

Repurchase Liability Funding For ESOPs (The Requirements; The Choices)

Revision #3 June 2012

by

Ron J. Lint, ASA, CEO
ATI Capital Group of Colorado, LLC
3578 Hartsel Dr., Unit E, PMB 321
Colorado Springs, CO 80920
ron@aticolorado.com

Employee Stock Ownership Plans (ESOPs) were legislated into existence as part of the Employee Retirement Income Security Act of 1974 (“ERISA”). An ESOP is, therefore, a qualified employee defined contribution plan that invests primarily in the stock of the sponsoring corporation. The purpose of ESOPs is to encourage broad based employee ownership in the private corporate sector. In order to entice company owners to offer ESOPs as an employee benefit, several powerful tax advantages were granted to companies and sellers who would agree to sell their stock, in whole or in part, to an ESOP, including tax deductible principal and interest for the Company on ESOP loans,¹ the ability for a company to deduct dividends paid to an ESOP,² the avoidance of capital gains tax on the proceeds of the stock sale to the seller,³ the ability to purchase capital goods (including, for example, an office building) for 66 cent dollars,⁴ the ability to purchase another company for 66 cent dollars,⁵ and restructuring of existing debt, allowing for the repayment of same with 66 cent dollars.⁶ The tax and financial advantages of a properly instituted ESOP are significant and merit serious consideration by company owners and financial advisors alike.

Advantages are also provided for the employee/participant. Upon death, permanent disability, retirement, or separation from service following vesting of benefits, employees have the right to ‘Put’ the company shares held in their qualified plan accounts to the company, and the company must repurchase the shares at the current fair market value, as determined by an independent valuation expert. The ‘Put’ is required by law.⁷ The sponsoring company must repurchase the stock, and in order for the plan to be in compliance (thus enjoying the tax advantages), the company must provide “adequate security” for this repurchase obligation.⁸ If “adequate security” is not provided, the plan could lose its tax-exempt status.⁹

¹ IRC §404(a)(9)(A) and §404(a)(9)(B), respectively.

² IRC §404(k)(1).

³ IRC §1042.

⁴ IRC §404(a)(9) and IRC §404(k)(1).

⁵ See Footnote #4.

⁶ See Footnote #4.

⁷ IRC §409(h) and Reg. §54.4975-7(b)(10).

⁸ IRC §503(a)(1); §1.503(b)-1(b)(1) of the Income Tax Regulations; IRC §409(h)(5)(B); IRS Announcement 95-33; §408(b)(1) of ERISA; §2550.408b-1 of the DOL Regulations; Internal Revenue Manual 4.72.4.2.8 (08-13-2001) and 4.72.4.2.8.1 (08-13-2001); IRS Letter Ruling 9438002, April 29, 1994; Revenue Ruling 80-269.

⁹ IRC §401(a)(23) and §409(h).

As a result of improperly installed ESOPs, “scams” (particularly with regard to ‘S’ corporation ESOPs), and the current environment following ENRON, the Department of Labor (“DOL”) and the Internal Revenue Service (“IRS”) are vigilant about ensuring that ESOPs are structured properly and that they, indeed, can honor the ‘Puts’ as they occur. Practitioners should be equally serious about proper structuring, and not being associated with any ESOP transaction that does not, whether by design or by inaction, provide an appropriate funding mechanism for honoring ‘Puts’ as they come due. Likewise, the sponsoring corporation should be even more acutely aware of the need to provide a funding program for the market that they created for company stock by installing an ESOP. This employee benefit must be honored; employees must be paid. Setting up an ESOP, which immediately benefits the Seller (usually the founder of a private company) and, by its very existence, creates a market for private-company stock, but then fails to adequately fund that market, is avaricious and particularly repugnant to all that is fair and just in dealing with employees.

The Invisible Liability: The question being asked about funding mechanisms is: How should a company fund for this emerging liability, which, by the way, the AICPA (American Institute of Certified Public Accountants) does not require to be booked on the financial statements of the sponsoring corporation? Because GAAP (Generally Accepted Accounting Principles) does not require the booking of this liability (a real liability, not a contingent one), and because repurchase liability can be put off for the duration of the original ESOP loan, with respect to vested terminations, company management often becomes lulled into a false sense of security. Unfortunately, practitioners often encourage this counterfeit sense of well-being, followed by a protracted lack of good ole common sense business planning. Practitioners and sponsoring company management alike seem to think that this future challenge will somehow take care of itself. Management often makes the statement: “Well, that problem won’t occur for a number of years; we’ll be able to self-fund by that time. I’ll worry about it later.” The fact is that if an ESOP company does not immediately start funding for this emerging liability, and continue a reasonable program from that point on, it will, in all likelihood, not be able to catch up, and the company could subsequently be destroyed by inaction. This is the source of much of the yellow journalism about ESOPs. It’s not the ESOP that causes the problem; it’s the inaction and prevarication of management, often exacerbated by inept professional advice. An unfunded ESOP is like two freight trains (one, an unwary company; the other, unaware employees) dead-heading toward each other on the same track. A devastating collision will occur at some point.

It is often the case that management does not fully realize just how significant the repurchase liability can become. Take, for example, a \$10 million ESOP transaction. Then suppose that the company does not grow at all over the next twenty years. A Repurchase Liability Study (an actuarial study estimating the extent of the liability over a twenty-year period) will then show that the company will have to come up with \$10 million over that twenty-year period in order to honor ‘Puts.’ Where is the money coming from? Now assume that the company grows reasonably, which it probably will, and the Repurchase Liability Study indicates that the company will have to come up with, say, \$20 million over the next twenty years. Again, where is the money coming from? To further exacerbate the problem, some participants may die, or become permanently

disabled, thereby becoming 100% vested and eligible to receive a payout from the company. In addition, ESOPs have diversification rules that allow qualifying participants to require the ESOP to diversify a significant portion of their account balances, as certain milestones are reached. Again, where is the money coming from? These unplanned payouts can occur at the most inopportune time, from a corporate financial point of view. Most ESOP companies are not aware of the critical nature of repurchase liability, and they don't plan for it in any methodical or reasoned manner.

Adequate Security Defined: Having established the legal requirement for a 'Put Option' in every ESOP plan established by a non-publicly-traded company, and having shown that 'Puts' must be "adequately secured,"¹⁰ the question remains as to the definition of "adequate security." Neither §4975(e)(7), nor §409(h) of the Internal Revenue Code of 1986, as amended ("the Code"), to include the regulations there under, define the term "adequate security." However, the regulations under §503 of the Code do provide an instructive definition. Section 503 of the Code denies exempt status to certain organizations, including those described in §4975(g)(2) or (3) of the Code (certain governmental and church plans), that engage in prohibited transactions. ESOP transactions not properly designed to include "adequate security" could clearly result in the denial of exempt status, or the loss of all tax advantages, and the possible imposition of interest and penalties.

The Income Tax Regulations¹¹ and the DOL Regulations¹² provide that something more than the company's promise to pay is required. In order to support the claim of "adequate security," something else must be pledged that can be sold, foreclosed upon, or otherwise disposed of to pay off the debt to the plan participant. The regulations go on to state that "the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result." Therefore, the regulations clearly require more than a promise to pay by the company:

Additional security must be pledged, and that security must be tangible and accessible. It must be saleable, or foreclosable, and the security must not be subject to any unreasonable loss of principal or interest. In addition, it is necessary that a chattel mortgage, or some other proof of claim be recorded and that property be clearly identified.¹³ Furthermore, a Put Option is not "adequately secured" by the promissory note of a company, even if secured by the full faith and credit of the company.¹⁴ (Emphasis added.)

Adequate security, therefore, must be tangible, accessible, saleable, foreclosable, and not subject to the unreasonable loss of principal or interest. Moreover, a chattel mortgage, or some other proof of claim, must be recorded and the security be clearly

¹⁰ See Footnote #8.

¹¹ §1.503(b)-1(b)(1) of the Income Tax Regulations.

¹² §2550.408b-1 of the DOL Regulations.

¹³ Rev. Rul. 80-269, and §1.503(b)-1(b)(1) of the Income Tax Regulations.

¹⁴ Rev. Rul. 80-69; IRS Announcement 95-33.

identified. A chattel is a personal possession, including tangible goods. A chattel mortgage is a recorded mortgage on a movable item of property (not real estate). Additionally, the promissory note of the company, even if secured by its full faith and credit, is not sufficient to be considered “adequate security.”

In an attempt to more clearly understand the definition of “adequate security” as intended by the IRS, refer to Part 4 of the Internal Revenue Manual, which states that a Put Option is not “adequately secured” if it is not secured by tangible assets.¹⁵ The Manual goes on to offer examples of “adequate security,” including: an irrevocable letter of credit, a surety bond issued by a third party insurance company rated “A” or better by a recognized insurance rating agency, or a first priority perfected security interest against company assets capable of being sold, foreclosed upon, or otherwise disposed of in case of default. Moreover, the insufficiency of notes secured by the company’s full faith and credit is made clear.

Note that in two of the three examples proffered, the IRS intends that the security be guaranteed by a third party (a bank or an insurance company). In the third example, a perfected security interest in the company’s assets is suggested. It is clear that the assets must be tangible and have real value in the open market. “Adequate security,” therefore, must possess the following eight Attributes (the first eight in the following list), to which the author added three additional Attributes:

1. Tangible
2. Accessible
3. Saleable
4. Foreclosable
5. Possess real cash value
6. Not subject to any unreasonable loss of principal or interest
7. Supported by a formal recording or chattel mortgage
8. Preferably guaranteed by a third party
9. Contain a tax advantage benefiting the corporation
10. Not result in an appreciable diminution of equity
11. No diminution in stock value should occur due to funding program

Examples Proffered by the IRS: The examples used by the IRS to properly secure the repurchase liability are: a. an irrevocable letter of credit; b. a surety bond; and c. a perfected interest in the company’s hard assets (recorded).

The examples presented by the IRS suggest that ‘Puts’ must be secured by real assets that are set apart for one purpose only: payments to participants. And, it is apparent that the IRS intends that these ‘Puts’ be paid. Notice, however, that the examples proffered by the IRS are problematic. Two of the three examples provided are neither saleable nor tangible (surety bonds and irrevocable letters of credit). Moreover, private companies involved in a leveraged ESOP transaction rarely have the capacity to obtain an irrevocable letter of credit. Furthermore, a company with a highly leveraged

¹⁵ IRS Manual Part 4, §4.72.4.2.8.1, ¶3.

ESOP will almost always have a loan agreement that precludes the company from giving anyone but the lender a security interest in the tangible assets of the company. To complicate the problem further, at this writing, the author is unaware of any company in the United States that offers surety bonds for leveraged ESOPs. We are left with uncertain guidance from the IRS in terms of the examples offered; however, the goal is clear: 'Puts' must be paid. It is necessary, therefore, that each ESOP company design a funding mechanism that satisfies the intent of the IRS requirements.

The Quantification of Puts: It is critically important that companies and ESOP Trustees understand that repurchase liability is a real and emerging liability. 'Puts' that create this liability must be paid, and sufficient resources must be set aside to honor this obligation. However, in order to honor this obligation, one must know the amount of the obligation. This brings up another great failing of many Plan Sponsors, Trustees, and other plan administrators. Rarely are studies done to determine the extent and amount of the repurchase liability. Sometimes an attempt is made to determine the extent of the liability, but it is sophomoric at best, usually produced on a spreadsheet showing anticipated retirements. A properly constituted Repurchase Liability Study is a sophisticated actuarial study showing anticipated cash needs over a twenty-year period. The study takes into account various labor tables to determine terminations, ages, and gender of all participants, growth expectations of the company, interest rates, distributions due to age and time in the plan, disability, retirement, and death.

Once a proper study is completed, the company and the Plan Trustee can easily determine cash needs for repurchase liability for many years to come. Armed with this knowledge, the company can then build a funding plan that makes sense, one that is not over or under funded.

Methods of Funding for Repurchase Liability: There are seven basic methods of addressing the issue of repurchase liability. A blended approach is not considered to be a separate method. Each will be discussed in light of IRS and DOL requirements, and specifically the eleven Attributes previously listed. A grade will be assigned based upon the number of Attributes violated: four or more Attributes violated = F; three Attributes violated = D; two Attributes violated = C; one attribute violated = B; no Attributes violated = A. This is the authors grading system, and is not meant to be authoritative. Note that Attributes #4 and #7 appear to be closely associated, in a legal sense. For purposes of this analysis, however, no attempt is made to tie them together, or to specifically define their differences from a legal perspective.

1. **Pay-As-You-Go Method:** Under the pay-as-you-go method, the company will implement a strategy of paying future distributions resulting from the ESOP out of future cash flow of the company, or future borrowing. The company will need to accurately budget for the projected repurchase liability. If the company does not adopt other funding methods, the valuation professional will probably discount the value of the stock of the company because of the lack of set-aside funds to cover the coming repurchase liability, thus increasing financial risk (the "Z Score") of the company. This is an excellent example of "I'll worry about it later." Companies that adopt this method normally exacerbate the problem by not engaging a repurchase liability

study. There is literally no planning, trusting instead on the good fortunes the future is assumed to hold. In essence, management has decided to do nothing.

Analysis:

- a. Attribute 1: Funding is not tangible.
 - b. Attribute 2: Funding is not accessible.
 - c. Attribute 3: Funding is not saleable.
 - d. Attribute 4: Funding is not foreclosable.
 - e. Attribute 5: No real cash value exists.
 - f. Attribute 6: Since no funding exists, the lack of planning is obviously subject to unreasonable loss of principal and interest.
 - g. Attribute 7: Nothing exists to record, or upon which to provide a chattel mortgage.
 - h. Attribute 8: There exists no guarantee by a third party.
 - i. Attribute 9: No tax advantages exist.
 - j. Attribute 10: A diminution in the equity of the company will occur.
 - k. Attribute 11: The company will be devalued due to the unfunded liability.
 - l. This method appears to violate all eleven Attributes; overall grade: **F**.
2. **Sinking Fund Method:** The sinking fund can take many forms. For example, a company could decide to simply start a savings account and make regular payments to it. Similarly, a company could decide to make regular payments to an investment account that would then be invested into stocks, bonds, or mutual funds. All deposits are made with after-tax dollars.

Analysis:

- a. Attribute 1: Funding is tangible.
- b. Attribute 2: Funding is accessible, although no outside contract exists requiring that payments be made.
- c. Attribute 3: Funding is saleable.
- d. Attribute 4: Funding is foreclosable.
- e. Attribute 5: Real cash value exists.
- f. Attribute 6: The funding is subject to market swings and to the cash needs of the corporation. Companies rarely earmark investment accounts as belonging solely to the ESOP for purposes of funding the liability. In addition, in times of cash shortages, companies will look to this account as a source of needed cash, much like the Federal Government does when it borrows from the Social Security Fund. In normal operation, this method is subject to unreasonable loss of principal and interest, and is not professionally managed; however, if professional management is utilized, then stable investments can be assumed.
- g. Attribute 7: There is no recording of this asset, or a chattel mortgage, in the normal operation of this method. Such recording is possible should the Trustee and the Board of Directors of the company take steps to officially earmark and protect the investment fund.
- h. Attribute 8: There exists no guarantee by a third party, although secure investments could be made that would satisfy this requirement.

- i. Attribute 9: No tax advantages exist.
 - j. Attribute 10: No diminution in the equity of the company will occur upon funding. The sinking fund is an asset of the corporation; therefore, causing no diminution to equity.
 - k. Attribute 11: The company will not be devalued due to the unfunded liability.
 - l. This method appears to violate Attributes 6, 7, 8, and 9; overall grade: **F**, in normal operation; grade of **B**, if Attributes 6, 7, and 8 are improved.
3. **S-Corporation Method:** Beginning on January 1, 1998, earnings from an S-Corporation owned by an ESOP (“S-ESOPs”) are not subject to federal income tax. As a result, S-ESOPs have the ability to accumulate cash in a repurchase account inside the ESOP. This allows that none of the funds required to repurchase stock be subject to taxation. The unusually good tax treatment of S-ESOPs does not diminish the requirement to fund (set aside cash) for the repurchase liability. Therefore, if funds are not set aside, this method is not much better than the Pay-As-You-Go Method. Tax treatment is one thing; setting aside funds is quite another.

Analysis:

- a. Attribute 1: Funding is tangible.
 - b. Attribute 2: Funding is accessible. The tax advantages of an S Corporation ESOP provide reasonable assurance of available funding.
 - c. Attribute 3: Funding is saleable in the sense that it is available to plan participants to fund for repurchase liability.
 - d. Attribute 4: Funding is foreclosable by the plan Trustee or by a court of law.
 - e. Attribute 5: Real cash value exists.
 - f. Attribute 6: Assuming professional management by the Trustee or his appointed agent, the funding will not be subject to unreasonable loss of principal and interest.
 - g. Attribute 7: Recording of the asset is actually accomplished by the cash or investments being held by the ESOP, which is a qualified plan. No chattel mortgage is needed.
 - h. Attribute 8: There exists no guarantee by a third party, although secure investments could be made that would satisfy this requirement.
 - i. Attribute 9: Tax advantages do exist.
 - j. Attribute 10: A diminution in the equity of the company will occur due to contribution being made by the company to the ESOP.
 - k. Attribute 11: The company will not be devalued due to the unfunded liability.
 - l. This method appears to violate Attributes 8 and 10; overall grade: **C**, in normal operation; grade of **B**, if Attribute 8 is improved.
4. **Recycling Method:** Under the recycling method, the company would make cash contributions to the ESOP for the purpose of the ESOP purchasing all or some of the stock from terminated participants. Since the goals of the company are to retain and attract talented employees, and perpetuate the company, this method permits the ESOP to continue in existence by repurchasing shares of stock from departing participants. From the company’s viewpoint, it would receive a tax deduction for contributions of cash made to the ESOP to the extent allowed under IRC §415, although

the act of making such contributions diminishes equity. Additionally, the Trustee is making a fiduciary decision (upfront, without knowing the desirability of stock ownership in the future) to purchase the stock from all departing participants. In this case, the ESOP would have first right of refusal on honoring 'Puts.'

Analysis:

- a. Attribute 1: Funding is tangible.
 - b. Attribute 2: Funding is not necessarily accessible in that the company may not be able to make the necessary contributions, and no contract exists requiring that payments be made.
 - c. Attribute 3: Funding is saleable in the sense that it is available to plan participants to fund for repurchase liability.
 - d. Attribute 4: Funding is foreclosable by the plan Trustee or by a court of law.
 - e. Attribute 5: Real cash value exists.
 - f. Attribute 6: Assuming professional management by the Trustee or his appointed agent, the funding will not be subject to unreasonable loss of principal and interest.
 - g. Attribute 7: Recording of the asset is actually accomplished by the cash or investments being held by the ESOP, which is a qualified plan. No chattel mortgage is needed.
 - h. Attribute 8: There exists no guarantee by a third party.
 - i. Attribute 9: Tax advantages do exist.
 - j. Attribute 10: A diminution in the equity of the company will occur due to contribution being made by the company to the ESOP.
 - k. Attribute 11: The company will be devalued due to the unfunded liability.
 - l. This method appears to violate Attributes 2, 8, 10 and 11; overall grade: **F**.
5. **Stock Option Method:** Under the stock option method, the company establishes a stock option program for its key employees (or, in some cases, all employees) permitting them to purchase stock of the company, as the company repurchases the stock from participants exiting the ESOP. Under this scenario, the company uses the cash received from such employees at the time of exercise of the stock option to satisfy its repurchase liability obligation. The company is, therefore, depending on employees to provide for its repurchase obligation. This is another example of "I'll worry about it later." Companies that adopt this method also normally exacerbate the problem by not engaging a repurchase liability study. There is literally no planning, trusting instead on the good fortunes the future is assumed to hold with respect to the ability of various other people being financially capable and desirous of funding the repurchase obligation. In essence, management has decided to do nothing.

Analysis:

- a. Attribute 1: Funding is not tangible.
- b. Attribute 2: Funding is not necessarily accessible in that the employees may not be able to make the necessary purchases, and no contract exists requiring that payments be made.
- c. Attribute 3: Funding is not saleable in that no program exists.
- d. Attribute 4: Funding is not foreclosable.

- e. Attribute 5: Real cash value does not exist.
 - f. Attribute 6: Funding is subject to unreasonable loss of principal and interest.
 - g. Attribute 7: No recording is accomplished; no chattel mortgage is filed.
 - h. Attribute 8: There exists no guarantee by a third party.
 - i. Attribute 9: Tax advantages do not exist.
 - j. Attribute 10: A diminution in the equity of the company will not occur due to purchases being made by the employees.
 - k. Attribute 11: The company will be devalued due to the unfunded liability.
 - l. This method appears to violate Attributes 1 – 9 and 11; overall grade: **F**.
6. **Qualified Plan Method:** Under the qualified plan method, the company would expand its profit sharing plan, and possibly its 401(k) plan, to invest in stock of the company. Under ERISA, qualified plans, other than ESOPs, are prohibited from purchasing stock in the sponsoring company beyond a small percentage of their overall portfolio. This method does not provide for repurchase liability at all.

Analysis:

- g. Attribute 1: Funding is tangible.
 - h. Attribute 2: Funding is not necessarily accessible in that the company's 401(k) plan, for example, may not be able to make the necessary stock purchase, and no contract exists requiring that payments be made.
 - i. Attribute 3: Funding is saleable in the sense that it is available to plan participants to fund for repurchase liability.
 - j. Attribute 4: Funding is foreclosable by the plan Trustee or by a court of law.
 - k. Attribute 5: Real cash value exists.
 - l. Attribute 6: Assuming professional management by the Trustee or his appointed agent, the funding will not be subject to unreasonable loss of principal and interest.
 - m. Attribute 7: Recording of the asset is actually accomplished by the cash or investments being held by the ESOP, which is a qualified plan. No chattel mortgage is needed.
 - n. Attribute 8: There exists no guarantee by a third party.
 - o. Attribute 9: Tax advantages do exist.
 - p. Attribute 10: A diminution in the equity of the company will occur due to contribution being made by the company to the qualified plan(s).
 - q. Attribute 11: The company might be devalued due to the unfunded liability.
 - r. This method appears to violate Attributes 2, 8, 10, and 11; overall grade: **F**, in normal operation; grade of **D**, if Attribute 11 is approved.
7. **Corporate-Owned Life Insurance Method:** Under the corporate-owned life insurance ("COLI") method (the "insurance method"), the company purchases life insurance contracts on the lives of selected company management personnel. The company is also the beneficiary of the policies. A select few of the top insurance companies have product lines particularly suited to ESOP transactions. It suggested that High Cash Value products be used for this purpose. The cost to the Company is lower than other types of policies and the build-up of cash value is much more rapid and significant. The selection of a top-rated carrier, with ESOP experience and a

thorough understanding of appropriate product lines for funding repurchase liability, is essential.

In general, the repurchase liability obligation is funded by the build-up of cash value inside the policies, which remains as an asset on the books of the corporation. As a result, the company experiences very little diminution in equity. Typically, the amount of life insurance purchased by the company is determined by a properly constituted Repurchase Liability Study (preferably performed independently) that will detail the amount of cash needed to fund 'Puts' over the next twenty years. The policies generally invest very conservatively, and sometimes contain an index feature, which ensures a minimum return on investment, thus protecting the corpus and guaranteeing that sufficient cash will be available for 'Puts.' This method insures the management of a qualified outside party, and the insurance contracts constitute a formal agreement. Moreover, all of the investment growth inside the policies is tax-deferred, although the initial purchase utilizes after-tax dollars.

Unique to any other funding method, the life insurance method provides a death benefit at some point in the future. This added benefit, payable to the company, is not considered in the Repurchase Liability Study, which concentrates only on the guaranteed build-up of cash value. Therefore, when a death benefit becomes payable, the inflow of funds into the company generally serves to offset all past and future cost of the ESOP program. This additional benefit is not considered in the eleven Attributes above listed, but is nevertheless an extremely important benefit of the COLI Funding Method.

THE ESOP PROTECTION TRUST: To further protect the cash values of the insurance contracts, which is, in essence, the funding for Repurchase Liability, it is highly recommended that an **ESOP Protection Trust ("EPT")**¹⁶ be created. This Trust, in essence, would be a grantor trust, and would resemble a protected escrow account. The **EPT** would provide an additional level of security for Plan Participants that has never before been attempted. Following is the suggested design of the **EPT**:

- a. The Company will "irrevocably transfer" ownership of 100% of the cash value of the COLI contracts to the **EPT**. In doing so, the Company gives up all rights to the cash values produced by the COLI policies and the employer cannot terminate the Trust. It should be noted, however, that the assets of the **EPT** remain subject to the claims of creditors, just as they do in a Rabbi Trust. In addition, the Company is responsible for any taxes due on the Trust.
- b. If possible, the Company should retain ownership and control of the death benefits of the COLI policies.
- c. The **EPT** will be restricted in that the valid claims of ESOP Participants, under the terms of the **ESOP Trust**, are the ONLY purpose for which a payment of

¹⁶ The concept of an ESOP Protection Trust is new and has never been done in the past. The concept was created by Mr. Steven A. Miller, CLU, ChFC, J.D., LLM. The creation of an EPT should not be a problem in that it is simply a well-designed Grantor Trust with certain specific provisions which are currently allowed by ERISA.

- Trust funds can be made. The **EPT** will, therefore, be considered a “Locked Trust.”
- d. The Trust assets cannot be secured – that is, employees must have the same status vis-à-vis the Trust assets as the employer’s general creditors.
 - e. The **EPT** can be further customized to suit the exact needs of the Company or the Trustee of the **EPT**. For example:
 - i. **Financial Triggers** could be incorporated into the **EPT** that would allow for the Trustee to make immediate distributions of Trust funds, or alternatively, to buy the shares of participants in anticipation of certain events. Triggers could be developed due to a change in corporate net worth, net income, debt load, or share price.
 - ii. **Non-Financial Triggers** could be developed, such as a change in control or adverse regulatory rulings that could result in automatic distributions.
 - iii. **Provisions Due to a Change in Control** such as the Trust could provide that, say, a vote of 67% of the Plan Participants must approve any change in the Trustee or terms of the Plan. This, for the protection of the Plan Participants.
 - iv. An exhaustive list of Financial and Non-Financial Triggers should be developed and brought before the Board of Directors, the ESOP Committee and the Trustee. The final decision concerning Triggers should be acceptable to all three parties.
 - f. **Trustee of the EPT:** Now the issue arises as to who should be the Trustee of the **EPT**. Typically the Trustee of such Grantor Trusts will be from the ranks of sponsoring-company management or, sometimes, a Bank Trust Department. Neither of these is a good choice. Management clearly has a conflict of interest and a bank will typically lack the experience and knowledge base necessary to provide Trust services to an ESOP, not to speak of the newly-conceived **EPT**. In addition, the rules of Bank Trust Departments make dealing with them cumbersome at best. It is suggested that the Trustee of the ESOP also be the Trustee of the EPT. This individual (an experienced, independent individual is suggested) will have NO conflict of interest; his/her goals, purposes, and responsibilities will be perfectly transferrable to the **EPT**. There will be NO differences or conflicts whatsoever in the goals and purposes of the ESOP vis-à-vis the **EPT**. There will be no conflict of interest! The concept of the ESOP Trustee being in full control of the Repurchase Funds is ground-breaking and insures that the participants will be protected with respect to their qualified plan values. This type of design will remove the possibility of the company using Repurchase Funds for purposes other than the purchase of departing participants’ shares, thus providing for maximum control and protection of the Trust funds.

An employer’s responsibility to pay benefits under a Qualified Plan is a legal obligation of the Company. However, when it’s time to pay these benefits, economic downturns, law suits against the Company, expensive expansion endeavors, or an array of other business problems may dictate otherwise – the ESOP Repurchase Fund gets depleted. In such cases, as we have seen repeatedly in ESOPs, the

Trust or the Trust Participants (the employees) are reduced to the untenable position of having to undergo expensive litigation to obtain promised benefits. The **EPT** will remove much of that concern as well as impress upon management the importance of the Repurchase Obligation – it simply cannot be ignored or put off to another day.

Warning: Avoid the urge to simply assign the cash value of the COLI policies to the ESOP Trust, mistakenly thinking that the assignment will accomplish all the goals of the **EPT** without the cost and effort. This is not true. If an assignment is made of the COLI cash value to the ESOP Trust, the tax-free contribution rules under §415 would likely be breached. This could easily result in not being able to make tax-free contributions to the Trust for the purpose of repaying the stock acquisition loan. You could end up with a taxable ESOP.

Analysis:

- a. Attribute 1: Funding is tangible.
- b. Attribute 2: Funding is accessible to the Trustee at any time through the cash values of the COLI contracts – now Locked in the EPT.
- c. Attribute 3: Funding is saleable in the sense that it is available to plan participants to fund for repurchase liability.
- d. Attribute 4: Funding is foreclosable by the Plan Trustee or by a court of law.
- e. Attribute 5: Real cash value exists.
- f. Attribute 6: Professional management does exist through the insurance carrier; therefore, the funding will not be subject to unreasonable loss of principal and interest.
- g. Attribute 7: Recording of the asset is actually accomplished by the Board of Directors of the company by assigning the cash values of the COLI policies to the EPT for the sole use of funding for Repurchase Liability. This is accomplished by means of recorded minutes (Company, ESOP and the **EPT**) accompanied by an attorney-prepared statement of purpose and obligation, and an Assignment.
- h. Attribute 8: The funding mechanism provided by insurance contracts offers the much needed third-party guarantee of benefits, for example through an index arrangement that guarantees a minimum investment return.
- i. Attribute 9: Tax advantages do exist in that the cash values inside the insurance contracts grow tax-deferred, although the initial insurance contracts are purchased with after-tax dollars.
- j. Attribute 10: No appreciable diminution in the equity of the company will occur due to contributions being made by the company to the insurance contracts, although there is a cost of insurance (administrative costs and commissions) associated with this funding mechanism that is not present in the other methods. The cash values of the COLI policies will remain on the books of the sponsoring-company.
- k. Attribute 11: The Company will not be devalued due to an unfunded liability.

I. This method appears to satisfy all eleven Attributes; overall grade: **A**.¹⁷

Conclusion: It is clear from the Code and the citations provided that the IRS and the DOL intend that ‘Puts’ must be “adequately secured.” Eight Attributes of “adequate security” have been derived from IRS publications, and the author has added three additional Attributes. All seven methods of repurchase liability funding have been analyzed and only one, the Insurance Method, appears to fully satisfy all eleven Attributes. Furthermore, it appears that the Insurance Method is the least expensive method of funding; this due to the tax deferred growth of the investments within the policies, and the eventual death benefit that is paid to the Company.

Whichever method is chosen, every company that already has an ESOP, and every company considering one should seriously address the issue of repurchase liability funding. The natural consequence of initiating an ESOP is to create a market for company securities. Initiating an ESOP brings with it a payment obligation to departing employees - the ‘Put.’ The ‘Put’ is a matter of law, being required by ERISA. The law requires that ‘Puts’ be paid in accordance with the plan document and ERISA Regulations. It logically follows that the created market must be funded and “adequately secured.” To fail in this is to breach the fiduciary responsibilities of management and the Trustee.

ESOPs are perhaps the most powerful tool of corporate finance in private companies to have ever been created. Congress gave the private business world this gift in 1974, but it must be accepted realistically and effectuated with wisdom and business acumen. Properly installed, an ESOP program will save enormous tax dollars, as well as provide incentives for the working force that will effectively drive the ESOPed company to previously unimagined levels of success. But, you have to do it correctly, with no shortcuts!!

Repurchase Liability Funding Methods - Graded					
Method	A	B	C	D	F
1. Pay as You Go					X
2. Sinking Fund			X		X
2. S-Corporation		X	X		
4. Recycle					X
5. Stock Option					X
6. Qualified Plan				X	X
7. Corporate-Owned Life Insurance	X				

Grade depends upon compliance with the eleven Attributes previously discussed. Where two grades appear for the same method, the overall and improved operations are compared. It is the author’s opinion that only methods appearing in the shaded area should be considered.

¹⁷ The author of this article is NOT insurance licensed and does not benefit in any manner from the sale of insurance.

THIS PAPER WAS EXTENSIVELY REVIEWED FOR ACCURACY BY THE FOLLOWING PROFESSIONALS:

- ❖ *Mr. Steven A. Miller, CLU, ChFC, J.D., LLM – Financial Advisor – Denver, CO*
- ❖ *Mr. Michael Mulhausen, CPA (former Partner-Ernst & Young) – CPA & Financial Advisor – Denver, CO*
- ❖ *Mr. Arlen L. Brammer, J.D. – Specializing in ERISA – Greenwood Village, CO*