Employee Stock Ownership Plans

PENSION RIGHTS CENTER

JUNE 1, 2016

TED SCALLET

EASCOLAW, PLLC

Who Is Ted Scallet

SEC General Counsel's Office 1975-1978
- Daniel v. International Brotherhood of Teamsters

DOL PBSD 1978-1983
- Donovan v. Cunningham

Private Practice 1983-2016
- Chao v. Hall Holding
- Henry v. Champlain Air
- Solis v. First Bankers Trust Services, Inc.
- Perez v. First Bankers Trust Services, Inc.

EascoLaw, PLLC

Private Versus Public Company ESOPs

Public Company ESOPs
- Tax advantages for public company to structure their 401k plan employer stock accounts as an ESOP
- Present the same ERISA Title I fiduciary issues as non-ESOP 401k plan employer stock accounts (non-diversification, excessive fees, potential employer conflicts of interest)
- Bill Bortz paper a good source on tax and fiduciary issues presented by public company ESOPs.

Private Company ESOPs
A DC Love Story

ESOPs -- The illegitimate son of Louie Kelso and Russell Long

Louis Kelso
- Created first ESOP in the mid-fifties. Considered employee ownership as macroeconomic theory (*The Democratic Manifesto)*
- Founded law firm and then merchant bank to advance the concept of employee ownership
- Made lots of money

Russell Long
- Senator for 33 years
- Chairman of the Senate Finance Committee from 1966-1981 when that was a Big Deal

Private Company ESOPs and the Drafting of ERISA
Russell Long to the Rescue

Kelso's Basic ESOP Transaction
- Plan borrows money from the company to pay the sellers
- Company borrows money from a bank to loan to plan
- Plan repays loan with contributions from the company

ERISA Problems and How Russell Long Fixed Them
- Double Jeopardy (lose your job and your pension too)
  - Individual Account Plan Exception in ERISA Section 407(d)
- Prohibited Transactions (insider transactions)
  - Adequate Consideration Test in Section 408(e)
- And Many Tax Goodies Too
- Special Participant Rights

Private Company ESOPs
Ted's Biases

Employee ownership is a Good Thing (and Secretary Perez agrees with me)

The tax advantages Congress has lavished on ESOPs are far too generous, but it leads to more money for participants

Formation transactions involving non-replacement plan ESOPs are almost never a Bad Thing

But once an ESOP is formed, the potential for abusive transactions can be high and special participant rights are too often ignored

Private Company ESOP Violations
Ted's Rankings

Definitely worth a look

- Formation transactions involving some plan assets or employee money
- Follow-on ESOP transactions
- Denial of ESOP participant rights

I don't care but the law thinks otherwise

- Formation transactions involving a non-replacement plan and no employee money

I don't care but DOL does

- ESOP company post-transaction corporate transactions

Private Company ESOPs
Participant Rights

Distributions

- Put option requiring employer to repurchase participant's stock at separation
- Can take five years
- Adequate security for unpaid amounts

Diversification

- Age 55 and ten years of service
- Investment options

Voting Rights

Annual Valuation

Private Company ESOPs
Fiduciary Issues in ESOP Transactions

The Adequate Consideration Test of Section 408(e)

- Fair market value as determined in good faith by the fiduciary
  - One prong/two prongs
    - Fair market value
    - Good faith determination
- Good faith and due diligence
  - The good faith roadmap of the *Sierra Aluminum* settlement
- Fair market value
  - Inconsistent valuations
  - Valuation judgment calls vs bad acts

Is the Seller a Fiduciary

- Who is controlling the process

Questions?

AGREEMENT CONCERNING FIDUCIARY ENGAGEMENTS AND PROCESS REQUIREMENTS FOR EMPLOYER STOCK TRANSACTIONS

The Secretary of the United States Department of Labor (the "Secretary") and GreatBanc Trust Company ("the Trustee"), by and through their attorneys, have agreed that the policies and procedures described below apply whenever the Trustee serves as a trustee or other fiduciary of any employee stock ownership plan subject to Title I of ERISA ("ESOP") in connection with transactions in which the ESOP is purchasing or selling, is contemplating purchasing or selling, or receives an offer to purchase or sell, employer securities that are not publicly traded.

A. Selection and Use of Valuation Advisor – General. In all transactions involving the purchase or sale of employer securities that are not publicly traded, the Trustee will hire a qualified valuation advisor, and will do the following:

1. prudently investigate the valuation advisor's qualifications;
2. take reasonable steps to determine that the valuation advisor receives complete, accurate and current information necessary to value the employer securities; and
3. prudently determine that its reliance on the valuation advisor's advice is reasonable before entering into any transaction in reliance on the advice.

B. Selection of Valuation Advisor – Conflicts of Interest. The Trustee will not use a valuation advisor for a transaction that has previously performed work – including but not limited to a "preliminary valuation" – for or on behalf of the ESOP sponsor (as distinguished from the ESOP), any counterparty to the ESOP involved in the transaction, or any other entity that is structuring the transaction (such as an investment bank) for any party other than the ESOP or its trustee. The Trustee will not use a valuation advisor for a transaction that has a familial or corporate relationship (such as a parent-subsidiary relationship) to any of the aforementioned persons or entities. The Trustee will obtain written confirmation from the valuation advisor selected that none of the above-referenced relations exist.

C. Selection of Valuation Advisor – Process. In selecting a valuation advisor for a transaction involving the purchase or sale of employer securities, the Trustee will prepare a written analysis addressing the following topics:

1. The reason for selecting the particular valuation advisor;
2. A list of all the valuation advisors that the Trustee considered;
3. A discussion of the qualifications of the valuation advisors that the Trustee considered;
4. A list of references checked and discussion of the references' views on the valuation advisors;
5. Whether the valuation advisor was the subject of prior criminal or civil proceedings; and
6. A full explanation of the bases for concluding that the Trustee's selection of the valuation advisor was prudent.

If the Trustee selects a valuation advisor from a roster of valuation advisors that it has previously used, the Trustee need not undertake anew the analysis outlined above if the following conditions are satisfied: (a) the Trustee previously performed the analysis in connection with a prior engagement of the valuation advisor; (b) the previous analysis was completed within the 15 month period immediately preceding the valuation advisor's selection for a specific transaction; (c) the Trustee documents in writing that it previously performed the analysis, the date(s) on which the Trustee performed the analysis, and the results of the analysis; and (d) the valuation advisor certifies that the information it previously provided pursuant to item (5) above is still accurate.

D. Oversight of Valuation Advisor – Required Analysis. In connection with any purchase or sale of employer securities that are not publicly traded, the Trustee will request that the valuation advisor document the following items in its valuation report,[1] and if the valuation advisor does not so document properly, the Trustee will prepare supplemental documentation of the following items to the extent they were not documented by the valuation advisor:

[1] As used herein, "valuation report" means the final valuation report as opposed to previous versions or drafts.

1. Identify in writing the individuals responsible for providing any projections reflected in the valuation report, and as to those individuals, conduct reasonable inquiry as to: (a) whether those individuals have or reasonably may be determined to have any conflicts of interest in regard to the ESOP (including but not limited to any interest in the purchase or sale of the employer securities being considered); (b) whether those individuals serve as agents or employees of persons with such conflicts, and the precise nature of any such conflicts: and (c) record in writing how the Trustee and the valuation advisor considered such conflicts in determining the value of employer securities;
2. Document in writing an opinion as to the reasonableness of any projections considered in connection with the proposed transaction and explain in writing why and to what extent the projections are or are not reasonable. At a minimum, the analysis shall consider how the projections compare to, and whether they are reasonable in light of, the company's five-year historical averages and/or medians and the five-year historical averages and/or medians of a group of comparable public companies (if any exist) for the following metrics, unless five-year data are unavailable (in which case, the analyses shall use averages extending as far back as possible):
    a. Return on assets
    b. Return on equity
    c. EBIT margins
    d. EBITDA margins
    e. Ratio of capital expenditures to sales
    f. Revenue growth rate
    g. Ratio of free cash flows (of the enterprise) to sales
3. If it is determined that any of these metrics should be disregarded in assessing the reasonableness of the projections, document in writing both the calculations of the metric (unless calculation is impossible) and the basis for the conclusion that the

metric should be disregarded. The use of additional metrics to evaluate the reasonableness of projections other than those listed in section D(2)(a)-(g) above is not precluded as long as the appropriateness of those metrics is documented in writing. If comparable companies are used for any part of a valuation – whether as part of a Guideline Public Company method, to gauge the reasonableness of projections, or for any other purpose – explain in writing the bases for concluding that the comparable companies are actually comparable to the company being valued, including on the basis of size, customer concentration (if such information is publicly available), and volatility of earnings. If a Guideline Public Company analysis is performed, explain in writing any discounts applied to the multiples selected, and if no discount is applied to any given multiple, explain in significant detail the reasons.

4. If the company is projected to meet or exceed its historical performance or the historical performance of the group of comparable public companies on any of the metrics described in paragraph D(2) above, document in writing all material assumptions supporting such projections and why those assumptions are reasonable.
5. To the extent that the Trustee or its valuation advisor considers any of the projections provided by the ESOP sponsor to be unreasonable, document in writing any adjustments made to the projections.
6. If adjustments are applied to the company's historical or projected financial metrics in a valuation analysis, determine and explain in writing why such adjustments are reasonable.
7. If greater weight is assigned to some valuation methods than to others, explain in writing the weighting assigned to each valuation method and the basis for the weightings assigned.
8. Consider, as appropriate, how the plan document provisions regarding stock distributions, the duration of the ESOP loan, and the age and tenure of the ESOP participants, may affect the ESOP sponsor's prospective repurchase obligation, the prudence of the stock purchase, or the fair market value of the stock.

9. Analyze and document in writing (a) whether the ESOP sponsor will be able to service the debt taken on in connection with the transaction (including the ability to service the debt in the event that the ESOP sponsor fails to meet the projections relied upon in valuing the stock); (b) whether the transaction is fair to the ESOP from a financial point of view; (c) whether the transaction is fair to the ESOP relative to all the other parties to the proposed transaction; (d) whether the terms of the financing of the proposed transaction are market-based, commercially reasonable, and in the best interests of the ESOP; and (e) the financial impact of the proposed transaction on the ESOP sponsor, and document in writing the factors considered in such analysis and conclusions drawn therefrom.

E. Financial Statements.

1. The Trustee will request that the company provide the Trustee and its valuation advisor with audited unqualified financial statements prepared by a CPA for the preceding five fiscal years, unless financial statements extending back five years are unavailable (in which case, the Trustee will request audited unqualified financial statement extending as far back as possible).

2. If the ESOP Sponsor provides to the Trustee or its valuation advisor unaudited or qualified financial statements prepared by a CPA for any of the preceding five fiscal years (including interim financial statements that update or supplement the last available audited statements), the Trustee will determine whether it is prudent to rely on the unaudited or qualified financial statements notwithstanding the risk posed by using unaudited or qualified financial statements.

3. If the Trustee proceeds with the transaction notwithstanding the lack of audited unqualified financial statements prepared by a CPA (including interim financial statements that update or supplement the last available audited statements), the Trustee will document the bases for the Trustee's reasonable belief that it is prudent to rely on the financial statements, and explain in writing how it accounted for any risk posed by using qualified or unaudited statements. If the Trustee does not believe that it can reasonably

conclude that it would be prudent to rely on the financial statements used in the valuation report, the Trustee will not proceed with the transaction. While the Trustee need not audit the financial statements itself, it must carefully consider the reliability of those statements in the manner set forth herein.

F. Fiduciary Review Process – General. In connection with any transaction involving the purchase or sale of employer securities that are not publicly traded, the Trustee agrees to do the following:

1. Take reasonable steps necessary to determine the prudence of relying on the ESOP sponsor's financial statements provided to the valuation advisor, as set out more fully in paragraph E above;
2. Critically assess the reasonableness of any projections (particularly management projections), and if the valuation report does not document in writing the reasonableness of such projections to the Trustee's satisfaction, the Trustee will prepare supplemental documentation explaining why and to what extent the projections are or are not reasonable;
3. Document in writing its bases for concluding that the information supplied to the valuation advisor, whether directly from the ESOP sponsor or otherwise, was current, complete, and accurate.

G. Fiduciary Review Process – Documentation of Valuation Analysis. The Trustee will document in writing its analysis of any final valuation report relating to a transaction involving the purchase or sale of employer securities. The Trustee's documentation will specifically address each of the following topics and will include the Trustee's conclusions regarding the final valuation report's treatment of each topic and explain in writing the bases for its conclusions:

1. Marketability discounts;
2. Minority interests and control premiums;
3. Projections of the company's future economic performance and the reasonableness or unreasonableness of such projections, including, if applicable, the bases for assuming

that the company's future financial performance will meet or exceed historical performance or the expected performance of the relevant industry generally;

4. Analysis of the company's strengths and weaknesses, which may include, as appropriate, personnel, plant and equipment, capacity, research and development, marketing strategy, business planning, financial condition, and any other factors that reasonably could be expected to affect future performance;
5. Specific discount rates chosen, including whether any Weighted Average Cost of Capital used by the valuation advisor was based on the company's actual capital structure or that of the relevant industry and why the chosen capital structure weighting was reasonable;
6. All adjustments to the company's historical financial statements;
7. Consistency of the general economic and industry-specific narrative in the valuation report with the quantitative aspects of the valuation report;
8. Reliability and timeliness of the historical financial data considered, including a discussion of whether the financial statements used by the valuation advisor were the subject of unqualified audit opinions, and if not, why it would nevertheless be prudent to rely on them;
9. The comparability of the companies chosen as part of any analysis based on comparable companies;
10. Material assumptions underlying the valuation report and any testing and analyses of these assumptions;
11. Where the valuation report made choices between averages, medians, and outliers (e.g., in determining the multiple(s) used under the "guideline company method" of valuation), the reasons for the choices;
12. Treatment of corporate debt;
13. Whether the methodologies employed were standard and accepted methodologies and the bases for any departures from standard and accepted methodologies;

14. The ESOP sponsor's ability to service any debt or liabilities to be taken on in connection with the proposed transaction;
15. The proposed transaction's reasonably foreseeable risks as of the date of the transaction;
16. Any other material considerations or variables that could have a significant effect on the price of the employer securities.

H. Fiduciary Review Process – Reliance on Valuation Report.

1. The Trustee, through its personnel who are responsible for the proposed transaction, will do the following, and document in writing its work with respect to each:

a. Read and understand the valuation report;
b. Identify and question the valuation report's underlying assumptions;
c. Make reasonable inquiry as to whether the information in the valuation report is materially consistent with information in the Trustee's possession;
d. Analyze whether the valuation report's conclusions are consistent with the data and analyses; and
e. Analyze whether the valuation report is internally consistent in material aspects.

2. The Trustee will document in writing the following: (a) the identities of its personnel who were primarily responsible for the proposed transaction, including any person who participated in decisions on whether to proceed with the transaction or the price of the transaction; (b) any material points as to which such personnel disagreed and why; and (c) whether any such personnel concluded or expressed the belief prior to the Trustee's approval of the transaction that the valuation report's conclusions were inconsistent with the data and analysis therein or that the valuation report was internally inconsistent in material aspects.

3. If the individuals responsible for performing the analysis believe that the valuation report's conclusions are not consistent with the data and analysis or that the valuation report is internally inconsistent in material respects, the Trustee will not proceed with the transaction.

I. Preservation of Documents. In connection with any transaction completed by the Trustee through its committee or otherwise, the Trustee will create and preserve, for at least six (6) years, notes and records that document in writing the following:

1. The full name, business address, telephone number and email address at the time of the Trustee's consideration of the proposed transaction of each member of the Trustee's Fiduciary Committee (whether or not he or she voted on the transaction) and any other Trustee personnel who made any material decision(s) on behalf of the Trustee in connection with the proposed transaction, including any of the persons identified pursuant to H(2) above;
2. The vote (yes or no) of each member of the Trustee's Fiduciary Committee who voted on the proposed transaction and a signed certification by each of the voting committee members and any other Trustee personnel who made any material decision(s) on behalf of the Trustee in connection with the proposed transaction that they have read the valuation report, identified its underlying assumptions, and considered the reasonableness of the valuation report's assumptions and conclusions;
3. All notes and records created by the Trustee in connection with its consideration of the proposed transaction, including all documentation required by this Agreement;
4. All documents the Trustee and the persons identified in 1 above relied on in making their decisions;
5. All electronic or other written communications the Trustee and the persons identified in 1 above had with service providers (including any valuation advisor), the ESOP sponsor, any non-ESOP counterparties, and any advisors retained by the ESOP sponsor or non-ESOP counterparties.

J. Fair Market Value. The Trustee will not cause an ESOP to purchase employer securities for more than their fair market value or sell employer securities for less than their fair market value. The DOL states that the principal amount of the debt financing the transaction, irrespective of the interest rate, cannot exceed the securities' fair market value. Accordingly, the Trustee will not cause an ESOP to engage in a leveraged stock purchase transaction in which the principal amount of the debt financing the transaction exceeds the fair market value of the stock acquired with that debt, irrespective of the interest rate or other terms of the debt used to finance the transaction.

K. Consideration of Claw-Back. In evaluating proposed stock transactions, the Trustee will consider whether it is appropriate to request a claw-back arrangement or other purchase price adjustment(s) to protect the ESOP against the possibility of adverse consequences in the event of significant corporate events or changed circumstances. The Trustee will document in writing its consideration of the appropriateness of a claw-back or other purchase price adjustment(s).

L. Other Professionals. The Trustee may, consistent with its fiduciary responsibilities under ERISA, employ, or delegate fiduciary authority to, qualified professionals to aid the Trustee in the exercise of its powers, duties, and responsibilities as long as it is prudent to do so.

M. This Agreement is not intended to specify all of the Trustee's obligations as an ERISA fiduciary with respect to the purchase or sale of employer stock under ERISA, and in no way supersedes any of the Trustee's obligations under ERISA or its implementing regulations.

IN WITNESS WHEREOF, the Secretary and GreatBanc have executed this Agreement in duplicate originals on the dates indicated by their respective signatures.

FOR THE SECRETARY:

PATRICIA SMITH
Solicitor of Labor

G. WILLIAM SCOTT
Acting Associate Solicitor
Plan Benefits Security Division

RISA D. SANDLER
Counsel for Fiduciary Litigation

ROBERT L. FURST
Senior Trial Attorney

Syma Ahmad ____________ Date: 6/2/2014
SYMA AHMAD
JEFFREY M. HAHN
DAVID M. ELLIS
Attorneys for Plaintiff

FOR GREATBANC TRUST COMPANY:

By:______________________________ Date:_______

Title:______________________________

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ROBERT L. FURST
Senior Trial Attorney

_______________________________ Date:_______

SYMA AHMAD
JEFFREY M. HAHN
DAVID M. ELLIS
Attorneys for Plaintiff

FOR GREATBANC TRUST COMPANY:

By: _______________ Date: 6/1/2014

Title: Chairman

Special Considerations in Designing and Operating an ESOP
by
Gregory Brown and Kathleen Scheid

ESOP Participant Rights

Distribution Requirements

An ESOP, like other qualified deferred compensation plans, must provide that, unless a participant elects otherwise, the distribution of his or her vested account balance will begin not later than one year after the end of plan year during which he or she terminates employment because of retirement on or after the plan's normal retirement age, disability or death or, if he or she resigns or is dismissed, not later than one year after the end of the fifth plan year following the plan year during which he or she terminates employment (unless the employer reemploys him or her before such year). An ESOP must further provide that, unless the participant elects otherwise, his or her ESOP account balance will be distributed in substantially equal periodic payments (not less frequently than annually) over a period that does not exceed five years. ESOP distributions generally are eligible for rollover to an IRA or another qualified retirement plan.

If employer securities held by an ESOP are not readily tradable on an established market, the ESOP participants must be given the right (a "put option") to require the employer (not the ESOP) to repurchase distributed employer securities under a fair valuation formula. The fair market value for the stock subject to this put option is to be determined by an independent appraiser in accordance with IRC §401(a)(28)(C). To satisfy the put option requirement, the ESOP generally may use the fair market value of the employer securities determined as of the immediately preceding valuation date under the ESOP.

The put option period must cover at least 60 days following the date of distribution. If the put option is not exercised during that period, an additional put option period of at least 60 days must be made available during the next plan year, generally after the new valuation of employer stock has been completed and communicated to the former participant. The put option may not bind the ESOP to repurchase the stock, but may permit the ESOP to purchase stock tendered to the employer.

When a participant or beneficiary takes a total distribution of the employer securities held in his or her ESOP account in one taxable year and exercises his or her put option, the employer must pay the option price in either a single sum or in substantially equal annual installments over a period that begins no later than 30 days after the distributee exercises the option and extends no longer than five years. If the employer chooses the installment payment method, the employer also must provide "adequate security" for the unpaid amounts and must pay a "reasonable" rate of interest on those amounts.

According to the IRS, "adequate security" means security that is backed by something tangible that may be sold, foreclosed upon or otherwise disposed of in case of default. If a participant or beneficiary is receiving installment distributions of his or her ESOP benefits and exercises a put option with respect to an installment, the employer must pay the fair market value of the shares covered by the put option election within 30 days after the exercise.

Diversification

ESOP assets, unlike the assets of most other qualified plans, usually are not invested in a broad range of investment alternatives. Therefore, an ESOP must provide “qualified participants” – those who are at least age 55 and have at least 10 years of participation in the plan – an opportunity to “diversify” their plan holdings that consist of employer securities acquired by the ESOP after 1986. To satisfy this diversification requirement, the ESOP must permit the qualified participants to direct the investment of a certain percentage of the employer securities held in their ESOP accounts into other investment options during the “qualified election period.” The “qualified election period” is the six-plan-year period beginning with or after the plan year in which the participant attains age 55 (or, if later, beginning with the plan year in which the participant completes 10 years of plan participation). Qualified participants are entitled to make their diversification elections during the first 90 days of each plan year during the election period.

An ESOP may satisfy this diversification requirement in two ways. Under one alternative, the plan may distribute to a participant, in stock or cash, the portion of the participant’s account subject to the diversification requirement within 90 days after the period in which the diversification election may be made. If the ESOP distributes stock, the put option requirements apply and the stock may be rolled over into an IRA. An IRA that receives a rollover of ESOP stock retains the put option if the stock is not readily tradable on an established market at the time of distribution. If the ESOP distributes cash, the participant may roll the cash over into an IRA or another qualified plan that accepts rollovers. Any portion of a diversification distribution that is not rolled over is subject to taxation, including the 10 percent early distribution penalty under IRC §72(v).

The other alternative is for the ESOP to make available to qualified participants at least three diversified investment options (other than employer stock).133 An option to transfer assets to a plan that permits employee self-direction of investments (such as the employer’s 401(k) or profit-sharing plan) satisfies the diversification requirement, but an option to invest in employer securities does not. The ESOP is only required to offer the distribution or investment options to qualified participants. A participant does not have to accept the diversification opportunity and may choose to keep his or her ESOP account fully invested in employer securities.

Calculation of Diversification Portion

The portion of a qualified participant’s account that is subject to the diversification election during the qualified election period is equal to:

• 25 percent (for the first five years of the qualified election period) of the total number of shares of employer securities acquired by or contributed to the plan after 1986 that have ever been allocated to the qualified participant’s account on or before the most recent plan allocation date, less

• the number of shares of employer securities previously distributed, transferred or otherwise diversified pursuant to a diversification election made after 1986.

The resulting number of shares may be rounded to the nearest whole number. With respect to a qualified participant's final diversification election in the sixth year of the qualified election period, "50 percent" is substituted for "25 percent" in determining the amount subject to the diversification election.

The diversification computation is based solely on the number of shares allocated to the qualified participant's account. Other assets allocated to the account are not included in the computation.

Example: Amy begins participating in an ESOP in 2007 at age 46. Assuming that she remains employed by the employer sponsoring the ESOP, in the year 2017 she will have participated in the plan for 10 years and will be age 56. Therefore, for 2017 and each of the next five plan years, Amy will be eligible to elect a pre-retirement diversification distribution or transfer. If Amy has 100 shares of employer stock credited to her ESOP account at the end of the 2017 plan year, during the first 90 days of 2018 she may elect a diversification distribution or transfer of up to 25 shares (25 percent of 100 shares). Amy elects a distribution of 10 shares. At the end of 2018, Amy has 8 new shares of employer stock credited to her ESOP account. During the first 90 days of 2019, she may elect a distribution or transfer of up to 17 shares (25 percent of 108 total shares allocated to her ESOP account, minus the 10 shares previously diversified). Each year from 2017 through 2021, Amy's diversification election may result in the distribution or transfer of up to 25 percent of the number of shares allocated to her ESOP account, reduced by the number of shares previously diversified. For 2022, the final year of her qualified election period, Amy may elect to diversify up to 50 percent of the number of shares allocated to her ESOP account, reduced by the number of shares covered by her earlier diversification elections.

Voting Rights

The voting rights requirements of IRC §409(e) apply only to shares of employer stock allocated to participant accounts. To the extent that shares in an ESOP are not allocated (such as shares acquired since the last allocation date, or shares held in a suspense account), the ESOP trustee may exercise its discretion in voting such shares, unless the plan provides otherwise.

After October 21, 1986, an ESOP sponsored by a corporation that does not have a registration-type class of securities may provide each participant one vote on each issue on which he or she is entitled to direct the trustee to vote (without regard to the actual number of shares allocated to his or her account) and the trustee may vote the shares held in the plan in the proportions so directed by participants.178 Under this voting method, the trustee does not vote unallocated shares in its discretion. The IRS has ruled that an ESOP trustee may vote shares allocated to participants' and beneficiaries' accounts for which no directions are timely received without causing the ESOP to fail to comply in operation with the pass-through voting requirements of §409(e)(2).

The DOL has issued guidance regarding the duties of employee benefit plan fiduciaries in proxy voting situations which generally applies to all defined contribution retirement plans. However, DOL Interpretive Bulletin 94-2 also provides guidance that is particularly pertinent for ESOP fiduciaries regarding the requirements for more active monitoring of corporate management. The DOL's opinion is that, in situations in which proxy voting decisions may affect the value of a plan's investment in company stock, plan fiduciaries should make voting decisions with a view to enhancing value, taking into account the period over which the plan expects to hold the stock. In certain situations, it may be appropriate for a plan fiduciary to act to monitor or influence corporate management if the fiduciary expects that such activities are likely to enhance the value of the plan's investment.

The DOL Bulletin lists several issues that might prompt active monitoring and communication by fiduciaries, including the following:

- investigating the independence and expertise of candidates for the board of directors
- ensuring that the board of directors has sufficient information to carry out its responsibility to monitor management
- determining the appropriateness of executive compensation
- examining corporate policy regarding mergers and acquisitions
- analyzing the extent of debt financing and capitalization
- investigating long-term business plans and workforce development; and
- reviewing financial and non-financial measures of corporate performance.

Fiduciaries may carry out their monitoring and communication role through various methods, such as conducting meetings and corresponding with corporate management and exercising the legal rights of a shareholder.

Annual Valuation

IRC §401(a)(28)(C) provides that an ESOP that holds employer securities acquired after 1986 that are not readily tradable on an established securities market must have all valuations of those securities made by an independent appraiser. An "independent appraiser" means any appraiser that satisfies requirements similar to the requirements described in the regulations under IRC §170(a)(1). Generally, the ESOP independent appraiser should be a person who does not perform any services for a party whose interests may be adverse to the ESOP and who would satisfy an objective standard of impartiality.

Treasury Regulation Section 54.4975-11(d)(5) states that "valuations must be made in good faith and based on all relevant factors for determining the fair market value of securities." For transactions that do not involve a disqualified person, value may be determined as of the most recent annual valuation date and an independent appraisal will be determinative. For transactions between a plan and a disqualified person, value must be determined as of the date of the transaction, and an independent appraisal will be required for acquisitions after 1986.

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Employee Stock Ownership Plans: Are They Worth the Risks?

Introduction

Enron, Radio Shack, and United Airlines are a few of the many companies that have used employee stock ownership plans ("ESOPs") to link employee retirement benefits with company performance through investments in employer securities. When these companies went bust, their employees lost over a billion dollars in retirement savings.[1] Despite these past failings, the number of ESOPs has continued to increase,[2] thanks to the special tax breaks ESOPs receive.[3] Given their role in business transitions for retiring business owners,[4] and the positive arguments that can be mad e for ESOPs,[5] ESOP participation is likely to continue growing over the next decade. Yet, little attention has been paid to the risks that ESOPs present.[6]

In good financial times, ESOPs have the appearance of being an excellent deal for employees, because ESOPs offer partial ownership over the company that employs them. However, ESOPs pose serious

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[1] The value of Enron's retirement plan declined by $1.3 Billion. See David K. Millon, "Enron and the Dark Side of Worker Ownership," 1 Seattle J. For Soc.Just.113 (2002). United Workers agreed to wage cuts and a $4.9 billion loan in exchange for a 55 percent stake in the company. See Rachel Beck, "United Airlines' Employee Stock Ownership Program Doomed from Start," *Peninsula Clarion* (December 13, 2002), available at http://peninsulaclarion.com/stories/121302/bus_121302bus0050001.shtml#.VtR06lIYG6A (last visited May 3, 2016). Radio Shack securities in its 401(k) tumbled from $142 million in June 2007 to $3.5 million in June 2014. Mitchell Schnurmann, "Employees Net Their Future on RadioShack Shares," *The Dallas Morning News* (February 2, 2015), available at http://www.dallasnews.com/business/columnists/mitchell-schnurman/20150202-schnurman-employees-bet-their-future-on-radioshack-shares.ece (last visited May 3, 2016). Also see RadioShack form 5500 for plan years 2009 and 2013, which can be found through the Department of Labor at https://www.efast.dol.gov/portal/app/disseminate?execution=e1s1 (last visited May 3, 2016).

[2] According to The ESOP Association, a non-profit organization representing companies that sponsor ESOPs, there were approximately 10,000 ESOPs in the United States as of 2015, covering 10.3 million employees, or 10% of the U.S. private sector workforce. http://www.esopassociation.org/explore/employee-ownership-news/resources-for-reporters#statistics (last visited April 1, 2016).

[3] The tax benefits include Internal Revenue Code (I.R.C.)/26 U.S.C. §§:

- 402(e)(4) (nonrecognition of gain for the appreciation on the employer stock when distributed in kind)
- 404(k) (permitting a corporation to deduct dividends it pays to an ESOP)
- 409(p) and 512(e)(3) (permitting deferred taxation of an S corporation's business income to the extent it is owned by an ESOP)
- 415(c)(6) (permitting larger allocations to a participant's ESOP account)
- 1042 (no tax due on sale of privately traded stock to an ESOP).

The Treasury Department values these tax benefits at more than $25 billion over fiscal years 2016-2025. Department of the Treasury, Office of Tax Analysis, *Tax Expenditures*, Table 3 (published November 11, 2015), available at https://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2017-11132015.pdf (last visited May 2, 2016).

[4] See articles by National Center for Employee Ownership on business continuity and business transitions through ESOP. For example, NCEO, "Using an Employee Stock Ownership Plan (ESOP) for Business Continuity in a Closely Held Company," https://www.nceo.org/articles/esop-business-continuity (last visited Feb 29, 2016).

[5] See, e.g., Corey Rosen, *Do ESOPs need Reform? A Look at What the Data Tell Us*, 147 TAX NOTES (2015), available at https://www.nceo.org/assets/pdf/articles/Do-ESOPs-Need-Reform-Rosen.pdf (last visited May 3, 2016). Rosen argues, for instance, that ESOPs are better than traditional 401(k)s for low-income and younger employees because they do not require employee contributions, and that employer contribution rates in ESOPs are higher. Rosen also notes that employers sponsoring ESOPs are more likely to have a second retirement plan in addition to an ESOP, rather than substituting an ESOP for other types of retirement plan.

[6] See, however, Karla Walter & Danielle Corley, *Mitigating Risk to Maximize the Benefits of Employee Ownership*, CENTER FOR AMERICAN PROGRESS (2015), https://www.americanprogress.org/issues/economy/report/2015/10/28/124511/mitigating-risk-to-maximize-the-benefits-of-employee-ownership/ (last visited May 3, 2016).

risks that employees may not recognize until it's too late. This paper shows how participants in ESOPs do not face just a single risk, but a complex set of interrelated risks to their retirement benefits.

Unlike other retirement instruments, ESOPs are excessively invested in employer stock. This means that a financial decline for an employer that sponsors an ESOP equals a financial decline for its retirement plan. Moreover, employees are likely to lose their jobs and cash out their benefits at the exact time that their retirement plan has its lowest value. For companies whose stock is not publicly traded, the cash flow loss from benefit payments can accelerate the employer's financial decline. Leveraged ESOPs, one of the three basic types of ESOPs, create additional opportunities for owners to abuse employee retirement benefits.

The question decision-makers and employees should be asking themselves is, "Are ESOPs worth the risks?"

What is an ESOP?

An ESOP is a retirement plan comprised of separate accounts for each employee participating in the plan that are invested primarily in stock of the employer.[7] Therefore, over an employee's career, his or her account will increase in value if the stock appreciates and will lose value if the stock depreciates. In baseball terminology, the employee can hit a home run or can strike out, depending on the stock value at retirement.

Three Fundamental Problems in ESOPs

There are three fundamental problems in ESOPs, each of which corresponds to three fundamental types of ESOP.[8]

1. Too Much in a Single Stock

A fundamental principle of investing is to diversify so that too many eggs do not end up in a single basket.[9] The federal laws governing employer-sponsored retirement plans, such as pensions and 401(k) plans, require that the individuals in charge of investing plan assets diversify.[10] But there is an exception for ESOPs, which are designed to be invested in employer stock.[11] If the employer gets into financial difficulty, that difficulty will eventually be reflected in the stock price, so participants' retirement savings will suffer more because they will be disproportionately invested in a single, poorly performing stock. Furthermore, even when an ESOP allows participants to elect out of employer

[7] ERISA § 407(d)(6), 29 U.S.C. § 1107(d)(6), I.R.C. § 4975(e)(7), 26 U.S.C. § 4975(e)(7).

[8] The three types of ESOPs are:

(i) ESOPs where most of the plan is invested in publicly traded employer stock.

(ii) ESOPs that hold privately traded stock (often S corporation stock).

(iii) Leveraged ESOPs, where the plan acquires stock from a principal owner using funds borrowed from a bank or other commercial lender.

Each of these three types can overlap with one another.

[9] See, for example, the Securities and Exchange Commission's "Beginner's Guide to Asset Allocation, Diversification and Rebalancing," available online at http://www.sec.gov/investor/pubs/assetallocation.htm (last visited April 1, 2016).

[10] ERISA § 404(a)(1)(C), 29 U.S.C § 1104(a)(1)(C). The law also contains a rule prohibiting a retirement plan to invest more than 10 percent of its assets in employer stock. ERISA § 407(a)(3), 29 U.S.C. § 1107(a)(3).

[11] ERISA sections 404(b) and 407(b), 29 U.S.C. §§ 1104(b) and 1107(b).

stock,[12] they often do not do so.[13] This places at greater risk those loyal employees whose faith in their employers leads them to hold on to the bitter end.

This problem is compounded by the fact that the dates when an employer lays off workers often correspond to dates when its stock value is down, so that the employer's stock tends to have *low values* at exactly those times when participants have *the greatest likelihood of needing to sell the stock*. No other retirement investment has this peculiar feature.

For example, RadioShack was a well-known entity that went through difficult times, and most of its employees are now out of a job. But its problems also led to corresponding problems for its employees' retirement savings.[14] RadioShack made matching contributions to its 401(k) plan in the form of RadioShack stock and, since 1990,[15] also had a separate ESOP invested in RadioShack stock that was merged into the RadioShack 401(k) plan in 2002[16]. Thus, the company's 401(k) plan contained an ESOP feature, causing participants who took advantage of the ESOP feature to become overinvested in employer stock. Radio Shack's stock traded at about $50 per share 20 years ago, at about $25 per share 10 years ago, and was at about 25 cents per share around the time of its bankruptcy in February 2015[17]. That means that, of its approximately 27,000 employees, those whose retirement savings accounts remained invested in RadioShack stock are now left with very little. This collapse in the employer's stock value over a 20-year period has been a particular disaster for the most loyal employees, who stayed throughout the decline.

Other high-profile examples of bankruptcies that led to dramatic losses of ESOP value are Enron in 2001,[18] Polaroid in 2001,[19] and United Airlines in 2002.[20]

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[12] While a participant has a right to elect to liquidate any employer stock held in his or her account in an ESOP holding *publicly traded stock* that is *part of a 401(k) plan*, that right does not apply in other ESOPs until after the employee has attained age 55 and participated in the ESOP for at least 10 years. ERISA § 204(j), 29 U.S.C. § 1054(j), I.R.C. § 401(a)(35), 26 U.S.C. §401(a)(35) gives participants in an ESOP holding publicly traded stock that is part of a 401(k) plan the right to diversify generally after three years of service. By contrast, participants in any other ESOP (i.e., an ESOP holding publicly traded stock that is not part of a 401(k) plan and an ESOP holding privately traded stock) only have the right to diversify a portion of their account over a six-year period (25 percent cumulative during the first five years and 50 percent cumulative in the 6th year) and only after attaining age 55 and 10 years of participation. I.R.C. §§ 401(a)(28) and 401(a)(35)(E)(ii), 26 U.S.C. §§ 401(a)(28) and 401(a)(35)(e)(ii).

[13] A high-profile example of a company whose employees had the opportunity to diversify out of employer stock in an ESOP before the stock value collapsed is Enron, which declared bankruptcy in 2001. Enron's pension plan contained an ESOP feature in which employees were allowed to diversify out of Enron stock that had been held for more than 5 years, but many did not. That stock eventually became worthless. Dugas, Christine, "Enron's Dive Destroys Workers' Pensions," *USAToday* (February 5, 2002), available at http://usatoday30.usatoday.com/money/energy/2002-02-06-enron-pensions.htm (last visited May 3, 2016).

[14] Thornton, Nick, "RadioShack Facing 401(k) Suits," *BenefitsPro* (February 6, 2014), available at http://www.benefitspro.com/2015/02/06/radioshack-facing-401k-suits (last visited May 3, 2016).

[15] RadioShack Annual 10-K report for 1993 filed with SEC on March 30, 1994, http://www.sec.gov/Archives/edgar/data/96289/0000096289-94-000029.txt.

[16] RadioShack Annual 10-K report for 2002 filed with SEC on March 28, 2003, available at http://www.sec.gov/Archives/edgar/data/96289/000009628903000003/0000096289-03-000003.txt (last visited May 3, 2016).

[17] Historical Radio Shack (RSH) prices taken from 10-K reports for 1995, 2005, and 2015, available at http://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&filenum=001-05571&owner=include&count=100 (last visited May 3, 2016).

[18] See Dugas, Christine, "Enron's Dive Destroys Workers' Pensions."

[19] Krasner, Jeffrey, "Polaroid Retirees Pay Price," *SFGate* (October 25, 2001), available at http://www.sfgate.com/business/article/Polaroid-retirees-pay-price-2865832.php (last visited May 3, 2016).

2. **Cash Distributions from ESOPs Holding Privately Traded Stock**

For a corporation whose ESOP is invested in publicly traded stock, the problem with its ESOP is limited to the risks associated with overinvestment in a single equity stock (it might do well, or it might be a disaster, akin to gambling). But for a corporation whose ESOP is invested in privately held stock that is not readily tradable on an established securities market[21] there are serious additional risks that can quickly escalate into a disaster for both the employees covered by the ESOP and the corporation itself, producing a vicious cycle.

An employee participating in an ESOP holding privately traded stock will need to have the value of the stock in his or her account paid out in cash during retirement, because there is no ready market in which to sell privately traded stock. The tax law guarantees employees participating in these types of ESOPs the right to receive payouts in cash, along with the right to have that stock's value determined using a "fair valuation formula."[22] This arrangement also benefits employers because employees, presumably, are better workers when they have a stake in the employer's success. So what could go wrong?

First, the value of the stock for purposes of the cash payouts must be determined by an independent appraiser.[23] But the person who makes that calculation is selected, either directly or indirectly, by the employer,[24] which might create a conflict of interest, since that person owes his or her job to the employer. An employer may be tempted to manipulate the stock value to appear lower if an employee with a large balance is coming up for a distribution or if the employer is in a cash flow crisis. Conversely, the employer may want to manipulate the stock value to be higher at the time the ESOP acquires the stock[25] or when a person controlling the plan is coming up for a distribution.

Second, participants in an ESOP technically do not have ownership rights to the employer stock held in their account because the stock is held in trust. This means that, even though the stock is being held in the ESOP for the exclusive benefit of the participants, the trustee – who is typically selected by the officers of the company – is the actual shareholder and thus exercises voting rights under the stock,

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[20] Ransom, Diana, "Giving Employees a Share," *Wall Street Journal* (November 17, 2009), available at http://www.wsj.com/articles/SB10001424052748704431804574540161152220116 (last visited May 3, 2016).

[21] An ESOP can hold privately traded stock only if the employer has no publicly traded stock. I.R.C. § 409(l)(1), 26 U.S.C. § 409(l)(1), 26. There are exceptions for convertible, noncallable preferred stock. I.R.C. § 409(l)(3), 26 U.S.C. § 409(l)(3) and for a newspaper that has multiple classes of stock. I.R.C. § 409(l)(5), 26 U.S.C. § 409(l)(5)..

[22] I.R.C. § 409(h)(1)(B), 26 U.S.C. § 409(h)(1)(B).

[23] I.R.C. section 401(a)(28)(C), 26 U.S.C. 401(a)(28)(C).

[24] The plan documents would typically allocate selection of the independent appraiser to the trustee, and the plan trustee is permitted to be an officer of the company. Alternatively, the plan document could allocate selection of the evaluator to an administrative body, such as the plan administrator (typically an employee or committee of employees of the company). Even if the evaluator is a professional selected by an independent bank trustee, the evaluator knows that the trustee that hired the evaluator serves at the pleasure of the employer.

[25] See, for example, Reich v. Valley National Bank 837 F. Supp. 1259 (S. D. NY 1993).

including selection of the board of directors.[26]

Third, the existing cash payout legal requirements enable employers to delay payouts for months or even years,[27] causing retiring employees to experience financial difficulty. While employers typically prefer for former employees to be paid out promptly, that attitude can quickly change if the corporation has a cash-flow problem. Retirement plans sponsored by private employers generally cannot cut back on lump-sum payout rights, but ESOPs holding privately traded stock are exempt from that rule, so if an employer has cash-flow difficulties, it can amend the plan at any time, without notice, and with an immediate effective date, to shift from lump sum payouts to five-year installments for its recently retired employees with the installments not even starting until seven years later. [28]

Moreover, corporations in severe financial difficulty often reduce their workforces. In that case, the laid-off workers would have the right to be paid eventually, *but the obligation to pay them would accelerate the corporation's cash flow challenges,* creating a vicious cycle in which the employer's financial problems compel it to lay off employees, the employer must pay those employees their retirement benefits, further exacerbating the financial problem, and leading to more layoffs.

If the employer simply does not have the cash to make the required payout, it will have violated the tax laws governing ESOPs.[29] The only action currently available to the IRS would be to eliminate the ESOP's tax-favored treatment and charge taxes on all of the ESOP's assets.[30] This would, however, result in companies terminating their ESOPs, as well as significant tax penalties to the innocent employees relying on the ESOP for their retirement income, neither of which will cause the employer to distribute money it doesn't have. And if a participant were to sue the plan individually in an attempt to obtain benefits, that lawsuit would achieve nothing if the employer has no money to pay the participant after the lawsuit.

3. Abuses Particular to Leveraged ESOPs

[26] I.R.C./26 U.S.C. §§ 401(a)(22) and 409(e) require that participants in ESOPs holding privately traded stock have the right to vote only on limited issues relating to major corporate mergers, sales, and reorganizations.

[27] ESOPs that offer lump-sum distributions can delay distribution for months: payouts in stock can be delayed until after the plan's next annual valuation, and cash does not have to be made available until a 60-day period after distribution of the stock. For example, an employee terminating employment in September of a calendar year would generally not be entitled to be paid until <u>the middle of the next year</u>. I.R.C. § 409(h)(4), 26 U.S.C. § 409(h)(4). Further, an employee terminating employment by reason of normal retirement age (such as after age 65), disability, or death only has a right to be paid in installments over five years commencing within one year after the end of the plan year of termination, which results in a delay of up to <u>two years</u> after the employee retires before the installments even begin. I.R.C. § 409(o)(1)(A)(i), 26 U.S.C. § 409(o)(1)(A)(i). Distributions to any other former employee can be delayed so that similar installments over five years do not even begin until up to <u>seven years</u> after the employee terminates employment. I.R.C. § 409(o)(1)(A)(ii), 26 U.S.C. § 409(o)(1)(A)(ii).

[28] ERISA § 204(g)(3), 29 U.S.C. § 1054(g)(3), I.R.C. § 411(d)(6)(C), 26 U.S.C. § 411(d)(6)(C), and 26 C.F.R. § 1.411(d)-4, Q&A-2(d)(1)(i).

[29] An ESOP typically does not hold free cash, so that cash payouts are made either (1) by the trustee by selling the stock to the employer or (2) by the employer after the stock has been distributed to the employee or his/her beneficiary under the put option rules at I.R.C. § 409(h)(1)(B) and (4), 26 U.S.C. § 409(h)(1)(B) and (4).

[30] Failure to comply with the terms of the plan causes plan disqualification. See also I.R.C. §§ 401(a)(23) and 4975(e)(7)(A), 26 U.S.C. §§ 401(a)(23) and 4975(e)(7)(A).

Retirement plans exist for the exclusive purpose of providing benefits to the employees participating in the plan, and employers generally cannot use retirement plan assets to finance employer operations. [31] Retirement plan assets must be used to provide additional retirement benefits or to pay fees related to the administration of the retirement plan. In the case of leveraged ESOPs, however, employers have the ability to avoid taking out a loan from a bank by having their ESOPs borrow from a bank instead (with the employer's guarantee, since the ESOP is not creditworthy by itself). The ESOP can then use that loan to purchase employer stock, and use the revenue from that stock sale to finance employer operations.[32]

For example, if an employer thinks the market has undervalued its publicly traded stock, it could establish an ESOP which borrows from a bank, have the ESOP use the loan to buy its own stock on the market, and then have the employer pay off the debt by making periodic contributions to cover the ESOP's debt repayments.[33] Likewise, an ESOP could borrow money to buy out the current owner when he or she retires, with the shares allocated over the loan repayment period. Then, if the company does poorly,[34] that becomes the problem of the employees participating in the ESOP rather than the previous owner, who had already been bought out.

Using leveraged ESOPs as tools for these types of corporate finance purposes can significantly harm the retirement security of the employees participating in that ESOP. While federal law requires that an ESOP loan be primarily for the benefit of the employees,[35] this has not prevented employers from abusing the ESOP rules when it is beneficial to the employer's owner.

An example is a situation where an ESOP loan had a 20-year term, with loan repayments limited to interest only until the final payment, so that the principal was not due until the end of the 20 years. At the end of the 20-year term, instead of repaying the principal, the loan was refinanced for an additional 10-year period (with principal still not repaid until the end). In a leveraged ESOP, the employer does not have to pay any retirement benefits until the debt has been fully repaid.[36] So, in this case, the participants do not have the right to receive any of their ESOP payments for 30 years.

Ways to Address These Problems

[31] ERISA §§ 404(a)(1)(A) and 406(a)(1)(B), 29 U.S.C. §§ 1104(a)(1)(A) and 1106(a)(1)(B).

[32] For more information on leveraged ESOPs and a helpful flowchart depicting how leveraged ESOPs work, visit the ESOP Association website at http://www.esopassociation.org/explore/how-esops-work/learn-about-esops/leveraged (last visited April 1, 2016).

[33] The purchased stock is held in the ESOP initially in a separate account (called a suspense account) for the benefit of no particular participating employees, and those shares are allocated annually from the suspense account to the ESOP accounts of participating employees as the debt is repaid. The shares released from the suspense account for a year are based on how much the debt repayments for the year are as a percentage of all current and future debt repayments, which results in the same number of shares of the acquired stock being released every year assuming the debt is repaid in level repayments over more than 10 years. 26 C.F.R. § 54.4975-7(b)(8).

[34] Or not as well as assumed by the valuator hired by the owner to determine the purchase price.

[35] ERISA § 408(b)(3)(A), 29 U.S.C. § 1108(b)(3)(A), I.R.C. § 4975(e)(3)(A), 26 U.S.C. § 4975(e)(3)(A).

[36] I.R.C. § 409(o)(1)(B), 26 U.S.C. § 409(o)(1)(B).

ESOPs have been growing rapidly in recent years, thanks to the special income tax subsidies for ESOPs. But little attention has been paid to the various problems that ESOPs present.
ESOPs are not saddled with a single problem, but a set of interrelated problems beginning with excessive concentration in a single equity-based stock, which then tends to be sold when its value is lowest. For privately traded companies, the resulting future cash flow drain of benefit payments can accelerate the employer's financial decline, while leveraged ESOPs create the opportunity for owner abuses.

The following simple, modest measures could protect employees whose retirement savings are held in ESOPs.

For all ESOPs:

- Direct a study of ESOPs by the Government Accountability Office (GAO) investigating, among other things, the rate of failure among ESOPs.[37]
- Require that participants in all plans have the same right to diversify out of employer stock as participants in ESOPs holding publicly traded stock that are part of a 401(k) plan.
- Encourage participants to elect out of employer stock if they have the right to do so. For example, require that a notice be given to participants encouraging them to invest no more than 10 percent of their total retirement savings in a single stock and warning them of the problems of investing in stock of the employer (such as those identified above in this paper, including the potential for payout delays).[38]
- Require that, when an employer amends its ESOP to take away participants' rights to accelerated payouts, such an amendment shall not take effect for at least 90 days after participants are notified of the amendment, giving eligible employees the opportunity to terminate employment and cash out their ESOP benefits under the old rules.
- Eliminate the very generous tax benefits for ESOPs, so there is not such an extreme government-provided incentive in favor of ESOPs, and to eliminate government involvement in competitive business structures.

For ESOPs holding privately traded stock:

[37] There will of course be ESOP successes too, but how high does the rate of successes have to be to justify the failures? Retirement investments should minimize the risk of large losses. ERISA section 404(a)(1)(C), 29 U.S.C. §1104(a)(1)(C).
[38] IRS Notice 2006-107, 2 C.B. 1114, includes a model notice recommending diversification. Unfortunately, the notice is only required (under ERISA section 101(m), 29 U.S.C. § 1021(m)) to be provided to participants with diversification rights under ERISA section 204(j). 29 U.S.C. § 1054(j), I.R.C. § 401(a)(35), 26 U.S.C. § 401(a)(35) (i.e., ESOPs that are part of a 401(k) plan), not to ESOPs to which I.R.C. § 401(a)(28) / 26 U.S.C. § 401(a)(28) applies). In addition, the notice only includes a weak warning that more than 20% "may not be properly diversified."

- Require that participants have the corporate voting rights of any shareholder, especially the right to select the members of the board of directors (so they actually have this principal power of an owner).[39]
- Require that the trustee be an independent bank, not an officer of the corporation.[40]
- Require that valuations be done by an independent professional in the business of valuing privately traded stock, who is appointed by the bank trustee.
- Require some free cash to be held in the plan as a reserve for cash payouts, such as the greater of 10 percent of the ESOP's assets or the amount projected to be required to make cash payouts in the near future, such as over the next five years.
- Give all participants the right to receive prompt cash payouts (e.g., in installments over three years, beginning within six months after termination of employment).
- Impose a penalty (such as an excise tax or personal liability) on the responsible corporate officer or the trustee (to the extent the trust holds free cash) if there is a failure to satisfy the cash payout rules.
- Organize the formal protections for participants in ESOPs to be located in both the tax law and in ERISA so that participants can sue to obtain their rights (instead of having to depend on the IRS to take action).

For leveraged ESOPs:

- Strengthen the requirement that an ESOP loan be primarily for the benefit of plan participants and beneficiaries, for example, by limiting the length of the loan to a reasonable term, such as 15 years, requiring level debt payments so that a significant portion of the debt is paid off every year rather than leaving the payment of principal to the very end of the loan term, and allowing changes to lengthen the loan term only in cases in which an independent professional determines that the employer is in severe financial distress.
- Eliminate the special payout delay described above for leveraged ESOPs.

The simplest (non-modest) change for all ESOPs would be to simply eliminate the exception which allows statutorily imprudent overinvestment in employer stock.[41]

[39] Well-run companies with ESOPs communicate regularly with plan participants, including sometimes providing detailed financial information about how the company is doing.
[40] Having an independent trustee is already widespread practice for ESOPs holding privately traded stock.
[41] Note that Fifth Third Bankcorp v. Dudenhoefer, 134 S. Ct. 2459, 189 L Ed. 2nd 457, 58 EBC 1405 (June 25, 2014), rejected a judicially-created presumption of prudence for retirement plan investments in employer stock.