

CLIENT ALERT

PARTIAL PLAN TERMINATIONS: A POTENTIAL PITFALL IN TOUGH ECONOMIC TIMES

Written by: Brian Wurpts, Principal and Vice President of SES Advisors

When we think about retirement plan terminations, we're usually referring to a unilateral decision made by a company's Board of Directors. When the Board decides to terminate a plan, its participants become fully vested, the assets of the trust are liquidated and benefits are distributed. Partial terminations are similar in some respects (affected participants fully vest, benefits are distributed, etc.), but partial terminations are the result of other business decisions or events such as the sale of a division, layoff or early retirement offer. These events are more common during periods of economic recession. Partial terminations cause the accounts of affected participants to immediately vest. This increases the ESOP sponsor's repurchase obligation (usually at a very unfavorable time). So it's important for employers to be aware of the criteria used to evaluate whether a partial termination occurred.

TYPES AND CAUSES OF PARTIAL TERMINATIONS

Partial termination may be caused by a plan amendment that causes a significant reduction in benefits, a discontinuance of contributions, reversion of plan assets to the employer, or a significant reduction in the number or percentage of plan participants. This last category of termination is often the result of a layoff, sale, or closing of a division or business location, but may also occur when the employer experiences an unusual employee turnover rate.

DETERMINATION CRITERIA

The determination of whether a partial termination has occurred is based on a facts and circumstances analysis. However, the Internal Revenue Service (IRS) has given us some guidance. Internal Revenue Procedure 2007-43 states:

“[W]hether a partial termination of a plan under § 411(d)(3) has occurred depends on the facts and circumstances, including the extent to which participating employees have had a severance from employment. If the turnover rate is at least 20 percent, there is a presumption that a partial termination of the plan has occurred.

Whether or not a partial termination occurs on account of participant turnover (and the time of such event) depends on all the facts and circumstances in a particular case. Facts and circumstances indicating that the turnover rate for an applicable period is routine for the employer favor a finding that there is no partial termination for that applicable period. For this purpose, information as to the turnover rate in other periods and the extent to which terminated employees were actually replaced, whether the new employees performed the same functions, had the same job classification or title, and received comparable compensation are relevant to determining whether the turnover is routine for the employer.”

Partial Plan Terminations

The tax courts have also provided some guidance, ruling in the past that a turnover rate of less than 10 percent is presumed not to be a partial termination, while partial termination is conclusively presumed when the turnover rate is more than 40 percent.

Turnover rate is evaluated based on the number of participants who had an employer-initiated termination of employment. In determining whether a partial plan termination occurred, employers may disregard the termination of participants who left voluntarily. Employers should have good documentation supporting the circumstances of an employee's termination (e.g., a copy of a resignation letter). While these employees may be excluded from the determination, once a partial termination occurs, all participants who terminated during the period are fully vested (regardless of their reasons for leaving). Partial terminations should be evaluated at least annually and over longer periods of time when the cumulative turnover rate is greater than 20 percent. Other facts and circumstances that may affect the evaluation include: documentation describing a reduction in force or layoff; offers of severance pay or early retirement; grouped employment termination dates; sale, relocation, or closure of a business location; and whether terminated participants were replaced by employees with the same function. Examples of mitigating circumstances include

a high turnover rate in the employer's industry, historical turnover rates, an absence of patterns in employer-initiated severance and evidence of participants' decisions to voluntarily terminate.

Typically the plan's fiduciaries unilaterally decide that a partial plan termination has occurred. The employer has the option of requesting a formal IRS determination. The IRS may also evaluate whether partial terminations have occurred when the plan is terminated, through its plan audit program or during the routine determination letter process.

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EXAMPLES OF PARTIAL TERMINATION DETERMINATIONS

- Company A's retirement plan was determined not to be partially terminated after a 19 percent turnover rate because the facts did not show employer abuse, bad faith or misconduct.
- A partial termination was deemed to have occurred when Company C terminated 12 of 15 of its plan participants when they refused to relocate to the employer's new business location.

- Company H argued unsuccessfully that turnover of 34 percent and 51 percent in successive years was not a partial termination.

- Company M laid off 22 percent of its participants over a period of three years. The courts determined that a partial termination did not occur because the layoffs resulted from two unrelated events and “were not improperly motivated.”

- Company R spun off a division representing 15 percent of the participants. Employees of the newly created entity were not eligible to participate in the plan. The courts determined that the level of turnover did not represent a “significant percentage” and no termination occurred.

SUMMARY

Partial terminations have a significant impact on the size of an ESOP sponsor's repurchase obligation. A determination of whether a partial termination has occurred depends on several variables. The employer may unilaterally decide that the plan has incurred a partial termination or may appeal to the IRS to make the determination. We strongly encourage employers to consult with their counsel and/or their third party administrator whenever they're considering or experiencing a significant reduction in workforce.

-Brian Wurpts

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FINANCING IN THE CURRENT ECONOMIC CLIMATE

Written by: Meg Shrum, Senior Vice President of SES Advisors

Securing financing for a leveraged ESOP transaction can be a challenge in any environment, but in the current economic climate, it can be quite daunting to say the least. Many financial institutions have taken huge hits to their balance sheets, and therefore, their capital ratios may be well below benchmarks set by the regulators. So - what can you do to improve your chances of obtaining financing?

PREPARING FOR FINANCING

While the bank's decision will ultimately come down to its perception of the company's ability to repay, there are several things you can do that will help in the underwriting process to show the bank that you are financially savvy and prepared for a long-term borrowing relationship.

- Provide good quality financial statements (upgrade if necessary)
- Have a budget for the current year and projections for the next 3 years
- Prepare a strategic plan outlining anticipated growth, market opportunities, large capital expenditures, and how you plan to attract new clients
- Have bios for your senior management team available
- Provide current A/R, A/P, backlog and other meaningful reports

If you are an existing ESOP company, much of the above information is

updated during your annual stock valuation process. Remember to be enthusiastic about your company - yet realistic about the future outlook.

WHAT TO EXPECT

So you've met with the bank and given them all the information requested - what now?

At this point, the lender and/or credit analyst will evaluate financial and background information, have a series of discussions with those who will ultimately approve the loan, and prepare a formal credit package for presentation to the Loan Committee. This may take a couple of weeks and you can expect to

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receive additional questions from the bank during this process. If approved, the loan terms will be presented to you in the form of a commitment letter which spells out all of the significant details: loan amount, interest rate, fees, repayment terms, collateral, guaranties, and a set of financial covenants to be measured at various times (usually quarterly or annually).

Covenants take two major forms: “thou shalt” and “thou shalt not.”

FINANCIAL COVENANTS

“Thou shalt” include:

- maintain insurance
- pay all taxes due
- submit regular financial reports
- maintain specific financial covenants

“Thou shalt not” include:

- take on additional debt
- sell off collateral
- change the company's ownership structure
- merge with or acquire other companies

If a “shalt not” makes sense for the company, it can usually be accomplished with the bank's consent. While at this point the bank may appear to be the bad guy, remember that they need to make loans but they also need to get repaid. Treat the bank as your partner - the more successful the company is, the more business there will be for the bank (loans, deposits, cash management services). They want you to be successful, but have numerous parties to answer to along the way (boards, auditors, regulators, shareholders). Prompt financial reporting is always a good idea, but if you hit a bump along the way, be proactive - take cost cutting or corrective action early and talk to your lender before the affected financial statement hits their desk.

REFINANCING SELLER NOTES

In our last Client Alert, we touched on the topic of refinancing existing seller notes. Banks should be willing to do so, especially if the company has a good track record of paying on the note,

Financing

the successor management team is in place, and the company's financial outlook and cash flows are sound. If the seller note is directly to the company, there are no real restrictions on how the new debt is structured. However, if the seller note is directly to the ESOP trust, the fiduciary must examine the costs and benefits of the transaction and the consequences of a failure to refinance and determine whether the refinancing is in the best interest of the participants.¹ It is the ESOP fiduciary's responsibility to ensure that participants - both current and future - are not adversely impacted as a result of the refinancing. While the exact terms of a refinance may not appear as favorable as existing terms, certain inducements may be offered by the employer for the benefit of the participants and to level the playing field. These may include: 1) an increase in employer contribution to the ESOP or matching portion of a 401(k) plan; 2) increased diversification rights to ESOP participants; 3) dividend "make-whole" payments to participants that would true up any adverse effects of a refinance. Any contemplated refinance should be carefully screened by your ESOP professionals to ensure that no fiduciary violation is triggered.

TODAY'S LENDING ENVIRONMENT

Historically, credit availability has

409A DEFERRED COMPENSATION DEADLINE RAPIDLY APPROACHING

December 2008						
Sun	Mon	Tu	We	Th	Fr	Sa
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30	31			

By December 31, 2008, all nonqualified deferred compensation arrangements must be in compliance with final regulations under Section 409A of the Internal Revenue Code.

Failure to comply with Section 409A subjects individuals to immediate taxation on their vested deferred compensation, plus a 20% excise tax and interest penalties.

Section 409A affects a wide range of plans, contracts and agreements. Broadly, any compensation earned in one year and payable in another may be subject to Section 409A. Arrangements that should be reviewed for 409A compliance include the following:

- Traditional nonqualified deferred compensation plans, supplemental retirement plans and excess benefit plans
- Equity based compensation plans, including stock appreciation rights, stock options, phantom stock and deferred equity awards
- Employment, consulting and change of control agreements
- Severance plans and agreements
- Bonus plans and long-term incentive plans
- Split dollar insurance agreements

If you have questions about how 409A may affect any of your plans or arrangements, the following SFE&G attorneys will be able to help:

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regularly cycled between free-flowing (where loans are plentiful at competitive rates and generous terms) and tight (where banks are very cautious and terms are less favorable). And while we obviously find ourselves in the latter category today, many banks are still making loans under certain conditions. Those I've spoken to recently say they continue to lend to their existing clients, that relationships (i.e., multiple banking services) make a difference, but that underwriting is more thorough, pricing has increased and covenant terms may be stricter (especially debt/EBITDA). Good deals are still getting done, but with perhaps a larger piece of seller financing or with a smaller percentage of the company being sold.

My own experience as a lender over both good and bad economic times

leads to advice of "be patient." In the end, banks need to lend money in order to make money, and want to get repaid under the agreed terms while avoiding extra scrutiny from regulators. Times will change and lenders will once again be knocking on your doors. Selling to an ESOP remains a great option for succession planning, and a little creative structuring using seller notes with warrants or convertible preferred stock can be an attractive alternative (or companion) to bank financing right now.

-Meg Shrum

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¹DOL Field Assistance Bulletin (FAB) 2002-1 addresses the fiduciary's obligations under Sections 404(a) and 408(b)(3) of ERISA.