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ESOP news Perspective

Problems To Avoid In ESOP Distributions

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ESOP distributions can be the most complex and challenging area of ESOP design and administration. As discussed in detail in our articles *Designing And Drafting ESOPs*[1], and *Avoiding ERISA Liability Issues In ESOP Repurchase Liability Planning*[2], ESOP sponsors and fiduciaries must be extremely careful to avoid fiduciary exposure, corporate liquidity (i.e., repurchase liability) problems and disgruntled participant claims.

Most ESOP distribution issues arise out of:

- Designing and drafting distribution provisions.
- Amendments and using distribution policies.
- Distribution forms and administration.

DESIGNING AND DRAFTING DISTRIBUTION PROVISIONS

The adverse impact of ESOP distribution provisions on company profits must be balanced with the company's desire to provide meaningful benefits to plan participants. In most cases, ESOP plan design starts with the assumption that distributions should resemble the form and timing for distributions from profit sharing plans or other plans sponsored by the employer. It is not unusual to find ESOPs drafted to provide distributions commencing in the year after separation from service and including single sum distributions. Often single sum distributions are called for in the document to allow distributees to take advantage of capital gain treatment for the appreciation in the stock's value - a sound, but often impractical planning point. We sometimes find ESOP plan documents drafted to allow the plan administrator to decide to distribute any time up to the sixth year after termination of employment in the administrator's discretion, in an effort to provide flexibility to the company.

The problem with this approach is that by starting with generous distribution provisions, future amendments to modify and extend distribution terms can and will be viewed as a "take away" by ESOP participants. Unfortunately, most times an exercise of the plan administrator's discretion to delay distributions or not offer a single sum payment is because of changes in the company's profitability. However, sometimes this occurs in anticipation of such a decline, and plan participants view it as somewhat arbitrary. The worst case scenario would involve

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[1] NCEO "Journal of Employee Ownership of Law and Finance," Vol. 20, No. 3, Summer 2008. Published by the National Center For Employee Ownership
[2] "Journal Of Pension Benefits," Spring 2006, Vol. 13, Number 3, © 2006, Aspen Publishers, Inc.

plan participant special circumstances that may result in an allegation of discriminatory treatment.

Plan sponsors are also cautioned to ensure that the summary plan description does not conflict with plan document or create an ambiguity between the plan document and the summary. For example, if a plan participant wishes to assert the more generous summary plan description provision (perhaps in the face of an attempt to exercise discretion by a plan administrator) the company should consult with counsel. The law on point varies because of the different federal Circuit courts, but in the Ninth Circuit for example, a plan participant has the right to the benefits, rights and features which are provided in the more participant-favorable document. This means that if the plan document is more favorable, then this is enforceable against the company; or if the summary plan description is more favorable, the participant may enforce the terms of the summary plan description.

When drafting, keep in mind that there are numerous exceptions to an employee's statutory right to request a distribution in shares from an ESOP. There are also multiple mechanisms for converting ESOP participant stock accounts into cash for distribution or direct rollover, as most employees desire. For example, many corporations rely on restrictions in corporate articles or bylaws to prohibit plan participants from taking a stock distribution. The Code permits an articles or bylaw restriction so that only employees of a corporation or an employee ownership trust may own shares of a company. However, we often see companies with non-employee shareholders rely on such a provision. We also find that these provisions are often in place or not properly drafted in the corporation's documents, even though the administrator or document drafters incorrectly believe that they are. Note also that corporate articles calling for "statutory close corporation" status are both insufficient for this purpose and create a whole host of corporate governance problems when there is an ESOP shareholder.

In most situations, we find plan documents drafted to include every alternative provision and clause found in the Internal Revenue Code. All of these ESOP-specific provisions and the Code provisions governing all retirement plan distributions are included, without much clarity as to how to apply the interrelating provisions. As a result, it is not clear exactly how the ESOP in question will distribute benefits. The best practice is to spare no effort in explicitly coordinating these alternatives.

AMENDMENTS AND USING DISTRIBUTION POLICIES

For years we have been encountering plan provisions, as described above, which appear to confer, or explicitly confer, discretionary authority on the plan administrator or trustee to change the form or manner in which distributions will be offered. We also find ESOPs relying on a separate document, often referred to as the "distribution policy," which either confers discretion on an administrative

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committee or specifies that modifications may be made to the distribution policy and not to the ESOP plan and trust document.

ESOPs such as these sometimes are relying on language in the Code which states that a plan sponsor may "modify" the ESOP's distribution options as long as it is done in a nondiscriminatory fashion and the modifications comply with the Code's ESOP distribution requirements generally. Some advisors have interpreted "modify" as meaning some action other than a plan amendment. Also, some advisors have taken the position that this Code provision trumps the more specific provisions found in Treasury regulations (enforced by the IRS) under this Code section. Statutorily and enforcement-wise, these are problematic perspectives.

All of the issues raised by this approach cannot be covered in this article, but include:

- The definition of what is the "plan."
- What "modify" means in the Code.
- Who has the power to amend or modify,
- Applying the general nondiscrimination requirements in the Code.

The ERISA definition of a "plan" includes the combination of documents, policies, utterances, etc. that together constitute the terms or benefits available to plan participants. This means that any distribution "policy" is only part of the ERISA plan, but is nevertheless a plan document that is subject to ERISA and the Code's requirements, which include rules and limits on the ability to amend or exercise discretion over the availability of benefits. ERISA also requires that every employee benefit plan provide a procedure for amending the plan and for identifying the persons who have authority to amend the plan. As a result, these plan terms may be amended only by the sponsor of the plan or a party that has been given plan sponsor or "settlor" authority for plan amendments. This must be clear and consistent among all the plan documents. This typically means the board of directors must amend the plan, and not a human resources representative or administrative committee. Attempts to amend or modify without proper plan terms or authority will fail. Delegation of authority using committees of a board of directors or having the sponsor be the plan administrator at the same time all raise subtle issues. There are also timing issues related to amendments to modify distribution terms which go beyond the scope of this article and need to be considered very carefully.

Exercises of discretion viewed as a modification are particularly dangerous because the Treasury regulations specifically state that exercises of discretion over the availability of benefits or alternate forms of distributions are prohibited. The regulations provide the limited circumstances under which an ESOP plan may be amended to change distribution forms. These regulations should be viewed carefully before making any changes. It might be best to include all of the

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permitted amendment alternatives in the powers to amend section of the plan document, along with the stated procedure and have the specific operative distribution provisions in the distribution section of the plan. In this fashion the employer and plan administrator will understand which alternatives are available under the Code and ERISA, from which they may properly amend or choose, subject to the other issues mentioned above.

In the current economic climate and in any situation where a company's liquidity or business circumstances change, plan consultants and attorneys need to be on top of these restrictions and opportunities. Finally, steps should be taken to keep distribution changes out of the hands of fiduciaries and in the hands of the employer, to avoid the application of ERISA's standards to the decision or act of modifying or amending.

DISTRIBUTION FORMS AND ADMINISTRATION

We seldom see ESOP distribution forms that completely and correctly match a plan document and summary plan description as far as types of benefit, rights to alternate forms of benefits and procedures for payment because of the nature of the stock account rights in each (almost) peculiarly unique ESOP. Because ESOP distributions are as complex as we have suggested, boiler plate distribution forms that are useful for 401(k) plans and profit sharing plans seldom address subtleties and complexities related to the ESOP rules and exceptions. Plan administrators should have their forms carefully reviewed and edited, (if not drafted) by plan counsel to ensure that the plan is not being operated contrary to the terms of the plan and the summary plan description. For example, there are three different mechanisms in the Internal Revenue Code under which distributions may be made in stock with those shares repurchased by the corporation to keep them out of the hands of former employees. One of them applies to subchapter S corporations and the other two are available to regular corporations or C corporations. Depending upon which avenue is taken, the paperwork will be significantly different. Cover letters and explanations and disclosures in addition to otherwise standard distribution forms need to be complete. We have seen IRS and DOL auditors asking for these documents and requiring plan administrators to go back to plan participants to offer them the alternate forms of benefits if they have not been properly notified.

ESOP distributions are confusing. Beyond the forms and required disclosures, we recommend communication pieces that are tailored to the client's workforce. Regardless of the educational level or sophistication of the particular company's employees, ESOP distributions typically require a "road map" to make the participant's rights understandable. In our experience, participant rights are widely misunderstood in part due to the general publications that participants will read covering the wide array of ESOP rights and provisions. Unless the plan administrator (at the company) has carefully read <u>the</u> plan document (sometimes

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unintelligible for reasons discussed above) and studied the summary plan description (which often is not tailored enough), they will not be fully aware of their usually specific obligations and mechanics of the distribution process.

No effort should be spared in the first administration cycle for an ESOP after it has been installed, or after the plan has been amended, to ensure that the plan administrator is in line with what the attorneys have done to the documents to stay in compliance with the law.

WHAT TO DO?

Be sure your ESOP documents are specific as to the form and mechanics of participant distributions. Safeguard against changes in distribution rights being construed as fiduciary acts of discretion. Examine your forms closely to ensure they accurately address the customization of your ESOP. Before you change the rules, plan ahead as much as possible, consult your counsel regarding the circumstances of your changes, and communicate the changes carefully.

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