

THE GROWING REQUIREMENTS ON ESOP THIRD PARTY ADMINISTRATORS OF PRIVATELY HELD COMPANIES

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This discussion provides an overview of the documents that an ESOP third party administrator should require, why they are required, and how they should be used. In addition, this discussion also describes the increased responsibilities that often fall upon the ESOP third party administrator when dealing with (1) an S corporation ESOP and (2) the proper planning for the ESOP repurchase liability.

INTRODUCTION

The responsibilities of a Third Party Administrator (TPA) who performs the administration of an employee stock ownership plan (ESOP) have changed dramatically over the past 10 years. As has always been the case, the rules governing the administration are found in the ESOP Plan Document and Trust Agreement (the "Plan"). However, this is not the only document that is needed when administering a leveraged ESOP.

This discussion summarizes all of the documents that a TPA should require, why they are required, and how they should be used. In addition, this discussion summarizes the increased responsibilities that often fall upon the TPA when dealing with (1) an "S" corporation ESOP and (2) the proper planning for the ESOP repurchase liability.

DOCUMENTS THAT A TPA SHOULD REQUIRE

The importance of having all of the required documents (in addition to the usual correct employee census data) is underscored by the increase in Department of Labor (DOL) audits that were triggered by the collapse of Enron. The DOL scrutinizes the employer stock valuations related to leveraged ESOPs. In addition, the DOL is also delving deeply into the administration of the leveraged ESOP. Add to this the fact that a great majority of client-staff with whom the TPA works is totally unaware of the TPA's need for the additional documents.

It is noteworthy that, as a general rule, the sponsor company client only looks at the administration of its ESOP a few times a year (e.g., valuation time, report time, and distribution time). Many sponsor company clients do not have an on-going relationship with an ESOP attorney. So

they turn to their TPA for all questions, and they expect the TPA to keep them out of trouble.

When there is a leveraged ESOP, it is becoming critically important for the accountant, financial adviser, sponsor company contact, and TPA to function as a team when there is a leveraged ESOP. This need is amplified when the ESOP is an S corporation. To function as part of this team, the TPA needs more than the traditional information. So being a pro-active TPA is becoming a requirement if ESOP clients are to receive the services they need.

The following discussion presents a list of documents (in addition to the usual plan documents, trust agreements, and employee census data) that are needed to administer a leveraged ESOP. The following discussion also summarizes the reasons why the documents are needed.

1. Stock Purchase Agreement and/or Stock Subscription Agreement (signed).

This agreement confirms who the seller is (or the sellers are), identifies the number of shares being sold, the type of shares (common or preferred) sold, and the purchase price. These data will eventually tie in to the ESOP Loan and Pledge Agreement which, in turn, identifies all of the relevant terms of the employer stock acquisition loan.

2. Statement of Consent and Statement of Election.

The Statement of Consent confirms that the sponsor company "consents" to the seller(s) taking advantage of the tax deferral provisions of Section 1042. The Statement of Election identifies all of the sellers who cannot participate in any allocation of any stock in which a seller has taken advantage of the tax deferral provisions of Section 1042 (these shares become

“restricted stock”—for lack of a better term—once they enter the ESOP Trust).

This is certainly true if the amount each seller sold was part of the 30 percent threshold required for anyone to take advantage of Section 1042, even if the specific seller does not take advantage of Section 1042. It is not so clear if the seller’s shares were not needed for the sale to reach the 30 percent threshold point.

However, armed with the information provided by the Statement of Election, the TPA has all the information needed to confirm with the ESOP attorney as to who is—and who is not—qualified to participate in the allocation of restricted stock in the trust.

3. Copy of each Loan and Pledge Agreement between the sponsor company and the ESOP trust and/or seller and the ESOP trust (signed).

Most ESOP documents will stipulate that either the “Interest and Principal” share release formula or the “Principal Only” release formula can be selected by the ESOP trustee. However, the loan document should have the actual formula required.

The loan document will also have all of the terms of the loan spelled out and should also have a statement that the shares pledged as security for the loan are released based on the identified release formula.

If there are multiple loans to the ESOP trust from different parties, there may also be a provision that stipulates one party cannot be paid faster than the others. It is far safer to have the actual signed loan documents than to depend on simply being told what someone thinks the loan provisions are. All this information is required to set up a proper amortization schedule for the ESOP loan(s).

4. Copy of Lender Loan Agreement to the sponsor company if the sponsor company borrowed money to loan to the ESOP trust (signed).

The primary reason for having a copy of this document is to confirm whether or not the lender has been assigned the employer stock pledged to the sponsor company as additional security for the loan. If the employer stock has been assigned, the lender will need to be notified each year how many shares must be released to the sponsor company so that the company can, in turn, release the shares to the ESOP trust for allocation to eligible participant accounts. While this is not a responsibility usually performed by the TPA, it is important to make sure that the sponsor company has assigned someone to take care of this task.

The sponsor company will then need to process new master share certificates modified to reflect the released shares. This latter process should be handled by the sponsor company or by the sponsor company’s attorney.

5. Revised/updated Articles of Incorporation (certification that they are properly filed with employer corporation’s state of incorporation).

If the plan being administered has preferred stock, it is very important that the TPA has a copy of the employer corporation Articles of Incorporation. The articles will identify: (a) if there is a dividend, (b) if the dividend rate is cumulative and for how long it is cumulative, (c) if the preferred shares are convertible to common stock when the loan is retired and the conversion rate.

This information is also needed for the TPA to set up the amortization schedule for ESOP loan(s).

6. Stock Ledger

While the TPA is not the ESOP valuation analyst, it is still important for the TPA to know the total number of shares issued in a given year. With this information, the TPA can confirm the shares recorded in the employer stock valuation report with the shares reported by the sponsor company as a part of the annual data collection process. As stated above, it is important that the professional team is, in fact, a “team.”

7. Complete ESOP transaction employer stock valuation report and each annual employer stock valuation report.

It has become apparent over the years that the TPA needs to see the full ESOP annual stock valuation report. The TPA is not responsible for the stock valuation. And, the TPA has a right to depend upon the information provided by the sponsor company and the valuation analyst. However, prudence suggests that more active involvement in the results provided by each entity is needed if the client is to be properly served.

The most common problems we have encountered are in relation to the annual employer corporation stock valuation and subsequent allocations to the ESOP participant accounts. For example, let’s say that there is no question that the valuation analysis of the sponsor company stock is correct in all respects. However, if the total number of shares issued is not correct, then (1) the value per share is in error and (2) all account balances of all ESOP participants are in error.

There is little value in completing an allocation report under the assumption that the TPA’s contact with the sponsor company knew the exact shares issued for the plan year in question. The sponsor company contact may know the shares the ESOP trust has, but do those shares still have the same relationship to the total value of the sponsor company? Have more shares been issued outside of the ESOP, thereby diluting the percent ownership the ESOP has and the corresponding share value? Have shares distributed to terminated ESOP participants been purchased by the sponsor company and retired? Or, has the sponsor company contributed new shares to the ESOP? And if it has, when were they contributed and were they considered in the valuation analyst’s determination of share value?

Again, the TPA is not the valuation analyst and is not a fiduciary of the ESOP trust. Be that as it may, the

TPA's knowledge in this area can be of great assistance to the sponsor company client and all members of the sponsor company's ESOP team as a facilitator of the ESOP administration process.

Lack of effective communications between the ESOP valuation analyst, the accountant, the ESOP attorney, the TPA, and the sponsor company can result in errors occurring that, simply, do not need to occur. No one is advocating that the TPA should take on the task of valuation analyst, accountant, and attorney. On the contrary, it is simply being recommended that a team encompassing these professional advisers be created. The foundation of this team effort is the sharing of information, which includes the TPA having the documents listed above.

S CORPORATION ESOP ADMINISTRATION ISSUES

The ESOP Association and the National Center for Employee Ownership have devoted a great deal of time to the special issues surrounding the administration of S corporation ESOPs. All of the documents mentioned above should also be in the hands of the TPA of an S corporation ESOP.

The procedural recommendations of a team structure also apply. However, the restrictions encompassed in Section 409(p) have created testing requirements that need to be completed at least annually (and based on certain factors, monthly or more frequently) related to the determination of disqualified persons and the problem of accidentally falling into a nonallocation year.

The issue is: Who should conduct this test? My recommendation is that it should be either the ESOP attorney, accountant, TPA, or a person who has developed a specialty for conducting the test. In any case, we recommend that someone is specifically charged with this responsibility, in writing, and has accepted the responsibility, in writing. Again, this is where the concept of working as a team comes into play in a very powerful way.

THE PROPER PLANNING FOR THE ESOP REPURCHASE LIABILITY

When is it time to implement a plan to deal with the sponsor company's ESOP repurchase liability? The answer is: sufficiently before distributions are started, so as to ensure payments to terminated participants and ensure a smooth process whereby the sponsor company's financial security is not undermined.

This, of course, will vary with each sponsor company. However, as a general rule, the planning process should start at least three years before the first payment to the terminated ESOP participants is due.

There is no question that the current repurchase liability programs are heavily dependent upon estimates of the sponsor company's: (1) growth, (2) employer stock value, and (3) employee turnover due to disability, death and, simply, termination. The projected employee retirement is fairly easy to determine. And, most TPAs will provide this information each year along with a projection of diversification requirements.

While current repurchase study programs provide actuarial scales for death and disability, most privately held sponsor company ESOPs are far below the employee numbers where these scales make any sense and usually represent a very small part of the repurchase cost.

The more difficult task in the repurchase study is estimating employee turnover, sponsor company growth, and sponsor company stock value. These three factors have the greatest effect on a sponsor company's repurchase liability results. Therefore, these three factors require the greatest deal of effort in developing statistically sound projections.

Yes, projections are typically a guess that usually becomes less accurate each year the projection is extended from the current year. However, even with these caveats, a well designed projection based on historical facts and responsible sponsor company expectations, can give a sponsor company a fairly accurate estimate of repurchase liability going into the future.

A repurchase liability study should be updated on a regular basis, at least every three years, or earlier if the projections are not tracking actual costs. With the repurchase study in hand, the sponsor company management can then develop a distribution policy that encompasses the company's planned cash flow. Exhibit A presents an illustrative distribution policy.

SUMMARY AND CONCLUSION

This discussion provided an overview of the documents that a TPA should require, why they are required, and how they should be used. In addition, this discussion also covered the increased responsibilities that often fall upon the TPA when dealing with (1) an "S" corporation ESOP and (2) the proper planning for the ESOP repurchase liability. As part of this process, the TPA, the valuation analyst, the accountant, the ESOP attorney, and the sponsor company should work together as a team. This team will enable each individual to have an expanded knowledge of the sponsor company's ESOP transaction, stock valuation, administration, and financial reporting.

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Exhibit A
Sample Company, Inc.
Illustrative Employee Stock Ownership Plan Distribution Policy

Column AA	Column BB	Column CC	Column DD	Column EE	Column FF	Column GG
		INDIVIDUAL DIST. LESS THAN \$10,000 REGARDLESS OF AGGREGATE	INDIVIDUAL DIST. \$10,000 TO \$24,999 AGGREGATE DIST. UP TO \$100,000	INDIVIDUAL DIST. \$25,000 TO \$49,999 AGGREGATE DIST. FROM \$100,001 TO \$150,000	INDIVIDUAL DIST. \$50,000 TO \$74,999 AGGREGATE DIST. FROM \$150,001 TO \$250,000	INDIVIDUAL DIST. \$75,000 AND OVER AGGREGATE DIST. \$250,001 AND OVER
A	DEATH	YEAR FOLLOWING EVENT 100%	YEAR FOLLOWING EVENT 100%	YEAR FOLLOWING EVENT 100%	YEAR FOLLOWING EVENT 100%	YEAR FOLLOWING EVENT 100%
B	DISABILITY OR NORMAL RETIREMENT	YEAR FOLLOWING EVENT 100%	YEARS FOLLOWING EVENT 1st year 50% 2nd year 50%	YEARS FOLLOWING EVENT 1st year 33% 2nd year 33% 3rd year 34%	YEARS FOLLOWING EVENT 1st year 25% 2nd year 25% 3rd year 25% 4th year 25%	YEARS FOLLOWING EVENT 1st year 20% 2nd year 20% 3rd year 20% 4th year 20% 5th year 20%
C	OTHER TERMINATIONS OF SERVICE	YEAR FOLLOWING EVENT 100%	COMMENCE 3RD YEAR FOLLOWING EVENT 3rd year 50% 4th year 50%	COMMENCE 3RD YEAR FOLLOWING EVENT 3rd year 33% 4th year 33% 5th year 34%	COMMENCE 3RD YEAR FOLLOWING EVENT 3rd year 25% 4th year 25% 5th year 25% 6th year 25%	COMMENCE 3RD YEAR FOLLOWING EVENT 3rd year 20% 4th year 20% 5th year 20% 6th year 20% 7th year 20%

- NOTES:**
1. **AGGREGATE** - Means the total of all distributions (e.g., death, disability, and other) for the year in question. Once a distribution is initiated for an ESOP participant, it will not change in future years. For example, if the ESOP participant's initial distribution falls in Column DD, it cannot be adjusted up to EE or down to CC. It is frozen in Column DD. Distributions totaling less than \$10,000 will always be distributed in a lump sum (COLUMN CC), regardless of the aggregate amount.
 2. The amounts shown are vested ESOP account balances in dollars. A distribution can consist of Sample Company, Inc. common stock. Should this occur, the common stock will be distributed to the ESOP participant and may be repurchased by the sponsor company or the ESOP trust according to the put option procedures in the ESOP. The percentage numbers relate to the percent of the ESOP accounts values.
 3. "Event" is the year in which the following occurs: death, disability, normal retirement, or other terminations.
 4. Assumes the ESOP participant consent received by written authorization provided by the ESOP trustee (or the ESOP committee). The years shown are plan years ending December 31.
 5. Subject to law and regulations. No one will be paid out less quickly than required by law.
 6. For further information on details of application, reference should be made to the formal policies of the individual ESOP trust.
 7. "THIS ESOP DISTRIBUTION POLICY IS SUBJECT TO AMENDMENT AT THE DISCRETION OF THE SPONSOR COMPANY."

EXAMPLE:

1. ESOP participant "A" quits and his/her distribution equals \$20,000 and the aggregate of all distributions for the year in question equals \$80,000. The distribution timing moves to Column DD. In all cases, when the ESOP participant's distribution amount is first determined and the distribution timing falls into a specific column identified by the amount of the individual distribution and the aggregate of all distributions for the initial year, the distribution timing for that terminatee ("A") is fixed. In later years, terminatee "A's" distribution amount is counted in the aggregate calculation for all terminatees receiving a distribution in that year.