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Courts, IRS Weigh in on Mandatory Conversion of Terminated Participants' ESOP Accounts

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Plan sponsors of employee stock ownership plans (ESOPs) that have been submitted for a favorable determination letter know that the IRS is carefully reviewing plan provisions that provide for the mandatory conversion of a terminated participant's ESOP account balance from employer securities to cash. Recent case law and IRS analysis provide a hopeful resolution that should allow ESOPs to retain this right, providing that newly articulated requirements are met.

Hoffman v. Tharaldson Motels Inc. Employee Stock Ownership Plan

In *Hoffman v. Tharaldson Motels Inc. Employee Stock Ownership Plan*, No. 3:08-cv-109 (D.N.D., Feb. 26, 2010), the U.S. District Court for the District of North Dakota, Southeastern Division, ruled that an amendment made to the Tharaldson Motels, Inc. Employee Stock Ownership Plan (Plan) that required a terminated employee to convert his shares of Tharaldson Motels, Inc. (TMI) stock to cash was permitted under the terms of the Plan and the Employee Retirement Income Security Act of 1974 (ERISA). The terms of the amendment specifically required that "any person whose employment was terminated . . . must sell his shares and then must liquidate his account and take the proceeds or leave the proceeds in the Plan and convert the shares to some stable low risk money market account inside the Plan."

The Plan was established in 1998 and restated in its entirety in 2002. The 2002 document was silent as to whether a terminating employee was permitted to retain shares of TMI stock in his or her Plan account. However, the court noted that prior to 2005 it was a well-established administrative practice to convert the account of a Plan participant whose employment with TMI ended from TMI stock to cash. The participant was then permitted to take a cash distribution of his or her account balance or reinvest the amount in a stable value fund. In other words, "Plan participants whose employment terminated were not allowed to retain their Plan interest in TMI stock." In 2005, the Plan was amended to reverse this policy to permit terminated Plan participants to retain shares of TMI stock. The Plan was amended again in 2006. This amendment reinstated the original distribution policy that predated the 2005 amendment. So after the 2006 amendment was adopted, Plan participants whose employment terminated were again denied the ability to remain invested in TMI stock in their Plan account.

Plaintiffs sued to have the 2006 amendment invalidated, or alternatively, to enjoin the application of the 2006 amendment to them because of the alleged failure to disclose the changes made by the 2006 amendment.

The court reviewed ERISA's "anti-cutback" rule and noted that it "prohibits amendments to a retirement plan that reduce a plan participant's 'accrued benefit.'" The court noted that ERISA protects "optional forms of benefit," which generally means that a participant's right to choose the way in which the payment of his or her accrued benefit will be made or applied is protected from change. Under the general rule, the change in the form in which payments are made under the Plan (in other words, from TMI stock to cash), as made by the 2006 amendment, would be a "cutback." "The IRS has, however, created a safe harbor by a duly promulgated regulation allowing plans to be amended to eliminate some alternative forms in which an account balance can be paid under certain circumstances." Under such regulations, the IRS specifically provides certain items that are *not* protected benefits, including "the right to a particular form of investment (e.g., investment in employer stock or securities)."

The court went on to note that the "anti-cutback" rules have been relaxed in light of the fact that it has become easier for participants to replicate payment options available under a qualified plan through other means. The court focused on comments made at the time the relevant regulations were under consideration by the Department of the Treasury, as noted in a 2000 report: "After considering these comments regarding the desirability of requiring the retention of an extended payment form, and in light of [plan] participants' [ability] to replicate any extended form [of investment] that a defined contribution plan may offer by rolling a single-sum distribution to an IRA, the IRS and the Treasury Department have determined that any advantage of requiring the retention of an extended payment form is outweighed by the countervailing considerations." The court noted that the plaintiffs are free to take their single-sum distribution and roll it into an IRA, at which point the plaintiffs may have self-directed investment choices without "burdening the Plan with the cost of providing the particular option they choose."

As a final comment, the court again focused on the fact that the "anti-cutback" rules guard against the erosion of an accrued benefit. As noted by the court, this requirement does not protect "benefits expected but not accrued." "The expectation of the Plaintiffs, that the TMI stock would increase in value should TMI be sold, is not an accrued benefit, but rather an expectation not covered by the anti-cutback rule." Additionally, the court acknowledged the Plan as a tool to motivate employees. "The holding of shares by present employees motivates the employees to maximize their efforts to promote company profitability. Their efforts should not go to increase the value of shares held by departed employees whose efforts are not increasing the value of the shares but are speculating on the increase in the value of the shares." As a result of this analysis, as long as the Plan protects an "accrued benefit," the court found that changes made to the form and structure of the Plan do not give rise to a breach of fiduciary duty claim.

On a Motion to Dismiss, the court ruled that the plaintiffs cannot state a claim upon which relief can be granted.

Response to Technical Assistance Request (#4)

Three days before the court ruled in the *Hoffman* case, the IRS issued a memorandum (Memo) in response to a Request for Technical Assistance with respect to rebalancing and reshuffling provisions in ESOPs. For purposes of the Memo, "rebalancing" is the "mandatory transfer of employer securities into and out of participant ESOP accounts, usually on an annual basis, designed to result in all participant accounts having the same proportion of employer securities." Alternatively, "reshuffling" is the "mandatory transfer of employer securities into or out of ESOP accounts, not designed to result in an

equal proportion of employer securities in each account" (i.e., reshuffling is generally referred to with respect to a terminated participant's account as conversion or segregation of such account into cash). The IRS reviewed both concepts under the stringent requirements imposed upon defined contribution plans in general and ESOPs in particular, including the discrimination requirements, anti-cutback rules, and participant diversification rights.

The IRS concluded that the right to a particular form of investment is not a protected benefit. Plan provisions *may* provide for rebalancing or reshuffling, subject to certain limitations, listed below:

- Plan provisions providing for the mandatory transfer of stock must be set forth in a "definite written program" and set forth a "definite predetermined allocation formula." The plan must, therefore, set forth the number of shares or amount of cash to transfer in or out of plan accounts and the manner in which transfers will be effectuated, including the date of valuation.

- The right of each participant to have or not have a particular form of investment in his or her account is a plan "right or feature" that is subject to the effective availability requirements. "Rebalancing which treats all participants the same, will not raise issues of current and effective availability. [Additionally] because terminated employees comprise a [separate] coverage group . . . a plan provision providing for the transfer of all employer securities from plan accounts of terminated employees [i.e., reshuffling] also does not raise issues of current or effective availability in form."

- The right to retain employer securities is not a protected benefit. *However*, the diversification rights applicable to an ESOP include a participant's right "not to have shares diversified pursuant to [the ESOP diversification requirements] mandatorily transferred back into his or her account." For example, if a participant diversifies employer securities pursuant to a valid diversification election, the ESOP may not, under a rebalancing theory, transfer such employer securities back into the participant's account.

- Reshuffling provisions that apply only to terminated employees and treat all of the terminated employees the same do not raise discrimination issues. However, the Treasury Regulations specifically provide that "consent to a distribution is not valid if the plan imposes a significant detriment on a participant who does not consent to a distribution. . . . A plan providing participants with the option of an immediate distribution would need to have language that preserves sufficient investment options in order to ensure that the loss of the employer stock investment is not a 'substantial detriment.'" For example, a plan may offer three alternative investment options or might offer other choices that include a life-cycle fund or targeted-retirement date fund.

In the two separate instances discussed above, the IRS and a District Court each recognized the ability of an ESOP to convert a terminated participant's ESOP account from employer securities to cash. The Memo published by the IRS specifically identified both rebalancing and reshuffling as permissible provisions to be included in an ESOP. This is good news for those ESOPs that wish to convert the account balances of terminated participants from employer securities to cash. However, it is important to note that the IRS's conclusions may require those ESOPs that wish to use either the rebalancing or reshuffling feature to review the ESOP provisions to ensure the necessary provisions are incorporated in

such a way as to meet the various plan document requirements set forth in the Memo. Furthermore, so as not to run afoul of the consent requirements outlined in the last bullet point above, plan administrators should consult with counsel to ensure their ESOP properly offers alternatives to investment in employer securities. Failure to do so may result in a reshuffling provision that does not comply with the IRS's requirements in either form or operation.

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

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