

COMMENTS CONCERNING ESOP REFINANCINGS
UNDER ERISA FIDUCIARY PROVISIONS

The following comments (“Comments”) are the individual views of the members of the Section of Taxation of the American Bar Association who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These Comments were prepared by individual members of the ESOP Subcommittee of the Employee Benefits Committee of the Section of Taxation of the American Bar Association (the “Section”). Principal drafting responsibility was exercised by Gregory K. Brown, Jared Kaplan, Helen Morrison, James Raborn and Ronald Rizzo. The Comments were reviewed by Seth Tievsky on behalf of the Section’s Committee on Governmental Submissions and by Stuart Lewis, Council Director.

Although members of the Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these Comments.

Contact: Gregory K. Brown
Phone: (312) 245-8864
Fax: (312) 644-3381
E-mail: gkbrown@gcd.com

COMMENTS ON ESOP REFINANCING ISSUES
UNDER ERISA FIDUCIARY PROVISION

I. Background

These Comments have been prepared by members of the ESOP Subcommittee of the Employee Benefits Committee of the American Bar Association Tax Section (the “Subcommittee”) for review and consideration by senior officials of the Pension and Welfare Benefit Administration (“PWBA”) of the U.S. Department of Labor (“DOL”) in connection with its deliberations on the preparation of guidelines for ESOP refinancings. It has been prepared subsequent to a telephone conference with DOL officials on this matter. The viewpoints expressed herein are those of certain members of the Subcommittee and do not necessarily reflect the viewpoint of the American Bar Association, the Tax Section or the Employee Benefits Committee. However, it is hoped that the issues and viewpoints discussed herein will prove useful to the PWBA in the preparation of regulatory guidelines on ESOP refinancings.

The authors have represented plan sponsors, trustees, sellers and lenders and other ESOP fiduciaries in ESOP refinancings over the last 10 years and have worked carefully on behalf of their clients to help them avoid prohibited transactions and fiduciary breaches. This group has been working with the refinancings of ESOP loans since the early-'90s and has developed a consensus among practitioners based on approaches described in IRS letter rulings using the “primary benefit” rationale during those periods. At the same time, we have been mindful of related ERISA fiduciary duty issues with respect to which we have had little or no guidance. We now respectfully request that PWBA will give consideration to the issues and viewpoints described in this Comment.

II. Executive Summary

Before going into the detail of the Comments, we would like to summarize our conclusions at the outset as follows:

1. All surrounding facts and circumstances need to be carefully examined in each ESOP refinancing as there are many unique factors involved in each refinancing.
2. ESOP refinancings should involve the procedural safeguard of an independent fiduciary.
3. We believe that the responsible ESOP fiduciary has a fiduciary duty to the trust as a whole rather than individual participants or classes of participants.
4. A quid pro quo between the plan’s sponsor and the trust is generally necessary in an ESOP refinancing. This quid pro quo will focus on dividend make-wholes, event protection, interest rate reductions, contribution commitments and other enhancements to the ESOP.

5. An unexpected corporate event and significant participant headcount reductions generally make ESOP refinancings easier for the interested parties to negotiate and resolve.

III. Considerations in Developing ESOP Refinancing Guidelines

Labor Reg. § 2550.408b-3 describes the requirements for exempt loans to ESOPs pursuant to Section 408(b)(3) of ERISA. However, these regulations do not address the requirements for refinancing an exempt loan.

However, the exempt loan regulations do reflect two key requirements that are transferable to refinancings of exempt loans:

1. Special scrutiny of transactions (Labor Reg. § 2550.408b-3(b)(2)).
2. Primary benefit requirement (Labor Reg. § 2550.408b-3(c)).

Adapting these requirements to the special circumstances under which ESOP refinancings normally arise is useful in developing guidelines for the issues confronted in a refinancing, as described below.

A. Facts and Circumstances

We believe that all facts and circumstances must be carefully examined to make sure that the ESOP is at least no worse off than it was prior to the refinancing. Here, both quantitative as well as qualitative factors are generally present. Ultimately, this involves a subjective judgment on the part of the responsible ERISA fiduciary, which judgment should be given meaningful deference where procedural safeguards are utilized and good faith judgment exercised, as described below.

This, of course, does not mean that the DOL would be unable to challenge a transaction merely because procedural safeguards have been observed and good faith judgment has arguably been exercised. It does mean, however, that the use of procedural safeguards and good faith judgment would provide confidence to the DOL to allow it to give meaningful deference on the subjective judgments of the parties to the refinancing in the absence of detailed substantive requirements. In such case, responsible parties should be able to move forward based on a rebuttable presumption that the transaction is permissible.

B. Procedural Safeguard

Ideally, the procedural safeguards described above should involve the use of an independent fiduciary acting on behalf of the ESOP with its own independent advisors to guard against conflicts of interest and self-dealing. Where this approach is not used, we would expect

that the ESOP refinancing transaction could be subjected to special scrutiny by the DOL to ensure that the ESOP fiduciary has acted properly on behalf of the ESOP trust.

We have observed that it is extremely difficult for corporate officers or other insiders who normally act in the best interest of the plan sponsor to also act in the best interests of ESOP participants and beneficiaries in an ESOP refinancing because of inherent conflicts. While it is possible for such individuals to retain their own qualified legal and financial advisors, and to use those advisors to engage in a transaction that will stand up to scrutiny, this is a tall order. It is far preferable to engage an independent fiduciary for this purpose. In this regard, we note that the prohibited transaction exemption for expedited handling of exemption requests strongly encourage the use of independent fiduciaries for this purpose. PTE 96-62.

We are unsure of whether a “safe harbor” approach would be helpful for this purpose. If the safe harbor were more procedural in nature, the safe harbor would be useful for all interested parties. Where the safe harbor is more substantive in nature, we believe that the unique facts and circumstances of each ESOP refinancing would make such an approach very difficult to design and perhaps even create more problems than it solves.

C. Fiduciary Duty

We believe that the fiduciary duty of the ESOP trustee is owed to the trust as a whole (rather than individual participants or current participants or future participants as separate groups) in engaging in an ESOP refinancing. While current participants (particularly those close to retirement age) are likely to be most affected by an ESOP refinancing, we believe that the use of a quid pro quo approach (as described below) will help deal with this issue in more than adequate fashion. We believe that a careful examination of ERISA case law in other contexts validates our viewpoint that the fiduciary duty is owed to the trust as a whole. *See Hughes Aircraft Company v. Jacobson*, 22 EBC 2265 (US Sup. Ct. 1999) and *Ameritech Benefit Plan Committee v. Communication Workers of America*, 220 F3d 814 (7th Cir. 2000).

We note that some PWBA officials have raised issues as to whether there is a different standard for a stand alone ESOP than for an ESOP that is integrated with a 401(k) plan. In the context of ESOP refinancings, we generally believe that there should not be a different standard for these alternative structures even where the ESOP integrated with the 401(k) plan is utilizing matching contributions and dividends to repay ESOP indebtedness. We do, however, believe, that under the quid pro quo approach, the negotiations between the parties and the ultimate resolution of the issues may be different in reaching a resolution that satisfies the best interests of the ESOP and its participants. The standard, however, should be the same in terms of general guidance.

D. Quid Pro Quo

A quid pro quo between the plan sponsor and the trust is generally necessary in an ESOP refinancing. Without this approach, it is difficult, if not impossible, to restore the ESOP to the economic position it was in prior to the refinancing.

A quid pro quo will normally focus on dividend “make wholes,” “event protection” and “contribution commitments:”

1. Dividend Make Whole. The use of a dividend make whole agreement is designed to compensate the trust as a whole for the amount of dividends used to repay an extended loan during the extended period. Obviously, if the company stock owned by the ESOP receives no cash dividends, this issue is unimportant. However, where cash dividends are paid on the company stock and these cash dividends are used to repay the ESOP loan, the longer the ESOP loan remains outstanding, the greater the dividends that are used to repay the ESOP loan. In other words, if the ESOP loan had not been refinanced, these dividends would have been paid on company stock allocated to participants’ accounts instead of being used to repay the ESOP loan. An argument certainly can be made that the trust, as a whole, has been harmed by the refinancing, with a value of the harm equal to the present value of the estimated cash dividends used to repay the ESOP loan which would have not been used to repay the ESOP loan had it not been refinanced. This issue often times is the most important one in reaching resolution on an ESOP refinancing.
2. Event Protection. This is designed to protect the trust as a whole where a corporate sale of company stock from the loan suspense account occurs during the extended loan period; the proceeds from the shares which would have been allocated had no ESOP refinancing occurred would be lost unless the plan sponsor agrees that these proceeds will not be used to repay the ESOP loan. If the proceeds from the sale of company stock are used to repay the ESOP loan, the trust as a whole, could be harmed when company stock which would have been allocated had no refinancing occurred, is used to repay the ESOP loan. Therefore, it is appropriate that the proceeds from unallocated shares which would have been allocated but for the extension of the loan amortization will not be used to repay the ESOP loan.
3. Loan Interest Rate Reduction. Another important factor is the interest paid on the loan. If the ESOP loan is refinanced, the principal on the ESOP loan will remain outstanding for a longer period of time. All other circumstances remaining equal, the interest owed by the ESOP on the loan should increase. However, it is our experience that generally the rate decreases for most refinancings in order to compensate the ESOP for the extended amortization period, independent of the prevailing interest rate environment.

4. Contribution Commitment. Where the plan sponsor has not previously committed itself to make contributions, or reserves the right to amend or terminate the plan, it is appropriate for the fiduciary to negotiate for an enforceable legal obligation of the plan sponsor to make contributions necessary to fully amortize the loan and/or keep the trust whole (or better). Obviously, where there is a preexisting contribution obligation, this rationale cannot be used in the quid pro quo approach.
5. Other Enhancements. The quid pro quo approach may also focus on other issues including, but not limited to, vesting liberalization, liberalized diversification rights, covenants that the matching contributions will not be reduced or that no further refinancings will occur unless negotiated with and approved by an independent corporate fiduciary and a commitment that no plan termination will occur before the ESOP loan is fully repaid. It is also possible that the additional benefit to the ESOP will be a negotiated amount that is to be contributed to the ESOP over a negotiated period of time.

E. Corporate Events

While the underlying corporate event is often relevant to the issue of ESOP refinancing, it is far easier to justify an ESOP refinancing where there has been significant participant head count reduction as a result of a business downturn, divestiture or spin-off of operating units or technological changes that require fewer employees, often times where the plan sponsor is nearing deduction limits or incurring very high expense charges which are ultimately hurting the value of the stock held by the ESOP.

We would point out that we are not advocating that an ESOP refinancing can be justified merely because the value of the stock being allocated to the accounts of participants as a result of the release of shares pursuant to debt payments is higher than industry standards or expectations. We believe that, in general, participants should get the benefit of company stock value appreciation as an inherent benefit of an employee stock ownership plan. However, where the values being allocated to participants are higher than expected because of the significant head count reduction resulting from unforeseen corporate events such as those described in the next preceding paragraphs, we believe that this is a relevant fact and circumstance to be evaluated by the fiduciary in approaching and negotiating the ESOP refinancing.

IV. Miscellaneous

We also want to be responsive to several other issues that came up during our telephone conference with senior officials of PWBA. In general, the range of extensions that we have observed on ESOP refinancings has generally been in the neighborhood of 5 to 10 years, although some of the members of our group have seen slightly shorter or longer periods. We have also observed that the interest rates have been changed on many of the transactions, generally to a lower interest rate.

Given recent world events and present economic circumstances, particularly with lower interest rates, it is possible that there may be an increased level of activity over the next 12 to 24 months in terms of ESOP refinancings. While we are not generally aware of widespread egregious refinancings being conducted, it has come to our attention on occasion that, where these have occurred, it is generally due to a lack of procedural safeguards and ignorance of the fiduciary issues and standards involved. We are unsure of how many of these may involve actual “bad actors” who are intentionally working against the interests of ESOP participants and their beneficiaries.

We understand that DOL may bring an enforcement action where there have been no procedural safeguards, no consultation with advisors, and documents have been merely signed without any care for or consideration of the interest of ESOP participants and beneficiaries. Where these circumstances arise, it seems to us that DOL has a duty to intervene and enforce the rights of ESOP participants and their beneficiaries. On the other hand, we would hope that DOL will not strictly apply the principles set forth in these Comments on a retroactive basis to refinancings completed on a good faith basis but without all of the safeguards set forth in these Comments.

We do not have a preference as to the form in which the guidance on ESOP refinancings should take. We would note that there is pressing need for guidance at the present moment and that the regulation process can be very time consuming. Thus, either an advisory opinion or interpretative bulletin are preferred if they are likely to afford quicker guidance to interested parties.

V. Conclusion

We trust that this summary will prove useful to PWBA in its consideration and deliberation on appropriate guidance on ESOP refinancings. We offer to make ourselves available to confer further with PWBA on these matters including, but not limited to, additional telephone conferences and face to face meetings. If possible, we would ask for an additional opportunity to offer comments to PWBA prior to issuing any written guidance so that we may comment on appropriateness and context without presuming to question any substantive judgments.