP for \$1,000,000. The term of the note to pay for the shares is 10 years at 5% interest and payments are made annually beginning in 2008. As a result, in 2008, a \$150,000 payment is due: \$100,000 in principal ( $\$1,000,000/10$ ) and \$50,000 in interest ( $\$1,000,000 \times .05$ ). Take a look at the impact on X's cash flow under each of the scenarios described above:

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# Legal Strategies For ESOP Companies In Hard Economic Times

**(1)** If Company X lends the money to the ESOP to pay Y for the shares, Y gets the full amount of the purchase price on closing day. In order to make the first payment on the loan, in 2008 Company X will contribute \$150,000 to the ESOP, which will then immediately pay that money back to Company X as a loan repayment. Company X's cash position is unchanged.



**(2)** If the ESOP has borrowed the purchase price from Y rather than Company X, Company X will make a \$150,000 contribution to the ESOP, which will use those funds to make a \$150,000 payment to Y on his loan. Company X's cash position has been reduced by \$150,000. As long as Company X has the cash, there is no problem.



## The Problem

But what if in 2008, Company X loses one of its major customers due to the economic recession, causing a big hit to its cash flow, and now finds itself unable to come up with \$150,000? If the loan is between Company X and the ESOP, X need only come up with \$150,000 temporarily because the ESOP will pay it back immediately.

However, if the loan is between Company X and Y, Company X has to find a way to come up with \$150,000 that the ESOP can pay to Y. If it cannot, everybody has a problem. The company does not have enough cash to make the required contribution. The ESOP will default on the loan with Y, which will result in the ESOP participants not getting stock allocated to their accounts in year one. Y will not receive the money he is owed for selling his stock to the ESOP.

## Possible Solutions

What can the company, the selling shareholder and the ESOP do if the company does not have the cash to contribute to the ESOP so

that the ESOP can repay the note to the selling shareholder? Here are a couple of options that may be considered:

**Refinance the Note.** The parties could agree to reduce the interest rate on the note, or to refinance the note to extend the term, thereby reducing the loan payments. In either case, the trustee of the ESOP has to satisfy its fiduciary obligations under ERISA. Department of Labor Field Assistance Bulletin 2002-1 requires that any note refinancing be solely in the interests of the ESOP participants and beneficiaries. The trustee must ensure that participants – both current and future – are not adversely impacted as a result of the refinancing.

**Note Exchange.** Here, the company purchases from the selling shareholder the note he holds from the ESOP in exchange for a new note issued by the company to the selling shareholder. Now the company owes money directly to the selling shareholder via a new note, and the ESOP owes money to the Company.

One advantage of this approach is that the trustee is not involved – all transactions are occurring between the company and the selling shareholder – and consequently the fiduciary duties involved in a refinancing are not implicated.

**Selling Shareholder Forgives Note.** If the selling shareholder is willing to do so, he may forgive the note from the ESOP. This requires a generous selling shareholder who is willing to forego the funds that are due to him for selling the stock to the ESOP. Note forgiveness has to be done carefully in order to avoid exceeding the limits under sections 404 (deductibility of contributions to an ESOP by the sponsoring company) and 415 (benefits and contributions to participant accounts) of the Internal Revenue Code. To address these issues, it may be possible to structure the forgiveness as a year-to-year process.

**Take Back Stock.** When the ESOP purchased the shares, it pledged those shares to the selling shareholder as collateral. If the ESOP does not make the \$150,000 payment in year 1, the selling shareholder can take back a certain number of shares, the fair market value of which is equal to the default amount (in this case, \$150,000). The actual number of shares subject to the default can change depending on the fair market value of the stock at the time of the default.

It is important to remember that there are ways to address a company's cash flow problems as they relate to the ESOP. The solution will depend on the particular circumstances of the company, the ESOP and the selling shareholder.

-Margaret Steere  
msteere@sfglaw.com

# ERISA FIDELITY BONDS

Written by: Karen Hurley, Senior Plan Administrator

**U**nder Section 412 of ERISA law, retirement plans are required to be covered by a fidelity bond in order to protect employee benefit plans from the risk of loss due to fraud or dishonesty on the part of persons handling plan funds or other property. Items covered under the fidelity bond must include all funds or property that the plan uses or may use as a source for the payment of benefits to plan participants or beneficiaries. The bond must be an ERISA Fidelity Bond, different from an employee dishonesty bond or fiduciary liability insurance, which do not meet the Department of Labor's requirements for ERISA compliance. The plan must be named as the insured on the bond, and a surety company provides the bond. The surety company is required to be named on the Department of the Treasury's Listing of Approved Sureties; a listing of these providers can be found at [www.fms.treas.gov/c570/c570.html](http://www.fms.treas.gov/c570/c570.html)

## How Does a Fidelity Bond Differ from Fiduciary Liability Insurance?

A fidelity bond protects the plan's assets. A fiduciary liability insurance policy protects the plan's fiduciaries. Fiduciary liability insurance, while not mandatory under ERISA, pays claims that might include errors in the administration of a plan, allegations of improper advice or disclosure, imprudent investments, negligence in plan administration or conflicts of interest with regards to investments.

## Who Should Be Covered?

Anyone who handles funds or other property of the plan is required to be bonded. This may include anyone who has physical contact with cash, checks or other plan property, has the power to transfer, negotiate or disburse funds, or has any decision making authority over the above. There are certain exemptions for banks, insurance companies or registered brokers or dealers under the Securities Exchange Act. Coverage is generally excluded for those solely rendering investment advice, or for a third-party administrator who would not "handle" plan funds. The responsibility for ensuring that plan officials are properly bonded may fall on several individuals, so it's important that your coverage be complete.

## How Much Coverage Do You Need?

A plan's coverage must be no less than 10% of the value of the plan's assets at the beginning of the plan year, with a minimum of \$1,000 and maximum of \$500,000 worth of coverage. If company stock is held within the plan, the maximum coverage amount is increased to \$1,000,000. Although ERISA cannot require that a plan obtain coverage in excess of the statutory maximum, nothing in section 412 precludes a plan from purchasing a bond for a higher amount if they so choose.

## What About Non-Qualified Assets?

If a retirement plan has more than 5% of assets held in non-qualifying assets, then these assets require coverage as well, as they carry a higher risk for loss. If not listed, an underwriter could deny coverage if there were a loss due to plan misuse or misappropriation. Non-qualifying assets would be viewed as investments in

*"The responsibility for ensuring that plan officials are properly bonded may fall on several individuals, so it's important that your coverage be complete."*

limited partnerships, collectibles, mortgages, real estate, or securities of "closely held" companies that are held outside of regulated institutions.

Pursuant to the audit waiver for small plans (generally those plans with fewer than 100 participants) filing schedule I of Form 5500, in order to claim exemption from audit, any person who handles non-qualified assets must be bonded for at least 100% of the value of the non-qualified assets if such assets constitute more than 5% of total plan assets. If the plan is found to have insufficient coverage, the audit waiver no longer applies. This means an independent audit is required to provide an annual full scope audit, proving significantly more expensive than a bond.

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# ERISA Fidelity Bonds

## How Much Will It Cost?

Premiums are usually less than 0.5% of the coverage amount and can be issued for multiple year periods, as long as the bond insures the plan for at least the statutorily-required amount. At the beginning of each plan year, the plan administrator or appropriate fiduciary must confirm that the bond continues to cover the required minimum, and that the appropriate plan officials are bonded. In the case of multiple years being covered, it's a good idea to have an "inflation guard" provision, which automatically increases the amount of coverage under a bond to meet ERISA requirements. Policies can usually be added as a rider to a 401(k) policy; however, any bond that insures more than one plan must allow for a recovery by each plan sufficient to insure each plan as though they were bonded separately.

If the plan purchases a bond to meet section 412's requirements, the plan may pay for the bond out of the plan's assets if it so chooses. Bonds cannot have a deductible, unless the deductible applies after payment of the maximum amount required under ERISA.

## The Consequences of Non-Compliance

Fidelity Bonds are high on the list of the DOL's compliance priorities, and may red flag the plan for audit if a bond is not in place or is undervalued. A lawsuit could be originated by a participant, or even the DOL, and a fiduciary could be held personally liable if a loss results to the plan, including responsibility for non-qualified assets.

Additional guidance regarding ERISA fidelity bonding requirements can be found at [www.dol.gov/ebsa/regs/fab2008-4.html](http://www.dol.gov/ebsa/regs/fab2008-4.html).

-Karen Hurley  
khurley@sesadvisors.com

## COLA INCREASES FOR DOLLAR LIMITATIONS ON BENEFITS AND CONTRIBUTIONS

On October 15, 2009 the Internal Revenue Service announced cost-of-living adjustments applicable to dollar limitations for pension plans for tax year 2010.

Code Section	2010	2009	2008	2007	2006	2005	2004	2003
<b>401(a)(17)/404(l) Annual Compensation</b> The maximum amount of an individual's compensation that may be considered when calculating tax-deductible contributions or allocating an individual's benefits.	245,000	245,000	230,000	225,000	220,000	210,000	205,000	200,000
<b>415(c)(1)(A) DC Limits</b> The maximum amount that may be contributed to an individual's retirement plans – includes 401k deferrals, match, profit sharing contributions, and ESOP contribution.	49,000	49,000	46,000	45,000	44,000	42,000	41,000	40,000
<b>409(o)(1)(C) ESOP Limits</b> ESOPs are permitted to spread benefit payments over more than five years for large account balances. The top number is the minimum balance that may be spread over more years. One additional annual installment may be added for each increment of the bottom number.	985,000 195,000	985,000 195,000	935,000 185,000	915,000 180,000	885,000 175,000	850,000 170,000	830,000 165,000	810,000 160,000
<b>414(q)(1)(B) HCE Threshold</b> Employees earning annual compensation over this threshold are considered Highly Compensated Employees ("HCEs"). This test looks back to compensation earned in the year prior to the Plan Year being tested. Employers may limit the HCE group to the top 20 percent of earners.	110,000	110,000	105,000	100,000	100,000	95,000	90,000	90,000
<b>416(i)(1)(A)(i) Key EE</b> Company Officers earning annual compensation over this threshold are considered "Key Employees" for Top-Heavy testing. An employee may also be considered a Key Employee based on his or her stock ownership.	160,000	160,000	150,000	145,000	140,000	135,000	130,000	130,000
<b>402(g)(1) Elective Deferrals</b> The maximum amount an individual may elect to defer under a 401k Plan.	16,500	16,500	15,500	15,500	15,000	14,000	13,000	12,000
<b>414(v)(2)(B)(i) Catch-up Contributions</b> Participants over the age of 50 may elect to defer additional amounts to their 401k as "Catch-up Contributions." These additional contributions are not counted under the Section 415 limits.	5,500	5,500	5,000	5,000	5,000	4,000	3,000	2,000

10 Shurs Lane Suite 102 Philadelphia, PA 19127 SES (215) 508-1600 SFE&G (215) 508-1500	6 South Street Suite 201 Morristown, NJ 07960 SES (973) 540-9200 SFE&G (973) 540-9292	401 Warren Street Suite 201 Redwood City, CA 94063 SES (650) 216-7707 SFE&G (650) 216-9393	P.O Box 205 Lake Anna, VA 23024 SES (540) 872-4601	235 Promenade Street Suite 497 Providence, RI 02908 SFE&G (401) 632-0480	156 College Street 3rd Floor Burlington, VT 05401 SFE&G (802) 860-4077
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