ESOP Freeze, Wind-Down, and Termination Considerations

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This practice note discusses planning considerations related to the termination or wind-down of an employee stock ownership plan (ESOP). These include tax ramifications and considerations arising under the Employee Retirement Income Security Act of 1974 (ERISA).

This practice note addresses the following topics:

- Decision to Terminate an ESOP
- Parties Involved in ESOP Termination
- ERISA Issues
- Internal Revenue Code Issues
- Steps to Terminating the ESOP
- Consequences of Wrongful Termination
- ESOP Freeze
- Partial Termination
- Converting an ESOP to a Profit-Sharing Plan

For an additional discussion regarding ESOPs, see Employee Stock Ownership Plan Design and Compliance and Employee Stock Ownership Plans in Corporate Transactions. For a broad discussion of issues related to retention of employer stock in a qualified plan, see Employer Stock in Retirement Plans Resource Kit and Lexis Tax Advisor — Federal Topical § 1C:14.05.

Decision to Terminate an ESOP

An ESOP is a tax-qualified defined contribution plan that is designed to invest primarily in employer securities. I.R.C. § 4975(e)(7). It is a unique form of a defined contribution plan in that it may also borrow money to fund its purchase of employer securities, and by doing so, it becomes a tool of corporate finance. It is commonly a stock bonus plan (and not a profit-sharing plan) since, as is required for stock bonus plans, distributions are (or may be) paid in the form of employer stock. See 26 C.F.R. § 1.401-1(b)(1)(iii).

Although an ESOP sponsor must establish an ESOP with the intent that it continues indefinitely, there are a number of reasons why an ESOP sponsor may decide that it is time to wind down, and potentially terminate, an ESOP. See 26 C.F.R. § 1.401-2 (the term "plan" implies a permanent as distinguished from a temporary program). Because of an ESOP's unique status as both a qualified plan that holds employer securities and as a tool of corporate finance, there are several items an ESOP sponsor must consider under the Internal Revenue Code of 1986, as amended (the IRC) and under ERISA, when winding down and terminating an ESOP. It will be easier to terminate a non-leveraged ESOP (i.e., one on which the employer or the plan has not borrowed in order to purchase the ESOP stock) or a formerly leveraged ESOP (i.e., where the ESOP loans have since been repaid). The process becomes more complicated where a loan has years remaining before it is fully amortized. There the employer may have to pay off the remaining amount, also resulting in a boon to the remaining ESOP participants.

Settlor vs. Fiduciary Decision

The decision whether to terminate an ESOP is a settlor, rather than a fiduciary, decision that is made by the ESOP sponsor. Curtiss-Wright Corp. v. Schoonejongen, 514 U.S. 73, 78 (1995); Akers v. Palmer, 71 F.3d 226 (6th Cir. 1995). While the decision to terminate an ESOP is a settlor decision, the reasons an ESOP may have for deciding to terminate an ESOP are numerous. To learn more about "settlor" versus "fiduciary" decisions regarding ERISA employee benefit plans, see ERISA Fiduciary Duties — Duties and Obligations of ERISA Fiduciaries.

Reasons to Terminate

One of the primary instances in which an ESOP sponsor will terminate an ESOP will be when there is a sale or pending sale of the ESOP-owned company. In such circumstance, the ESOP:

- May be terminated in connection with the transaction –or–
- May survive the transaction itself but be terminated shortly thereafter once the acquiring entity decides that the ESOP no longer fits as part of the new entity's overall benefit program offerings

For a discussion regarding ESOP termination in the context of a corporate transaction, see Employee Stock Ownership Plans in Corporate Transactions.

Additional Reasons for ESOP Termination

The plan sponsor may choose to terminate an ESOP for the following additional reasons.

Outlived the Purpose of Its Creation

An ESOP may also be terminated if it is determined to have outlived its purpose. An ESOP sponsor may decide that other forms of benefits are more desirable to its employees and a qualified benefit plan primarily holding employer securities is no longer desired to provide them with benefits. An ESOP may be formed solely for purposes of financing a transaction. In such case, when the ESOP has paid off its acquisition loan or if the company chooses to restructure its debt, the ESOP sponsor may no longer wish to keep the ESOP in place.

Costs of Maintenance Are Burdensome

ESOPs are often terminated when the costs for administering the ESOP become too high. The rising costs can be seen in a few different ways. ESOPs incur fees for trustee, valuation, plan administration, legal, and accounting services, among others, so if the annual costs for receiving such services has become too high, an ESOP sponsor may desire to terminate the ESOP. In addition, ESOPs face a repurchase obligation when it is time to pay ESOP participants (on termination of employment, according to plan terms, or even on a diversification event under I.R.C. § 401(a)(28)). See Employee Stock Ownership Plan Design and Compliance — Distinctive Provisions of an ESOP. A company may see that its upcoming repurchase liability is high, or it may not have the cash flows in the future to service such obligation. Consequently, it becomes attractive for the sponsor to terminate the ESOP before the liability associated with the obligation becomes too great.

No Longer a Viable Employee Benefit

New management at an ESOP sponsor may decide that the ESOP is no longer a desirable form of employee benefit and decide to terminate the ESOP. There are times when a company's management team (whether new or existing management) may decide that it no longer wishes to concentrate so much of its employees' retirement benefits in company stock, so they decide to either terminate the ESOP or convert it to a profit-sharing plan.

Economic factors or adverse business conditions may cause an ESOP sponsor to terminate an ESOP. Forecasting an upcoming recession (which will cause the company stock to lose value), corporate cash flow concerns, or bankruptcy are all economic reasons why an ESOP sponsor may desire to terminate its ESOP.

Fiduciary Duty to Divest Employer Stock

Finally, in rare situations the ESOP's trustee may be under a fiduciary duty imposed by ERISA to sell the stock of an ESOP sponsor, thereby terminating the ESOP's status as an ESOP. See e.g., Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409 (2014).

Parties Involved in an ESOP Termination

Once a decision has been made to terminate an ESOP, it is important to make sure that an ESOP sponsor involves a team of professionals that works with ESOPs on a regular basis, given their complexity. Professionals involved in an ESOP termination are typically the same professionals that were involved in the establishment of the ESOP.

In addition to the ESOP sponsor, the following parties will be involved in an ESOP termination:

- **Plan administrator.** The ESOP's administrator (the plan administrator), who may or may not be the same as the ESOP sponsor, is the entity, individual or group of individuals that is responsible for the ESOP's accounting and participant account balance functions, among other duties.

- **Trustee.** The ESOP's trustee makes fiduciary decisions in connection with the ESOP termination, including whether the ESOP receives adequate consideration in connection with a sale or making sure that procedural issues are addressed. If the ESOP's trustee is an internal trustee (e.g., employed by or affiliated with the ESOP sponsor) it may make sense, especially in connection with a sale and termination of an ESOP, that the sponsor or trustee engage an external, independent trustee for purposes of the sale transaction and associated termination. This engagement will help protect the internal trustee from fiduciary liability and help avoid even the appearance of a conflict of interest in a termination situation.
- **Custodian.** The custodian, if different from the trustee, is the entity holding the physical assets (primarily employer stock) of the plan.
- **Lender(s).** The ESOP's lender or lenders, who will want to ensure that all debt obligations of the ESOP are paid in connection with the termination and ensure that the termination process does not violate any debt covenants.
- **Legal advisors.** The ESOP and the ESOP sponsor's legal advisors will assist the ESOP and/or ESOP sponsor by amending the plan and ensuring that all requirements of ERISA, the IRC, and any other applicable law or regulation are met in connection with the termination.
- **Financial advisors.** The ESOP trustee's financial advisor will assist the trustee to ensure that the ESOP is receiving adequate consideration in connection with the termination and will likely be called upon to issue a fairness opinion in connection with the termination.
- **Human Resources or other communication group.** Communications firms, or even the ESOP sponsor's human resources department, will be called upon to help ESOP participants understand the ESOP termination process, to communicate the plan termination, and to help the participants understand what options are available regarding distribution/rollover of their account balances following the plan termination.

While all of the parties described above are not always used in every ESOP wind-down, termination, or freeze scenario, often many of the parties are and they help the ESOP sponsor ensure a smoother wind-down, termination, or freeze process.

ERISA Issues

When terminating an ESOP, be aware of the number of provisions of ERISA that come into play. Among them are:

- ERISA's fiduciary duties including those that are applicable to a trustee acting prudently and in the best interest of ESOP participants
- The requirement that a sale of stock held by the ESOP must not be for less than adequate consideration –and–
- Prohibited transaction rules (under ERISA § 406 and I.R.C. § 4975) regarding sales to parties in interest

Prudence / Exclusive Benefit

As an employee pension benefit plan subject to ERISA, an ESOP is subject to ERISA's fiduciary duties, subject to certain exceptions. See ERISA § 404 (29 U.S.C. § 1104). When deciding to terminate an ESOP, a fiduciary must always act solely in the interest of, and for the exclusive purpose of, participants and beneficiaries of the ESOP. ERISA § 404(a)(1) (29 U.S.C. § 1104(a)(1)). For a discussion on ERISA Section 404 requirements, see ERISA Fiduciary Duties.

The potential sale of shares of an ESOP sponsor held by an ESOP almost always implicates the prudence and the exclusive benefit prongs of ERISA fiduciary duties. Under the prudence test, ESOP participants must be at the forefront of all decisions a fiduciary makes. An ESOP sponsor often wears "two hats," as the sponsor often is the trustee. In the context of an ESOP termination, where a conflict of interest is or even may be present, it's best to appoint an independent trustee and also engage independent counsel for advice. See e.g., Pegram v. Herdrich, 530 U.S. 211 (2000); Donovan v. Bierwith, 680 F.2d 263 (2d Cir. 1982), THOMAS E. PEREZ, SECRETARY, DEPARTMENT OF LABOR, Plaintiff - Appellee Cross-Appellant v. HERBERT BRUISTER, Defendant - Appellant Cross, (5th Cir. 2016) and see Employee Benefits Guide § 6.03.

Valuing the Employer Stock That Is Sold

While not required, it may also be prudent for a trustee or other fiduciary in connection with a potential ESOP termination to keep track of negotiations over the price at which the employer stock is sold in connection with the ESOP termination. If the redemption is an internal transaction, it may be prudent to look at what sort of outside offers are available for the ESOP stock (either through solicitation or a review of market data) to maximize value for ESOP participants. See, e.g., Kindle v. Dejana, 238 F. Supp. 3d 353 (E.D.N.Y. 2017) (there were triable disputes as to whether the trustee made a good-faith effort to determine the fair market value of stock before recommending that the plan sell the stock to an affiliate and concerning his adherence to duty of care standards). The importance of determining a fair value for the employer stock is discussed, next, in applying the adequate consideration principle of ERISA Section 408.

Adequate Consideration and Using an Independent Appraiser

ERISA prohibits plan fiduciaries from entering into a transaction with a party in interest (like a plan sponsor). ERISA § 406(a)(1) (29 U.S.C. § 1106(a)(1)). Absent an exemption, ESOPs would not be able to exist given this prohibition. However, Section 408(e) of ERISA exempts transactions involving employer stock from this prohibition so long as the sale is for not less than "adequate consideration." ERISA § 408(e)(1) (29 U.S.C. § 1108(e)(1)). Adequate consideration, in the ESOP context, means fair market value as determined in good faith either by the ESOP's trustee or another named fiduciary. ERISA § 3(18)(B) (29 U.S.C. § 1002(18)(B)). To complement this ERISA requirement, the IRC requires valuations of employer stock that is not readily tradable in a public market to be performed by an independent appraiser. I.R.C. § 401(a)(28)(C). See, e.g., Montgomery v. Aetna Plywood, Inc., 1998 U.S. Dist. LEXIS 20581 (N.D. Ill. 1998) (directors and fiduciaries liable to the employee class for failing to see ESOP stock for adequate consideration).

Valuation for Sale vs. Valuation on Formation

The type of valuation for the original ESOP transaction is not necessarily the type of valuation that should be performed in planning an ESOP termination. For example, if, on plan inception, the ESOP purchased shares in two stages, the first stage transaction may have acquired a minority interest in the ESOP and the second stage may have acquired a majority interest in the ESOP. The valuation for a minority purchase is not the same as the valuation for a majority (controlling) interest. It may be the latter valuation that needs to be performed in planning a termination.

Once an independent appraiser has performed a valuation, the next step is for the trustee or other fiduciary to decide how to use the valuation. As of May 2018, the DOL has entered into settlement agreements with the following five different ESOP trustees setting forth how such trustees must proceed in ESOP transactions (either purchases or sales/terminations):

- Acosta v. Cactus Feeders, Inc., et. al., N.D. Tex., Civil Action No. 2:16-cv-00049-J, settlement agreement entered May 4, 2018
- Acosta v. Mueller, et. al., E.D. Wi., Civil Action No. 2:13-cv-1302-PP, consent order entered Dec. 27, 2017
- Acosta v. BAT Masonry Co., Inc., W.D. Va., No. 6:15-cv-00028-EKD-RSB, consent order filed Sept. 29, 2017
- Acosta v. First Bankers Tr. Servs., Inc., S.D.N.Y., No. 1:12-cv-08648-GBD, consent order and judgment, Sept. 21, 2017 –and–
- Perez v. GreatBanc Tr. Co., C.D. Cal., No. 5:12-cv-01648-R-DTB, consent order and judgment, June 2, 2014

See DOL Enters into 5th Settlement Agreement with an ESOP trustee and It Looks Familiar (Holland & Knight, May 10, 2018); DOL Enters into Another Settlement Agreement with ESOP Trustee (Holland & Knight, Feb. 28, 2018); Further ESOP Transaction Guidance Set Forth in Latest DOL Settlement Agreement (Holland & Knight, Oct. 9, 2017).

Also see 2019 NYU Review of Employee Benefits § 9.07, Recent DOL Enforcement Actions Focus on Valuations of Employer Securities in Purchase and Sale Transactions.

While each of the settlement agreements is only binding between the DOL and the applicable trustee, the settlement agreements, taken in the aggregate, are a useful template as to the DOL's thoughts on what constitutes "best practices." However, there are a number of ambiguities or uncertainties found in the agreements. For the agreements to be truly useful to the ESOP community as a whole, additional clarification and/or guidance from the DOL, either in the form of regulations or otherwise, is still needed.

However, despite these ambiguities, there are a number of similarities in the agreements and they each set forth positions from the DOL with respect to:

- Selecting a valuation advisor, including general rules dealing with conflicts of interest, and process
- Oversight of a valuation advisor, including what must be included in the analysis
- Financial statements
- General fiduciary review process
- Documenting the valuation analysis

- Relying on the valuation report
- Preserving documents
- Determining fair market value
- Handling control issues (only present in two agreements)
- Considering applicable clawbacks
- Reliance on other professionals –and–
- Insurance obligations (only present in one agreement)

Voting

If the termination is one that must be approved by ESOP participants (either by statute or by the terms of the ESOP document), take care to ensure that not only do the participants get the right to vote, but that they are adequately informed regarding such voting right.

In addition to participants voting shares of ESOP stock, the ESOP's trustee needs to be sure that it has reviewed the documents governing the ESOP, including the ESOP's trust agreement. This assures that the trustee understands how to vote shares in connection with the ESOP termination. Typically, the ESOP trustee is the one that is responsible for voting unallocated shares held by the ESOP. The trustee will either have the right to vote the shares in its discretion, as directed by the ESOP's administrator or administrative committee, or in the same proportion as participants voted shares, where the ESOP has a mirror voting provision. A failure to fully understand how to vote or failure to follow the ESOP's governing documents can open a trustee up to significant fiduciary liability.

Treatment of Unallocated Stock

When a leveraged ESOP is terminated with unallocated stock remaining, the IRS has taken the position in two private letter rulings that when an ESOP sponsor redeems a sufficient number of shares (held in the suspense account) to repay the ESOP's outstanding loan, the remaining unallocated shares can be allocated to ESOP participants' accounts in a nondiscriminatory manner. This will not adversely affect the exempt status of the ESOP loan nor require treating the additional shares allocated to the participants' accounts as annual additions under I.R.C. 415(c). PLR 200536028 (2005 PLR LEXIS 627), PLR 200536031 (2005 PLR LEXIS 628). Note that the private letter rulings are only binding on the taxpayers that requested the rulings. Therefore, review the facts of the specific ESOP termination or obtain an individual determination or private letter ruling that the termination (1) does not have an adverse effect on the ESOP's qualification or (2) run afoul of Section 415's annual additions limits. For a description of those limits, see "Annual Additions (I.R.C. § 415(c))" below.

Internal Revenue Code Issues

In addition to the provisions of ERISA that come into play during an ESOP termination, a number of I.R.C. provisions are implicated as well. Because an ESOP is a qualified plan, on termination, an ESOP must comply with the requirements that apply to all other qualified plans. However, because of an ESOP's special nature, some of these requirements require additional attention during an ESOP termination.

Vesting (I.R.C. § 411(d)(3))

The first requirement that an ESOP must comply with is that all unvested participant account balances become vested upon the ESOP's termination. I.R.C. § 411(d)(3); 26 C.F.R. § 1.411(d)-2(a)(1). Like many qualified plans, most ESOPs will provide that participants are not fully entitled to their account balance immediately upon entering the ESOP and follow one of the vesting schedules under I.R.C. § 411(a)(2)(B) that apply to employer contributions to defined contribution plans. When an ESOP is terminated, the participant will no longer be able to continue to become entitled to additional portions of his/her account balance over time. Therefore, I.R.C. § 411(d)(3) requires that plan participants become fully vested in their account balances when the ESOP is terminated. I.R.C. § 411(d)(3). Fully vesting participants upon an ESOP termination could cause a potentially significant additional economic outlay for the ESOP sponsor. The ESOP sponsor should take this into account and prepare for the additional cash expense (which could arise if participants request distributions or rollovers of their fully-vested account balances.

Anti-cutback Rule (I.R.C. § 411(d)(6))

A second requirement that an ESOP is to comply with upon termination is the anti-cutback rules of I.R.C. § 411(d)(6). The anti-cutback rules prohibit an ESOP sponsor from amending an ESOP to remove optional forms of benefits provided under the ESOP. I.R.C. § 411(d)(6); ERISA § 204(g) (29 U.S.C. § 1054(g). Generally, this means that if an ESOP allows a participant to receive his or her benefit in the form of employer stock, such a benefit cannot be removed on the ESOP's termination. However, regulations allow an ESOP sponsor to distribute cash to an ESOP participant in place of stock in certain situations, including when the stock of the ESOP sponsor:

- Becomes readily tradable
- Ceases to be readily tradable –or–
- Continues to be readily tradable, but (1) there is a sale of substantially all of the stock or substantially all of the assets of the ESOP sponsor, and (2) in either situation,

the successor employer continues to maintain the ESOP (or amended plan)

26 C.F.R. § 1.411(d)-4, Q&A-1(d)(1). In situations outside of the situations enumerated above, you will need to perform an analysis as to whether the termination of the ESOP will violate the anti-cutback rules. If there is doubt as to whether the anti-cutback rules are met, an ESOP sponsor can always file a determination letter with the Internal Revenue Service following the plan's termination to receive the IRS' blessing that the termination does not violate I.R.C. § 411(d)(6). For a greater analysis of anti-cutback risks, see Anti-cutback Rules for Qualified Retirement Plans (IRC § 411(d)(6)).

Pass-Through Voting Requirements (I.R.C. § 409(e))

While not required in all ESOP terminations, it is important for an ESOP sponsor to determine whether a pass-through vote to ESOP participants is required in connection with the proposed termination. I.R.C. § 409(e) requires that ESOP participants receive the right to vote the shares of ESOP-sponsor stock allocated to their accounts in the following situations.

- **For ESOP sponsors that are privately held (e.g., not publicly traded).** I.R.C. § 409(e) requires that participants must receive the right to vote with respect to any corporate merger or consolidation or a sale of substantially all of the assets of the ESOP sponsor.
- **For publicly traded ESOP companies.** I.R.C. § 409(e) requires ESOP participants to receive the right to vote shares allocated to their accounts regarding any matter to which those shares are otherwise entitled to vote.

I.R.C. § 409(e). For a further discussion on pass-through of voting rights in an ESOP, see Employee Stock Ownership Plan Design and Compliance — Pass-Through of ESOP Voting Rights.

Annual Additions (I.R.C. § 415(c))

I.R.C. § 415 limits the amount that can be contributed to a qualified plan on behalf of a participant during a limitation plan (usually, the plan year). For a defined contribution plan, generally, this limit equals the lesser of 100% of a participant's compensation for a plan year or an indexed dollar amount (which is $57,000 for 2020.). I.R.C. § 415(c)(1); I.R.S. Notice. 2019-59 (2019 IRB LEXIS 415). Special rules apply under I.R.C. § 415 that can limit the amount of the Section 415 annual addition to ESOPs. See "Special I.R.C. § 415 Limitations Considerations" under Employee Stock Ownership Plan Design and Compliance — ESOP Operation and Administration.

In the context of a sale, where unallocated shares are sold and then the proceeds are allocated to a participant's account, the IRS previously took the position that such excess proceeds constitute annual additions subject to I.R.C. § 415(c) limitations. See e.g.:

- **IRS PLR 9426048 (1994 PLR LEXIS 2164).** Amounts allocated to participant accounts as a result of the loan repayment constitute an annual addition for purposes of I.R.C. § 415 equal to the cost (basis) of the stock at the time it was contributed to the plan or otherwise acquired with the exempt loan proceeds.
- **IRS PLR 9417033 (1994 PLR LEXIS 141).** Proceeds of the sale of the unallocated shares of Company common stock in the ESOP's suspense account may be used to repay the outstanding balance of the exempt loan without causing the loan to fail to meet the exemption of I.R.C. 4975(d)(3) and allocations made to the accounts of the participants as a result of the repayment of the exempt loans would constitute annual additions under I.R.C. § 415 equal to (1) the product of the dollar amount allocated to such participant's account multiplied by (2) a fraction in which the stock's basis would be the numerator and the sales price would be the denominator.

However, since 1995, the IRS has seemed to reverse its position and indicates that proceeds from a sale of unallocated share are earnings rather than annual additions, and therefore, not subject to I.R.C. § 415(c) limits when the shares were allocated to participant accounts in a nondiscriminatory manner. See e.g., IRS PLRs 200536028 (2005 PLR LEXIS 627), 200536031 (2005 PLR LEXIS 628), 200514026 (2005 PLR LEXIS 15), 200321020 (2003 PLR LEXIS 218), 200147056 (2001 PLR LEXIS 1229), and 200034039 (2000 PLR LEXIS 1116).

As discussed above in "Treatment of Unallocated Stock", private letter rulings are binding only on the applicant seeking the ruling. Review and confirm the rules and regulations issued under I.R.C. § 415(c) to determine whether proceeds from the sale of previously unallocated shares constitute annual additions subject to the I.R.C. § 415(c) limits or are earnings that are not subject to these limits.

Excise Taxes (I.R.C. § 4978)

Finally, in the event that an ESOP is terminated where shares of such ESOP were acquired in an I.R.C. § 1042 nonrecognition transaction, the ESOP sponsor must review the ESOP's holding period to determine if certain excise taxes apply. I.R.C. § 4978 imposes an excise tax equal to 10% of the amount realized in a disposition if an ESOP disposes of shares acquired in an I.R.C. § 1042 transaction within three years of such transaction. I.R.C. § 4978(a)–(b). The tax is imposed upon the ESOP sponsor. I.R.C. § 4978(c); see, e.g., Ries Enters. Inc. v. Comm'r, T.C. Memo 2014-14 (2014), aff'd 588 Fed. Appx. 511 (8th Cir. 2014). While there are certain instances where this excise tax may not apply, it is important to review an ESOP's holding period when there is a termination following an I.R.C. § 1042 transaction. See e.g., I.R.C. § 4978(d). For a discussion on I.R.C. § 1042 and its application, see Lexis Tax Advisor — Federal Topical § 1C:14.05, paragraph [7], "Deferral of Gain on Stock Sales to ESOPs."

Steps to Terminating the ESOP

To formally and properly terminate an ESOP, an ESOP sponsor must go through a number of steps, keeping in mind that any misstep along the way can have dire consequences, as more fully discussed in Consequences of Wrongful Termination, below.

Corporate Resolution and Amendment

One of the first steps to take when deciding to terminate an ESOP is to adopt a corporate resolution documenting the desire to terminate the ESOP. This resolution is typically a resolution of the ESOP sponsor's board of directors, though it can be taken by any one or any group that has authority in the ESOP plan document to terminate the ESOP. The decision to terminate the ESOP in and of itself is not a fiduciary function, rather it is a settlor function, which is why the decision to terminate should be documented in the ESOP sponsor's resolutions. Lockheed Corp. v. Spink, 517 U.S. 882 (1996); DOL Adv. Op. 2003-04A Mar. 26, 2003). As a best practice, the resolution to terminate the ESOP should also include the ESOP sponsor's reason for terminating the ESOP.

For a sample resolution terminating a defined contribution plan that is NOT an ESOP, see Board Resolutions: Qualified Retirement Plan Termination (Defined Contribution Plan).

Replacing the Trustee

Often, in the same set of resolutions, but certainly a threshold question to be considered, is whether the ESOP's current trustee should remain as trustee during the ESOP's termination. If the ESOP trustee is an independent trustee, the need to replace the trustee in connection with the termination is not usually necessary. However, because the implementation of the termination is a fiduciary function, it is best to avoid conflicts (real or apparent) in connection with an ESOP termination. If the ESOP's trustee is an internal trustee or some other individual or group of individuals that is affiliated with the ESOP sponsor, a best practice is to replace that trustee for purposes of the termination.

Amendments to Comply with Required Amendments List

Finally, an ESOP must be amended to meet all qualified plan requirements effective as of its termination date and required to effect its termination. This amendment is also commonly a part of, or referred to in, the ESOP termination resolution. First and foremost, in connection with a termination an ESOP should be brought into compliance with applicable law. See Required Amendments List. Often the IRS requires plans to be amended throughout their life cycle in order to maintain their qualified status. However, because the remedial amendment cycle filing program for IRS determination letters is no longer in place, it is incumbent on ESOP sponsors to ensure that the ESOP complies with all applicable laws to remain qualified. Rev. Proc. 2016-37, 2016-2 C.B. 136. The Revenue Procedure permits a determination letter request on a plan's termination.

For more information on requesting a determination letter from the IRS regarding the ESOP's qualified status on termination, see the "File Form 5310" discussion below.

After ensuring that the ESOP complies with all applicable laws, the ESOP sponsor should also review the ESOP and provide for a number of other amendments to be made in connection with the ESOP termination. Specifically, the ESOP should also be amended to:

- Provide that all participants are fully vested in their accounts.
- Restore forfeitures to vested terminated participants who left the employ of an ESOP sponsor while partially vested but who have not yet incurred five consecutive one-year breaks in service.
- Provide for final allocations of amounts or shares that are released from the ESOP's suspense account.
- Describe how benefits are to be distributed.
- Revise, as necessary, the fiduciary responsibilities allocated to plan fiduciaries.
- If applicable, provide for the conversion to a profit sharing or other type of plan, or provide for the merger with another plan.
- Do anything else that may be required per the terms of the ESOP plan document

It is important to note that if the ESOP wishes to take advantage of any special provision of the IRC that is not set forth in the ESOP plan document prior to termination, you will need to include that provision as part of the amendment to terminate for it to be effective. See EP Determinations ESOP Cadre Guidance (Nov. 2009).

Notify ESOP Participants

Next it is important to review the ESOP plan document and if necessary, notify ESOP participants about the potential ESOP termination. As described more fully above, I.R.C. § 409(e) requires ESOP participants be provided the right to vote securities allocated to their accounts. I.R.C. § 409(e). If the transaction requires participant voting, the ESOP sponsor should communicate the transaction in advance to the participant and provide the participants with enough financial information to enable them to make an informed decision about whether to approve the potential transaction. This information should be distributed sufficiently in advance so that there is enough time for both the participants to vote and for the ESOP sponsor or its representative to tally the results of the votes. The plan sponsor can use the same methods of voting, including electronic voting, that it uses in permitting other shareholder voting. While the amendments should be reported in a summary of material modification for an on-going plan (as required under 29 C.F.R. §§ 2520.104b-1(b), 2520.104b-3(a)) it's best to report the changes sooner for a plan that is being terminated. This can be made in an omnibus communication about the plan termination and the plan seeking a determination letter.

Participants also need to be notified of their account balances and that they may have the right to elect their form of benefit when it is time for the participants to receive their final ESOP distributions. If known, the participants should also be given information about the availability of rolling over their account balances to either a successor plan or their own individual retirement accounts. You can distribute a participant tax notice required under I.R.C. § 402(f) for this purpose. The ESOP's administrator should also confirm that distribution paperwork is up to date and ready to be distributed to participants at the time of termination.

Finally, if the ESOP sponsor intends to file a Form 5310 (described more fully below), the ESOP sponsor will also want to notify participants, in a Notice to Interested Parties, that the ESOP is being submitted for a determination by the IRS. 26 C.F.R. § 1.7476-2. These topics are discussed more fully in the "File Form 5310" section, below.

For a sample I.R.C. § 402(f) tax notice, see Eligible Rollover Distribution Notice (Non-Roth Contributions).

Valuation

In the event that an ESOP termination is made in connection with an outside sale or other tender offer, a price per share has likely been presented to the ESOP sponsor. However, the ESOP's fiduciaries must also ensure that the price per share for the ESOP is at least fair market value. If the amount offered is not at least fair market value, the ESOP's fiduciaries may be at risk for breaching their fiduciary duties to the ESOP.

To ensure that the price per share is at least fair market value, direct the sponsor to identify an outside advisor that can undertake or orchestrate a formal valuation process for the ESOP shares. This process will involve a thorough due diligence process by the ESOP trustee's financial advisor. The financial advisor's due diligence process will likely mirror the process the financial advisor would undertake when the ESOP was established. This means that the financial advisor would likely want to review company financials and other information, speak with key members of the company's management, and conduct a review of anything else that would go allow the financial advisor to issue a fairness opinion to the trustee.

While a preliminary share value analysis is likely to be performed in connection with the proposed termination, the valuation and any fairness opinion that is presented should be updated to be accurate as of the date of the termination. For an ESOP to enter into a transaction that is exempt from the prohibited transaction rules:

- The sale price of ESOP shares must be at least equal to the fair market value of such shares. –and–
- The transaction, taken as a whole, must be fair to the ESOP from a financial point of view as of the transaction date.

An analysis performed before the transaction date may not necessarily be correct as of the transaction date. The topic of obtaining adequate consideration for the shares sold is addressed further above at ERISA Issues—Adequate Consideration and Using an Independent Appraiser.

Purchase/Redemption Transaction

Once the terms of the termination are finalized, including, if applicable, establishing a redemption price for the ESOP shares, then the formal terms of the redemption or other purchase should be finalized and presented to the trustee for review. If a redemption is contemplated, the trustee should be given the opportunity to review the terms of the offer and then accept, reject, or negotiate the terms of the offer. As is the case with any ESOP transaction, if there is a proposed redemption, the negotiation process should be documented.

Once an agreement has been reached, the trustee and the ESOP's counsel(s) should finalize the agreement to document the proposed transaction and the ESOP's termination. The parties should also work with their counsel to determine if any ancillary documents need to be prepared or amended/terminated in connection with the proposed transaction.

File Form 5310

While not required, an ESOP sponsor may decide to file a determination letter request with the IRS in connection with the ESOP's termination. Such a determination is requested using an IRS Form 5310. Receiving a favorable determination letter provides an ESOP sponsor the assurance that the ESOP's written terms satisfy the IRS's rules for qualified plans. In addition, because the determination letter process was recently updated, there are only a few times when an ESOP sponsor can now obtain a determination letter for its plan—upon formation and in connection with the termination. In addition, if there are specific areas of concern regarding the ESOP or if the ESOP wishes to fully and properly correct any plan defects, a determination letter request is the time to address those concerns or defects and when the IRS will approve those fixes. Correcting errors, whether found before or after the sponsor files for determination letter, must be made through the IRS Employee Plan Compliance Resolution System (EPCRS) under Rev. Proc. 2019-19, 2019-19 I.R.B. 1086. For more information about using the EPCRS program, see EPCRS Correction Rules and Procedures.

Because a determination letter is not required, some ESOP sponsors take the approach that filing a Form 5310 is not something that is desirable, whether for timing reasons, costs reasons, or other reasons. However, the failure to obtain a Form 5310 is something that must be disclosed on a final Form 5500 filing. If an ESOP sponsor checks the box on its final Form 5500 filing that a determination letter was not received in connection with the ESOP's termination, the risk of an audit following the filing of the final Form 5500 may increase.

Distribute Assets

Once the termination process is complete it is time to distribute assets to participants. An ESOP sponsor should work closely with its third-party administrator to determine that participant account balances are up to date (including any allocations made or revised in connection with the termination). Distributions are to be made in a timely manner and the ESOP sponsor should not delay in making the distribution of ESOP assets. Perez v. Cal. Pac. Bank, 2015 U.S. Dist. LEXIS 94180 (N.D. Cal. 2015). Remember that allocations must at all times comply with the rules set forth in the IRC (as described above). After the allocations and account balances have been reviewed, it is likely the ESOP's administrator will direct the ESOP's trustee to distribute assets to the participants.

Payments to participants will be made in accordance with the terms of the ESOP (as amended in connection with the termination). Because the ESOP will cease to exist after termination, if large account balances are to be made in anything other than a lump sum, a note to participants may have to be provided from the ESOP sponsor. Account balances should be able to be rolled over to another qualified plan or an individual retirement account set up by the participant.

Distributions to participants can be made in the form of cash or stock (subject to a put right). In most cases distributions to participants will be made in cash, not employer stock. However, there may be occasions where distributing shares may be preferable. For example, in a redemption transaction, if the ESOP sponsor has sufficient capital capacity and wants to avoid obtaining a loan to finance the payment to participants, the ESOP could distribute stock to participants and the ESOP sponsor could redeem the stock from participants in exchange for notes.

Whether distributions are made directly to a participant or rolled over will have an impact on whether amounts must be withheld from distributions to a participant. If a participant elects to receive cash, the ESOP sponsor must withhold 20% from such distribution for federal income taxes. I.R.C. § 3405(c)(1)(B); 26 C.F.R. § 35.3405-1T, Q&A-13. No withholding is required if participants receive stock of the ESOP sponsor or if the participants directly roll over their proceeds to another qualified plan or individual retirement account. If a participant receives both cash and shares of ESOP sponsor stock, withholding is only required on the cash portion of the distribution. 26 C.F.R. § 35.3405-1T, Q&A-29. In addition, if a participant receives an early distribution (e.g., before they reach age 59 1/2, the participant is also subject to early distribution taxes. I.R.C. § 72(t).

After making distributions, the ESOP sponsor (or its third-party administrator) will report distributions to participants on an IRS Form 1099-R using the appropriate codes by January 31 of the year following the year in which distributions were made. Withholding amounts are reported to the IRS on Form 945 no later than the last day of the month following the calendar quarter in which the withholding occurs.

In the event an ESOP sponsor is unable to locate a participant, the ESOP sponsor must make a diligent search to find such participant. At a minimum, the fiduciary of the ESOP must:

- Send a notice to the last known address using certified mail
- Check the records of the ESOP sponsor or any related plans of the ESOP sponsor for an updated address
- Send an inquiry to any designated beneficiary of the missing participant
- Use free electronic search tools

DOL Field Assistance Bulletin 2014-01. For further instruction on locating missing participants, see Locating Missing Participants in Qualified Retirement Plans and Missing Participant PBGC Program Procedures Checklist.

Final Form 5500

Getting the response to a determination letter request can take time and may take longer than a year, even where the Form 5310 is filed soon after the plan termination is effective. Once the above steps are completed and the ESOP is ready to finally be closed out to a zero balance, the ESOP's administrator will file a final IRS Form 5500 for the ESOP. The final Form 5500 must be filed within seven months of the final distribution of benefits from the ESOP. When filing the final Form 5500 it is important to mark the return as "FINAL" in order to lower the chance of follow-up questions from the IRS and/or DOL in subsequent years.

Consequences of Wrongful Termination

In the event that an ESOP sponsor doesn't properly terminate its ESOP, the consequences can be dire for a number of parties involved: the ESOP sponsor, the ESOP's original selling shareholders, ESOP participants, and the ESOP's trustee. Such consequences may arise either by statute (e.g., under ERISA or the IRC), through a suit by a regulatory agency (e.g., the DOL or IRS), or by private plaintiffs. In addition, note that terminating an ESOP shortly after an ESOP transaction does not undo potential liability associated with the ESOP's formation. See e.g., Brundle v. Wilmington Trust N.A., 241 F. Supp. 3d 610 (E.D. Va. 2017).

Breaches of Fiduciary Duty – DOL Involvement

As described above in ERISA Issues, an ESOP fiduciary owes a number of duties to ESOP participants. If the fiduciary is careless or fails to follow a defined process in connection with the ESOP's termination, the DOL could bring a case against the ESOP fiduciary for breach of fiduciary duty.

The DOL's Employee Benefits Security Administration ("EBSA") is responsible for ensuring that ESOPs protect the ESOP's participants and beneficiaries. See EBSA, ERISA Enforcement. EBSA investigates ESOPs (including ESOP terminations) to ensure that:

- There are no conflicts of interest.
- There are no wasteful corporate activities or malfeasance.
- Participants receive the benefits they are due under the ESOP.

See EBSA, ERISA Enforcement "ERISA Civil Violations."

The DOL can bring a claim for a breach of fiduciary duty against an ESOP under Section 502(a) of ERISA. See ERISA § 502(a)(2), (5) (29 U.S.C. § 1132(a)(2), (5)). In bringing an action, the DOL can seek recovery of actual losses incurred in connection with a fiduciary breach, injunctive relief, or it may seek equitable relief such as restitution or imposition of constructive trusts depending on which Section of ERISA the DOL brings its suit.

IRC Violations – IRS Involvement

Much like the DOL can investigate or bring a suit against an ESOP, the IRS can also investigate or bring a suit against an ESOP for violations of the I.R.C. For more information about a number of I.R.C. issues that apply to ESOPs, see Internal Revenue Code Issues above. IRS investigations are typically in the form of an audit, but the IRS is also able to bring a claim against an ESOP in court.

Participant Litigation

Private plaintiffs can also, singularly or part of a class, bring an action against an ESOP in connection with an ESOP's termination. Private plaintiffs are able to bring an action not only for violations of ERISA or the IRC, but also for violations of corporate law or breach of contract claims.

Participants will bring claims for breaches of fiduciary duty against an ESOP under Section 502(a) of ERISA. ERISA § 502(a)(2), (3); (29 C.F.R. § 1132(a)(2), (3)). Whether a participant is entitled to monetary damages in connection with their suit or only equitable relief depends upon which Section of ERISA the participant brings his or her claim. Id.

Section 1042 Issues

A special area of the IRC which may invite scrutiny from either the IRS or individuals is if the termination of the ESOP causes a violation of I.R.C. § 1042. For more information about I.R.C. § 1042 and its application, see Lexis Tax Advisor — Federal Topical § 1C:16B.04," Application of Tax and Qualification Rules to ESOPs," paragraph [4].

While excise taxes under I.R.C. § 4978 arise and apply to the ESOP sponsor in connection with a transaction that does not meet the requirements of Section 1042, selling shareholders that elected I.R.C. § 1042 treatment in a transaction that now fails to meet the requirements of I.R.C. § 1042 because of the ESOP's termination may have a private claim against the ESOP as well.

ESOP Freeze

In some cases, an ESOP sponsor may desire to "freeze" rather than terminate its ESOP. When an ESOP sponsor freezes rather than terminates an ESOP, the ESOP remains in place and must continue to follow all applicable laws including ERISA and the IRC; the ESOP sponsor just ceases making contributions to the ESOP.

Cease Making Contributions

Once an ESOP is frozen, no further contributions are required to be made. To formally freeze the ESOP, a resolution and amendment process similar to the one described above in Steps to Terminating the ESOP should be undertaken. However, instead of resolving to terminate the ESOP, the resolutions resolve to cease making contributions to the ESOP and should prevent new participants from entering the ESOP after the freeze date. While no further contributions are made to the ESOP, when a participant terminates his or her employment or otherwise ceases participating in the ESOP, such participant's shares held by the ESOP are typically either retired or purchased by an individual or entity outside of the ESOP. Shares can also be distributed to participants subject to a put.

While freezing an ESOP may be desired to prevent future contributions to the ESOP, an ESOP sponsor still must make sufficient contributions to the ESOP in order to allow the ESOP to repay its debt to the ESOP sponsor (or lender). Therefore, freezing an ESOP may not be desirable if an ESOP has a large number of unallocated shares. But note, that an ESOP sponsor may be able to forgive the debt the ESOP owes the ESOP sponsor to prevent future contributions to the ESOP. In such circumstance, a contribution equal to the amount of the forgiven debt will need to be recorded on the books of the ESOP sponsor. This would mean that the remaining unallocated shares within the ESOP will be immediately allocated to participants'' accounts, which will result in a "bonanza" to those participants receiving the allocation (at least, by accelerating the allocations that will no longer be made over the remainder of the loan repayment period). However, you'll need to carefully review I.R.C. § 404 deduction limitations in this scenario to ensure that the deemed contribution to the ESOP does not exceed 25% of the ESOP sponsor's eligible payroll in order to comply with these limitations. See I.R.C. § 404(a)(3)(A), (9) and Lexis Tax Advisor — Federal Topical § 1C:16B.04 "Application of Tax and Qualification Rules to ESOPs," paragraph [5].

Otherwise Comply with Applicable Law

A frozen ESOP is still a qualified plan under the IRC and an employee pension benefit plan under ERISA Section 3(2). ERISA § 3(2) (29 U.S.C. § 1002(2)). Therefore, the ESOP must still be operated pursuant to the plan document and in accordance with the rules of ERISA and the IRC. This means that an ESOP sponsor must still make sure that:

- The shares held in the ESOP are valued on an annual basis.
- Participants must still be given rights to diversify their shares out of the ESOP under I.R.C. § 401(a)(28).
- Participants still benefit from an increase in the value of the shares held in the ESOP (or share in the loss in the case of a decrease in value).

As an active plan, the ESOP sponsor is still required to provide the annual valuation of a participant's account to such participant. The ESOP sponsor also is required to file all annual reports with governmental agencies (e.g., a Form 5500).

Why Freeze vs. Terminate?

Because an ESOP is still an active plan when it is frozen, the question often arises why an ESOP sponsor would desire to freeze an ESOP rather than terminate it. One reason: when an ESOP is frozen, participants retain their vesting status in the ESOP (rather than being fully vested in connection with an ESOP termination). In fact, a common reason that an ESOP sponsor chooses to freeze its ESOP is because the ESOP sponsor can simply no longer afford to make regular contributions to the ESOP. Note that this is not always desirable when there are unallocated shares in the ESOP because, as described above, the ESOP sponsor must still make contributions sufficient to allow the ESOP to repay its debt to the ESOP sponsor (or outside lender).

ESOPs are also frozen in advance of a redemption situation where the ESOP is going to be used to buy out one or more owners. By freezing the ESOP, the ESOP sponsor does not have to finance the full redemption amount associated with a termination. Rather, it will only have to finance the portion of the shares it is redeeming.

Partial Termination

In contrast to the termination or freeze options described above, where an ESOP sponsor affirmatively decides to change its ESOP, the ESOP may (perhaps inadvertently) be partially terminated in certain situations, even if an ESOP sponsor has no desire to do so.

Facts and Circumstances Test

Whether an ESOP experiences a partial termination is determined with regard to all of the facts and circumstances in a specific situation. 26 C.F.R. § 1.411(d)-2(b)(1). The facts and circumstances include the exclusion, whether by plan amendment or severance by the ESOP sponsor, of a group of employees who have previously been covered by the ESOP, as well as plan amendments that adversely affect the rights of participants to vest in benefits under the ESOP. 26 C.F.R. § 1.411(d)-2(b)(1).

Facts and circumstances indicating that the turnover rate for an applicable period is routine for an ESOP sponsor would favor a finding that there is no partial termination for that plan year. Rev. Rul. 2007-43, 2007-2 C.B. 45. A rebuttable presumption exists that a partial termination occurs during a plan year if, during such plan year, there is an employee turnover rate of at least 20%. Rev. Rul. 2007-43, 2007-2 C.B. 45; Matz v. Household Int'l Tax Reduction Inv. Plan, 388 F.3d 570 (7th Cir. 2004). The turnover rate is determined by dividing the number of participants who had an ESOP sponsor-initiated severance from employment during the applicable period by the sum of all of the participants at the start of the applicable period and the individuals who became participants during the plan year. Rev. Rul. 2007-43, 2007-2 C.B. 45. Turnover rate alone, however, is not enough to be dispositive of a partial termination, as there are facts where a large turnover in employee population may not be a partial termination. See e.g., Administrative Committee of the Sea Ray Employees' Stock Ownership and Profit-Sharing Plan v. Robinson, 164 F.3d 981 (6th Cir. 1999).

It is important to work with an ESOP's administrator to review whether a partial termination occurs during any plan year, but especially when big changes are made either at the ESOP-level (e.g., freezing the ESOP) or at the ESOP-sponsor level (e.g., shutting down a factory) during a plan year. While an ESOP sponsor typically determines whether a partial termination has occurred, the IRS (either in connection with a determination letter filing or in connection with an audit) or even a court may make a determination that an ESOP has incurred a partial termination. Id.

Effect of Partial Termination

In the event an ESOP incurs a partial termination during a plan year, affected participants must become 100% vested in their account balance. I.R.C. § 411(d)(3)(A).

This also means that affected participants who have left employment and may have had the unvested portion of their accounts forfeited are owed those forfeited amounts. If those forfeitures have been distributed to other participants and cannot be recovered, the ESOP sponsor will be responsible for making the affected participants whole and may have to correct this through the Employee Plans Compliance Resolution System. Rev. Proc. 2019-19, 2019-19 I.R.B. 1086.

Converting an ESOP to a Profit-Sharing Plan

Finally, an ESOP can be converted to (or from) another type of qualified plan. Technically the conversion of an ESOP to a profit-sharing plan (or another qualified plan) is not a plan termination at all, however a number of the provisions that apply to ESOPs, both positive and negative, will cease to apply to the converted plan.

To convert the ESOP to a profit-sharing plan, an ESOP sponsor would have to go through the corporate resolution and amendment process described above; however, the ESOP sponsor would not have to fully vest ESOP participants. Rather participants could continue to vest according to the schedule set forth in the ESOP pre-conversion. The plan would have to be amended to allow for discretionary profit-sharing contributions (i.e., nonelective contributions) to be made to the plan (if they were not already permitted in the ESOP).

Following the conversion, the internal loan between the ESOP sponsor and the ESOP would end and the unallocated shares would no longer be outstanding (they would likely be redeemed by the ESOP sponsor, although that is not the only available option). The value of the unallocated shares would be netted against the ESOP suspense account balance and any gain would be allocated to participant accounts.

The ESOP sponsor could then provide that either that entire balance in participant accounts is transferred over to the profit-sharing plan, either in the form of cash or stock (though if transferring cash, a contribution to buy the shares back would have to be made to the plan) or only the allocated shares are transferred over to the profit-sharing plan. In the latter scenario the unallocated shares can be redeemed from the converted plan over time.

The converted plan is then subject to the requirements of a qualified plan under both ERISA and the IRC.

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Christopher Buch is a Chicago business attorney with a multi-disciplinary practice that focuses on a variety of executive compensation, employee benefits and employee stock ownership plan (ESOP) matters. He leverages a seasoned perspective to clients' business challenges and the development of business strategies.

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In addition, a significant portion of Chris' practice focuses on ESOPs, representing plan sponsors, ESOP trustees, selling shareholders, ESOP committees, lending institutions and other fiduciaries in connection with both ESOP transactions and ongoing ESOP compliance.

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