



Handling the ESOP Repurchase Obligation Legal Issues

presented by

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Biography

- Brian Hector is a partner in the Employee Benefits and Executive Compensation Practice of Morgan, Lewis & Bockius and chairs the firm's ESOP practice group.
- Mr. Hector focuses his practice on ERISA and employee benefits law including the areas of ESOPs, qualified plans, all types of executive compensation, fiduciary liability, and related securities law issues.
- Mr. Hector has served as counsel to companies and shareholders regarding the use of ESOPs in numerous transactions, including equity repurchases, ownership succession transactions, and corporate reorganizations. He has also represented lenders and trustees in ESOP transactions.
- Mr. Hector has also represented several clients before the IRS and the Department of Labor in connection with employee benefits matters, including in connection with ESOPs.
- Mr. Hector designs all types of executive compensation arrangements that are both equity and non-equity benefits, including stock options, deferred compensation plans, long-term incentive plans, SARs, and phantom stock plans.
- Mr. Hector has lectured extensively regarding employee benefits and ESOPs. He speaks regularly at the annual national conferences of The ESOP Association, the National Center for Employee Ownership, at their local and regional conferences, and at numerous other seminars.
- He teaches at John Marshall Law School in the area of Employee Benefits Law.

Legal Compliance Issues

- Put Option Rights
- Timing and Method of Repurchase
- Distinction Between C and S corporation
- Trust or Company Buy Back

Put Option Rights

- Within Set Time Limits, terminated participants have the right to put their shares back to the corporation or trust.

Put Option Rights

- Timing
 - 1st Option Period – within 60 days following the date of the stock distribution from the ESOP
 - 2nd Option Period – if the participant does not exercise the put option right in the 1st Option Period, then within a 60-day period during the following plan year after the 1st Option Period

Put Option Rights

- Suggestion for the 2nd Option Period –
 - 60-day period beginning after the new determination of the stock's FMV and after notifying the participant of the FMV

Timing and Method of Repurchase

- Retirement, Death, Disability – within 1 year of plan year in which termination took place
- All other terminations – within 1 year of plan year which is the 5th plan year following the plan year in which termination took place
- In Service Distributions

Timing and Method Repurchase

- Method of Repurchase
 - Lump Sum
 - Installments
 - Promissory Note

Method of Repurchase

- If installment distributions, value of stock will change with each distribution
- If promissory note, value of note remains the same (i.e., the distribution of a promissory note is essentially a lump sum distribution)
- Disadvantage of a promissory note - -
 - Reasonable interest rate
 - Adequate security

- Adequate security - -
 - Must be tangible
 - Hard assets of the corporation
 - If a lien, must be a first lien on corporate assets
 - Examples include real estate, inventory, receivables, letter of credit
 - Company stock is not adequate security

Timing and Method of Repurchase

- Participant may delay distribution to retirement age, if over certain fixed limitations

Timing and Method Repurchase

- If installment distribution, must be for no longer than 5 years, although it may be extended by one year for each \$195,000 or fraction by which the balances credited to the participant's account exceeds \$985,000
- A promissory note must be for no longer than 5 years
- Each must provide for equal payments

Distinction Between C and S corporation

- C corporation
 - must give the participant the option of stock distribution
 - Stock may be rolled over into IRA and retained in that type of account
 - Participant may keep stock, unless by-laws require immediate sale back under certain requirements

Distinction Between C and S corporation

- S corporation
 - May distribute cash or stock
 - If stock distributed, may require immediate sale back, regardless of what by-laws provides
 - Stock can be rolled over into an IRA, but must be immediately sold back

Trust or Company Buy Back

- Unlike company repurchase, stock repurchased by trust will maintain stock with employees
- Important issue, particularly for ESOPs holding less than 100%, to avoid dilution of ESOP ownership

Trust or Company Buy Back

- If Trust buys back stock, source of funds includes - -
 - Contributions
 - Earnings (S or C corporation dividends)

Liquidate Terminated Accounts

- Cash may be used to cash-out some or all of a terminated participant's account
- Many companies have this option to avoid terminated participants from reaping appreciation after they leave
- Also a way to get more stock back to active participants and not dilute the ESOP

Cash Distributions

- Avoids administrative hurdles of stock distributions
- Easier for rollover purposes
- Best approach for S corporation ESOPs but can be done for C corporation ESOPs as well

Required Diversification

- A participant can diversify a certain portion of their stock account, if the participant is --
 - at least 55, and
 - participated for 10 years

Required Diversification

- Diversification election may be made by a participant each for a six year period.
- Amount that can be diversified is - -
 - 25 percent of the stock credited to the participant's Company Stock Account, plus all amounts previously diversified; less
 - all amounts previously diversified.
- In the case of the last year in the election period, the
 - 50 percent of the stock credited to the participant's Company Stock Account, plus all amounts previously diversified; less
 - all amounts previously diversified.

Documenting Repurchase Obligation

- Plan Document
- Summary Plan Description
- Distribution Policy

Funding Repurchase

- Sinking Fund in the corporation
- Contributions to the ESOP
- Loan to the ESOP

Questions ?

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