The Public Company ESOP in 2004

DAVID W. POWELL

David W. Powell is a Principal with the Groom Law Group in Washington, DC. A CPA as well as an attorney, Mr. Powell is a former President of the Washington Employee Benefits Forum and has practiced in the field of employee benefits for over 20 years. The author wishes to thank Ian Lanoff, Bob Gallagher, Lou Mazawey, Rick Matta and Emmy Zuckerman for their assistance and advice in the preparation of this article.

In March 2000, before the collapse of Enron and WorldCom, and before the names Sarbanes and Oxley became inextricably tied to corporate governance, the author, along with fellow Groom Law Group Principals Ian Lanoff and Tom Terry, wrote an article in the *Journal of Accountancy,* which described the then-current issues facing employee stock ownership plans (ESOPs) sponsored by public companies. At the time, the authors viewed the hot topics affecting public company ESOPs as involving the deductibility of dividends used to repay loans, the "pass through" of dividends to participants in cash or reinvested in employer securities, fiduciary issues, accounting changes, "reloading" the ESOP with shares, refinancing exempt loans and employer stock grantor trusts.

Things have changed since that time, and ESOPs maintained by public companies have been much in the news lately. Most of that attention was engendered by the spectacular collapse of several large public companies and has focused on the fiduciary questions surrounding the investment of plan assets in employer stock. This article will briefly review those issues but more importantly, will try to distill some of the "lessons learned." But there are a number of other ESOP issues and technical questions that have arisen in recent years, many unique to ESOPs maintained by public companies. Issues affecting private company ESOPs—such as S corporations, 1042 transactions, and stock valuation issues—have continued to evolve as well, but in our view have already received a fair amount of attention in the tax press. ESOP issues of public companies have not received as much attention. This article will attempt to remedy that.

This article will focus on new developments in several particular areas since 2000: fiduciary issues, securities law issues, insider trading concerns,

the impact of Sarbanes-Oxley, new rules for dividends, recent DOL guidance on refinancing, company bankruptcies, and accounting and record-keeping issues arising under unit accounting.

FIDUCIARY ISSUES

> It's important for fiduciaries not to become complacent. . . . In-house fiduciaries must be sensitive to company-related events that can cause their fiduciary duties to conflict with their role in the company. Also, any downturn following a bull market may cause problems. It may be advisable for fiduciaries to consider in advance what their responses would be to such contingencies.
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> *Journal of Accountancy*, March 2000.

That was not written with the help of a crystal ball. It is standard advice. Since that time, though, experiences with employer securities in such companies as Enron, WorldCom, and others have certainly reinforced it. A lot of ink has been and will continue to be spilled on what the Enron and WorldCom plan fiduciaries, in particular, did or did not do as their share prices collapsed, and the litigation over those plans will further develop the body of knowledge on ERISA fiduciary duties, particularly the duties of those who appoint fiduciaries, the liability of officers and directors, and the duties of directed trustees.

The final story on the major stock collapses of recent years has not been written, but it is possible to learn some lessons that can be applied now. If some of these lessons are not new, at least there now exist nice object lessons in what happens when they are ignored.

Lesson 1

There are fiduciaries with respect to employer stock in an ESOP. It is important to know exactly who they are. Case law continues to draw a distinction that, while an ESOP is designed to invest primarily in employer securities by definition, that does not mean that plan fiduciaries can sit idly by as its value drops. And it is important to remember that someone is a fiduciary with respect to all plan investments, including employer stock. But who are they? A close look at plan and trust documents will usually indicate who at least some of those fiduciaries are. For many public companies, a committee or committees will be the principal fiduciary for plan investments, including employer stock, under the plan and trust documents.

But someone can also become a fiduciary *in fact* by exercising discretionary authority and control over the management of the plan or the

investment of plan assets. In other words, those actually "calling the shots" on the investment of plan assets or the administration of the plan may be fiduciaries as well as the people or committees named in the plan and trust documents. As several of the recent cases involving employer securities have pointed out, a person or entity appointing a fiduciary can be a fiduciary as well, with respect to the act of making such appointments. Proper identification of the plan fiduciaries is also important because a fiduciary can in some cases become liable for breaches committed by other fiduciaries.

A particular question arises when the plan or trust simply names the company as the fiduciary. That is whether such a designation makes the company's board members or officers fiduciaries as well. The answer is murky, because case law has tended to focus on whether the individual in question was functioning as a fiduciary "in fact," *i.e.*, was actually making fiduciary decisions, even if on behalf of the company, rather than on the person's title. The lack of clarity in determining who may be a fiduciary in fact when the company is named, and the prospect for second-guessing by courts, is currently leading plan sponsors away from designating the company as a fiduciary and towards more specific designations, such as the relevant committee, specific officers and so on.

Lesson 2

Once you know who your fiduciaries are, consider who they should be. As noted above, even if not named as a fiduciary in the plan and trust documents, a person can become a fiduciary simply by exercising fiduciary duties "in fact." We suggest that it is likely to result in better fiduciary decision-making if the company has deliberately determined who should be making fiduciary decisions regarding a plan, clearly designated them as fiduciaries, and made certain those individuals in turn understand their fiduciary duties. It is also better for the company to decide who should be making decisions as a fiduciary than to let the court tell them who was a fiduciary after the fact.

In the course of considering who should be the fiduciaries, several considerations arise that must be evaluated by each plan sponsor based on its own facts and circumstances. Some of these considerations may include how senior the executives should be who will be making fiduciary decisions, whether any "insider" knowledge that particular individuals may have could raise problems (see discussion below), and whether corporate counsel should serve on fiduciary committees, which may raise questions concerning attorney-client privilege.

Lesson 3

Monitor employer securities as an investment. There is little support for taking the position that employer stock is a completely "hands off"

investment. But it is not entirely clear what the standard of fiduciary duty is with respect to employer stock in an ESOP. This is an area that is evolving in the litigation, but perhaps the best current view, and a useful one for fiduciaries trying to come to grips with what they should be doing, derives from a decision from the Third Circuit in 1995, *Moench v. Robertsen.*[1] *Moench* essentially stands for the proposition that there is a "presumption" that it is prudent for an ESOP to invest in employer securities. However, that is a rebuttable presumption, and the fiduciaries might, under some circumstances, be forced to conclude that employer securities are an imprudent investment. So, under *Moench*, an ESOP fiduciary may be able to hold into employer securities and not sell them under circumstances when, for any other type of plan investments, the fiduciary might conclude it should be sold. Recently, the Seventh Circuit and Ninth Circuits followed reasoning similar to *Moench* in *Steinman v. Hicks*[2] and *Wright v. Oregon Metallurgical Corporation.*[3]

Accordingly, many practitioners have concluded that the appropriate fiduciaries for the investment in employer stock (once it has been determined who they are) should monitor its performance, not unlike what it does with other investments, and maintain records of their deliberations. How the fiduciary acts upon that information with respect to employer securities may, however, then be different than what it would do with respect to other investments because of the *Moench* presumption. Engaging in such "procedural prudence" is likely to result in a fiduciary's decision being afforded more deference.

A related point to consider arises when there are employer securities in the company's defined benefit plan (subject to the 10 percent limitation of ERISA Section 407(a)) as well as in the ESOP. The fiduciary for the investment in that plan may be different than for the company's defined contribution plan. And because ESOPs and defined benefit plans have different purposes and different funding needs, there may be good reasons for making different decisions about whether to buy, hold, or sell employer securities as between the two plans. But it may also be important for the plan fiduciaries to be able to articulate the reasons for acting differently with respect to employer securities under different plans.

Lesson 4

Consider expanding employee diversification rights. In a typical public company ESOP, the employee may direct the investment of that part of the employee's account derived from his or her own salary reduction contributions into and out of employer securities much like he or she does with other plan investments, such as mutual funds. At the same time, employer stock allocated as the employer match or nonelective profit-sharing contributions under the ESOP are usually required to remain invested in employer securities until distribution from the plan, usually upon termination from employment or retire-

ment, and often subject only to the diversification rules of Code Section 401(a)(28) (which generally permit employees age 55 or over with 10 years of participation to diversify up to 50 percent of their ESOP account).

Expanding the rights of participants to diversify their ESOP accounts, however, may have the benefit of putting less pressure on the plan fiduciaries to make the proper decision as to when to buy, sell or hold the security by shifting that responsibility to the participant. This is particularly true to the extent that the ESOP becomes subject to ERISA Section 404(c), which provides that if a plan provides for individual accounts and permits the participants and beneficiaries to exercise the investment control over their accounts, no person who is otherwise a fiduciary shall be liable under ERISA for any loss which results from the participant's or beneficiary's exercise of such control. Thus, the fiduciaries can be largely relieved of liability for a failure to buy or sell the employer security. But fiduciary duties cannot be removed entirely by Section 404(c). As illustrated by the *Enron* claims, and as has always been indicated by the Section 404(c) regulations, the fiduciary will remain responsible for whether it is prudent for the investment in question to be offered under the plan. So if the value of an employer security collapses before the participants can effectively sell it, for example, the fiduciaries may still be subjected to claims that they should have acted to remove the security as an investment, presumably by selling it earlier. This is particularly true if the claims can be made that the fiduciaries were insiders having knowledge that should have lead to that conclusion. (Insider trading issues are discussed more below.)

Nevertheless, the trend has been to allow greater employee diversification rights. There are potential downsides to be considered—reductions in shares held may result in less dividends to repay exempt loans and could create an issue of satisfying the requirement that ESOPs be "primarily invested" in employer securities (more about this, too, below). However, a number of pension bills which have come up before Congress in the wake of the Enron debate would liberalize the diversification rules, at least for public companies, and it remains possible that the rules will be liberalized at some point.

Lesson 5

Communicate better with employees. ESOP summary plan descriptions are getting a fresh look in light of the ESOP fiduciary litigation. In particular, disclosures concerning the risks of employer securities, the importance of diversification, and how unit accounting works, where applicable, are being beefed up.

SECURITIES LAW ISSUES

Following not far behind the fiduciary issues being litigated in *Enron* are the securities law issues. To greatly oversimplify matters, these issues

have arisen because officers and insiders of companies who allegedly knew of wrongdoing either gave out false information, or at least failed to give out truthful information. This impacts ERISA fiduciary duties in at least two major ways; first, there is a question of whether those persons have a duty to provide information to the plan fiduciaries to act upon, and second, there is a question of what a fiduciary should do when he or she possesses non-public information. The principal concern of a plan fiduciary will often be this second concern. Reconciling securities law issues and ERISA fiduciary issues can be very difficult. One early case, *Hull v. Policy Systems*[4] generally held that ERISA did not impose a duty to violate securities law, and that fiduciary committee members were not obligated to trade based in insider information they possessed. But the answer may turn out to be more complicated. In its amicus brief in the *Enron* case, the Department of Labor (DOL) has suggested a harder analysis, which might be characterized as that a fiduciary must satisfy both ERISA and the securities laws. In their brief in the case, the DOL has argued that the officers of Enron who were also plan fiduciaries and who held nonpublic information could have:

1. Disclosed the poor financial condition of Enron to all the shareholders (plan and public);

2. Eliminated Enron stock as a plan investment at the time questions about Enron's financial condition were initially raised; or

3. Reported to the SEC or DOL that potential misinformation was being provided.

Obviously, the application of the DOL's analysis will be a very difficult one for fiduciaries in some situations. The response will depend upon the facts of each case, and in some cases, it may become advisable to seek the further guidance of the DOL.

INSIDER TRADING CONCERNS

Another practical concern is whether the selection of plan fiduciaries may exacerbate insider trading concerns. First, we would observe that it is the possession of insider information, not the title of the individual, which gives rise to insider trading concerns. And second, trying to rid a fiduciary committee of anyone who might at some point possess insider information might lead to an opposite problem of duties being delegated to individuals whose knowledge or junior level is such that it may make them more prone to claims that they were not making prudent decisions compared to senior employees. However, it may be advisable to review who sits on plan fiduciary

committees involving investment of employer securities to determine whether some corporate positions will routinely raise insider trading concerns.

SARBANES-OXLEY

Much of Sarbanes-Oxley Act of 2002, passed largely in response to Enron, deals with corporate governance, but provisions of it impact employee benefit plans directly where a plan imposes a "blackout" on trading employer securities and other plan investments. For employee benefit plans, the Act's imposes substantial requirements for providing notices to participants and beneficiaries before the blackout period begins. However, in addition to the substantive notice requirements added by Sarbanes-Oxley to ERISA (enforced by significant monetary penalties for failures), the securities laws were amended to impose requirements prohibiting certain directors and executive officers from trading employer securities outside of the plan during a plan blackout period.[5] Important elements in both the ERISA and securities law rules are the definition of blackout period and the exceptions to the definition, such as "regularly scheduled" blackout periods. The ERISA and SEC rules are similar but not identical, and fail to overlap fully in some important ways. Companies should exercise particular care in satisfying both sets of rules.

DEDUCTIBILITY OF ESOP DIVIDENDS AFTER EGTRRA

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) liberalized the rules by which employers can deduct dividends paid as shares held in an ESOP. Prior to EGTRRA, a company could deduct dividends paid to an ESOP which were reinvested in employer securities only if the dividends were used to pay an exempt loan or distributed in cash to the participant.[6] The IRS had already slightly liberalized those rules through a series of private letter rulings permitting reinvestment of dividends otherwise distributed in cash in employer securities, but those reinvestments were essentially treated as Section 401(k) elective contributions, subject to the Section 402(g) and 415 limits, and available only to active participants. This interfered with the other Section 401(k) contributions by the participant and the process was administratively burdensome.

The changes made by EGTRRA eased these administrative burdens. The amount subject to the election is no longer constrained by the Section 402(g) or 415 limits, and does not affect the participant's other Section 401(k) elections. It can also be made by inactive participants and beneficiaries of deceased participants. The new law imposes a number of new requirements, notably including that the participant must be fully vested in any

dividend for which an election is permitted. The IRS has given guidance on these requirements in IRS Notice 2002-2. However, one requirement, that the plan must be designated as an ESOP, has given rise to some complications.

Some background is helpful to understand why. In the typical pre-EGTRRA public company ESOP, the entire plan was not usually designated as an ESOP. Rather, the only account designated as an ESOP required to be invested in employer securities (subject only to required diversification rights) was typically the employer matching contribution account. Such a plan usually had another major account holding employer stock, which was the account for employees to invest their own salary reduction contributions in employer stock, but this account was typically not designated an ESOP. There were two main reasons for this; first, the matching account was the only account that needed to be an ESOP under prior law, typically because it had (or once had) an exempt loan used to acquire the shares used for the employer nonelective contribution, and second, it was viewed as the safer approach to designate only accounts that would meet the "primarily invested" requirement by definition (because they held only employer securities, plus, in some cases, a small amount of cash for liquidity) so that the requirement would always be met.

But the new dividend deduction rules of EGTRRA put pressure on plan sponsors to expand the portion of the plan designated as an ESOP. First, the new Section 404(k) deduction rules only allowed the deduction of dividends if paid to an ESOP. The only thing that had to be done for the company to capture a deduction for the dividends paid to the account holding employer stock purchased with the participants' own salary reduction money was to designate that account to be an ESOP as well, and add a cash distribution election. But for many employers, a nondiscrimination problem loomed before making such an ESOP designation.

This was because elective contributions under Code Section 401(k) are subject to a fairly rigid nondiscrimination rule known as the "average deferral percentage" or "ADP" test. This test restricts the elective deferrals by highly compensated employees (HCEs) to a certain percentage of compensation in proportion to average deferral made by nonhighly compensated employees (NHCEs). The test tends to result in material limitations on contributions by HCEs in many public company plans. Importantly, under prior regulations, an ESOP could not be aggregated with the rest of a 401(k) plan for running this test. And many employers found that HCEs tend to invest more heavily in employer stock than NHCEs. As a result, if only the employer stock investment fund based on employer contributions under a 401(k) plan were designated as an ESOP, dividends would not be deductible, but if the employer stock fund was designated as ESOP as well, it was often difficult to pass the ADP test. Running two separate ADP tests was often costly to perform as well.

Companies found two ways to work around this problem. One was to not let Section 401(k) contributions be invested in employer stock until some time period had passed. The result, presumably, though not yet formally approved by the IRS, is that all Section 401(k) contributions would be to a non-ESOP, and thus a separate ADP test did not have to be run. At a later time, these funds could then be invested in employer stock if the participant so chose. Another, and perhaps more popular, response was to designate the entire plan as an ESOP, thus reducing the ADP test to a single plan-wide test. In many public company qualified plans, between the large quantity of stock built up over the years and the run-up in stock values in the '90s, more than 50 percent of the value of the plan's assets consisted of employer stock, so the "primarily invested" requirement could be met on a plan-wide basis.

More recently, the IRS has proposed a change to reverse Treasury regulations that currently do not permit ESOPs and non-ESOPs to be aggregated for ADP testing, so as to allow such aggregation in the future.[7] Assuming the proposed regulation becomes final, the reason for designating the entire plan as an ESOP will go away. This raises a question of whether an employer with a plan already designated as an ESOP in its entirety should make any changes in response. Not necessarily. But it should be recognized that the "primarily invested" requirement may raise issues for a plan in the future, if the value of employer stock in the plan as a whole were to fall below 50 percent. Note, first, that the consequences of such a drop may not be immediate, because it is possible that the "primarily invested" requirement may be applied taking a long-term view of the plan's investments. But a prolonged drop in value could certainty raise the issue of whether the plan still qualifies as an ESOP.

Another issue that may be presented is whether a plan can be amended to provide that it (or at least the non-employer stock accounts within it) are no longer a ESOP, and, if so, what the consequences of that would be, such as whether and how the ESOP rules would continue to apply if the plan is no longer an ESOP. The IRS has provided little guidance on such issues, but regulations indicate that if a plan ceases to be an ESOP, the "protections and rights" of participants must be nonterminable.[8] Under that view, if a plan were to be amended to no longer be considered an ESOP in its entirety, but rather an ESOP only as to the accounts in the plan that hold employer stock, the ESOP rules would presumably continue to apply not only to the employer stock held in the plan, but the account balances in the plan on the effective date of the change. It is possible there would be little effect from such a change, though, if the stock remains publicly traded and the plan preserves the right of a participant to receive his or her entire distribution in stock.

NEW GUIDANCE ON ESOP REFINANCINGS

In Field Assistance Bulletin 2002-1, dated September 26, 2002, the DOL broke its silence on how it views the prohibited transaction exemption for ESOP loans and the ERISA fiduciary requirements applied to the refinancing of ESOP loans. This was an area of some controversy since the Internal Revenue Service imposed a moratorium in the mid-1990s on issuing rulings on the permissibility of ESOP loan refinancings (under the parallel Internal Revenue Code prohibited transaction excise tax exemption for ESOP loans and the related regulation) and representatives of the DOL had begun to speak informally of significant reservations concerning such refinancings and audited a number of plans which had refinanced their loans.

The Field Assistance Bulletin is essentially a memorandum to DOL representatives in the field. It describes the issue and provides background, analysis and the DOL's conclusion. In this case, the bulletin described the obligations in connection with the refinancing of an exempt loan of a fiduciary under the fiduciary requirements of ERISA Section 404(a) and the prohibited transaction exemption for ESOP loans under ERISA Section 408(b)(3).

The Field Assistance Bulletin in a nutshell states that:

- ESOP refinancings are okay if:
  - — the fiduciary satisfies the primary benefit requirement. If so, fiduciary duties under 404(a)(1) will "typically" also be satisfied.
  - — the plan and loan documents do not prohibit it.
- Determining whether the primary benefit requirement has been met is to be based on "all the surrounding facts and circumstances."
- The refinancing may also benefit the employer, but the fiduciary must act with undiluted loyalty to the participants and beneficiaries.
- The primary benefit requirement is met if the fiduciary reasonably concludes that the transaction is
  - — advantageous to the plan's participants and beneficiaries after a careful assessment of the costs and benefits of the transactions, and
  - — the terms of the transaction are at least as favorable as the terms that would have resulted from an arm's length negotiation between independent parties.
- The fiduciary may consider "inducements" offered by the employer to enter into the refinancing. Common inducements may include:
  - — a commitment that shares held in the suspense account will not be applied to repayment of the outstanding portion of the

ESOP loan if the ESOP is terminated.
— additional diversification rights to participants
— an increase in the employer matching contribution
— the payment of a "dividend make-whole" to compensate participants and beneficiaries for the increased use of dividends for loan repayment.

- One circumstance of particular importance is whether the sponsoring employer has previously made an "enforceable commitment" to make all of the contributions necessary to repay the loan. In these cases, the Bulletin suggests that "substantial" additional consideration may be necessary to enter into the transaction.

The Field Assistance Bulletin was welcome news inasmuch as many refinancing transactions followed such an approach before 2002. Because the Bulletin reinforces the "facts and circumstances" nature of whether the "primary benefit" requirement is met, use of an independent fiduciary to evaluate the costs and benefits of the transaction to the participants and beneficiaries of the ESOP was and remains a useful approach to avoiding real or perceived conflicts of interest that might otherwise lead to subsequent second-guessing of fiduciary decisions.

COMPANY BANKRUPTCY AND ESOP COMPLIANCE ISSUES

When a public company with an ESOP declares bankruptcy, the fiduciary issues discussed above are commonly at the forefront. But there are issues of complying with Internal Revenue Code requirements as well. The principal tax issues arise because the shares cease to be publicly traded. ESOP shares which are "readily tradable on an established securities exchange" are not required to be independently appraised, and are not subject to the so-called "put option" requirement, that a participant have the right to require that the employer repurchase the shares under a fair valuation formula. An "established securities exchange," in the eyes of the IRS, includes only the NYSE, ASE and NASDAQ, but *not* the over-the-counter bulletin board (OTCBB) or the "pink sheets." If the stock in question ceases to be traded on an "established securities exchange," which is a typical result in connection with a bankruptcy (though not necessarily occurring at the same time as the bankruptcy), the ESOP will at a minimum have to begin complying with the independent appraisal and put option requirements.

Presumably, satisfaction of the appraisal requirement may be accomplished by having the stock appraised as of any day in the plan year in which it ceases to be readily tradable on an established securities exchange. The last day of that plan year may be most useful if it provides a valuation that can also then be used for Form 5500 purposes.

Some fiduciaries may determine simply that, following bankruptcy or de-listing, employer stock should be sold and eliminated as a plan investment. Where that does not happen, though, operation of the put option raises additional questions. One issue may be what will happen if the employer, being in bankruptcy, cannot honor a put. And even if the employer can honor the put, the question arises as to how to value the stock for purposes of the put. One option would be the appraised value. Another, if the stock is traded on the OTCBB or pink sheets, may be the price on these markets, *e.g.*, with the bankrupt employer or the plan simply selling the shares on whatever market exists. There is scant authority on these questions, and the answer will depend upon the facts of the situation, the bankruptcy court, and the possible involvement of the DOL or IRS. However, failure to satisfy the independent appraisal and put option requirements may result in disqualification of the plan for tax purposes, and in the case of improper or nonexistent put options, a prohibited transaction may result as well.

Convertible preferred shares may give rise to an additional issue, and that is how to treat the preference that these shares have, sometimes expressed as a floor price that will be honored by the issuer. Presumably, that preference is an unsecured claim in the bankruptcy, and how that claim is treated will also have to be addressed in the bankruptcy court. The preference and any such claim may also affect the appraisal of the security.

A further issue that may arise in connection with a bankruptcy is what happens if, due to a loss of share value, the plan ceases to be "invested primarily in employer securities." This assumes that the fiduciary does not conclude that the stock may recover, since it is possible, though by no means clear, that the requirement may be satisfied on a long-term basis. However, a failure to meet the requirement will mean that the plan ceases to be an ESOP. Neither the DOL nor the IRS has given clear authority on what the consequences are when an ESOP no longer meets the "primarily invested" requirement. A number of Code requirements accompany ESOP status, including the put option requirements (409(h)), special distribution rules (409(a)), special allocation limitation on shares acquired in 1042 transactions (409(n), though this will rarely apply to public company ESOPs), voting rights (409(e)), special definitions for employer securities (409(l)), qualified gratuitous transfers (664(g)), the diversification rules (401(a)(28)(B)) and independent appraisal requirements (401(1)(28)(C)). The prohibited transaction exemption for an exempt loan to acquire employer securities also depends upon the ESOP status of the plan, but somewhat problematically that loan may be defaulted upon by the time these questions arise.

Proposed regulations under Code Section 411(d)(6), the anti-cutback rules, also address some of these issues. For example, the right to a particular form of investment (*e.g.*, employer stock) is not a protected benefit. In addition, the proposed regulations permit an employer to substitute, with respect to

all participants, cash distributions for stock distributions where the employer stock ceases to be readily tradable. An employer may also eliminate a lump sum or installment option for employer stock which becomes subject to the "put option" requirements, provided that the distribution requirements otherwise applicable to an ESOP are met (for example, distributions may be delayed under the special ESOP distribution rules of Code Section 409(o)(1)). Plan amendments may be required to effectuate such changes.

UNIT ACCOUNTING ISSUES

Attention has begun recently to be focused on the common use of "unit" accounting in public company ESOPs. In unit accounting, essentially, the employer stock is not individually allocated to participant's accounts as shares, but rather is accounted for as a fund, and the participant's accounts are treated as holding divisible "units" in the fund. Because there typically is a certain amount of cash held in the fund at any given time—dividends or contributions being held pending payment on an exempt loan, or in order to facilitate cash withdrawals, for example—there will normally be a slight difference between the value of a unit and the comparable value of a share, depending upon whether the stock's performance has been greater or lesser than the short-term investment of the cash.

One area of growing concern has been that ESOP participants may not understand that a unit is not exactly the same as a share of stock, and the differences that may result from the amount of cash in the fund. Increasingly, summary plan descriptions are being revised to explain how unit accounting works and how it may affect the value of the participant's account.

Because there is little guidance on unit fund accounting, there is also some variation in how such funds account for dividends. For example, some plans treat dividends on ESOP stock as receivables by the fund from the ex-dividend date until the date paid and received by the plan. When the dividend is received, the receivable is reversed and the cash is reinvested in employer securities. This has the effect that, if a participant receives a distribution based on the value of a unit between the ex-dividend date and the date the dividend is received, that distribution is then based on the value of that unit including the receivable. However, another method is not to set up a receivable for the fund on the ex-dividend date. In that case, if a participant receives a distribution after the ex-dividend date but before the subsequent payment date and allocation to the fund, the participant may then be sent a residual check.

STOCK REDEMPTIONS AS DEDUCTIBLE DIVIDENDS UNDER SECTION 404(K)

The Ninth Circuit in *Boise Cascade Corp. v. U.S.*[9] ruled last year that amounts paid to redeem ESOP stock that was then used to make cash distributions to terminating participants could be deducted as dividends under Section 404(k). The redemptions were held to be treated as dividends because, in that case, there was no meaningful reduction in the shareholder's proportionate interest in the corporation, if the trust rather than the individual participants are viewed as the shareholder. Caution should be exercised, however. The IRS is understood to remain in disagreement with the holding in *Boise Cascade*, and may challenge such deductions in other circuits. The position of the IRS is set forth in Revenue Ruling 2001-6.

CONCLUSION

ESOPs continue to pose interesting and difficult questions given the spotlight from Enron and WorldCom, augmented by legislative changes of EGTTRA and further DOL and IRS guidance. Further legislation, too, of course, may be on the horizon. Public companies should stay fully informed on these issues, and plan for them. As suggested in the *Journal of Accountancy* years ago, for public company ESOPs, where potential liabilities can be great, an ounce of prevention is worth a pound of cure.

ENDNOTES

1. 62 F.3d 553 (3d Cir. 1995)
2. 352 F.3d 1101 (7th Cir. 2003)
3. 360 F.3d 1090 (9th Cir. March 11, 2004)
4. 2001 WL 1836286 (not required in F. Supp. 2d) (D.S.C. 2001).
5. For more information on these rules, *see* Ufford, Winters & McGuiness, "New Rules for Blackout Periods under the Sarbanes-Oxley Act," at *www.groom.com*.
6. Before and after EGTRRA, dividends used to make ESOP loan payments may be deductible, as described in more detail in the March 2000 *Journal of Accountancy* article mentioned above.
7. *See* Prop. Treas. Reg. § 1.401(k)-1(b)(4)(v) (July 17, 2003).
8. Treas. Reg. § 54.4975-11(a)(3)(ii).
9. 329 F.3d 751 (9th Cir. 2003)