HUNTON ANDREWS KURTH

Client Alert

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Considerations for ESOP Administrators During the COVID-19 Economic Crisis

The economic crisis and impact of COVID-19 are presenting unique issues for fiduciaries, trustees and administrators of ESOPs. This client alert summarizes several issues for fiduciaries and administrators of ESOP to consider in addressing those issues. If you need further guidance on any of these issues or other ESOP related items, please contact one of the Hunton Andrews Kurth attorneys below.

ESOP Valuation & Repurchase Obligation Considerations:

Overview: Given most ESOP valuations are based on December 31, 2019, ESOP administrators and trustees may need to take additional steps to meet "adequate consideration" requirements for stock transactions during 2020.

ESOP valuations are likely being either finished or starting for the valuation of privately held company stock based on a December 31, 2019 valuation date. ESOP administrators, fiduciaries and trustees may be left with a dilemma on how to approach a valuation that is higher than the current value of the company stock for application of the diversification and distribution rules, for put rights and contributions of company stock during 2020. Assuming the ESOP fiduciary recognizes that there is a strong likelihood that the December 31, 2019 valuation is overvalued by a significant percentage and is looking for ways to address this issue, this client alert provides some considerations for ESOP administrators, fiduciaries and trustees.

<u>Keep in mind Adequate Consideration Requirements:</u>

Overview: To avoid a prohibited transaction between the ESOP and any party-in-interest, any sale or purchase of company stock must be based on the value applying an arms-length transaction concept.

ERISA Section 408(b)(17) provides an exemption from the prohibited transaction rules where there is a sale or exchange of company stock between the ESOP and a party-in-interest so long as the transaction is made for "adequate consideration" (*i.e.,* defined under ERISA as a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any party in interest). If the adequate consideration requirement is not met between the ESOP and a party-in-interest, a prohibited transaction occurs, triggering excise tax and requiring unwinding of the transaction. The adequate consideration requirement generally provides that the transaction must reflect the fair market value as of the transaction date. Generally, the valuation date is stable for a plan year such that the adequate consideration is met for the year, but given the market conditions for 2020, this may not be the case. Given that risk, ESOP fiduciaries and administrators should consider mitigation actions in order to meet the adequate consideration requirement for implicated transactions – such mitigation actions can be an interim valuation date or, to the extent permissible under ERISA and the Code, consider opportunities to delay any distributions during 2020.

Consider an Interim Valuation Date to reflect the current economic situation:

Overview: Consider implementing a mid-year 2020 valuation date to reflect current economic circumstances.

Given the December 31, 2019 valuation date would be utilized for diversification rights, contributions, distributions, put rights and rights of first refusal during 2020, an interim 2020 valuation may be appropriate. Further, the ESOP fiduciary should consider any fiduciary implications for utilizing a December 31, 2019 valuation date for 2020 transaction. If an ESOP administrator decides to implement an interim valuation date, it should determine what date should be used for an interim valuation and review its plan document to determine whether an amendment is necessary to provide for such action.

Consider opportunities to delay distributions or repurchase obligations.

Overview: Review your ESOP plan document to determine whether any 2020 distributions may be delayed.

The IRS issued some relief to delay certain ESOP transactions as described below. Absent those specific delays, ESOP administrators should look at their plan document to see whether there are any opportunities to delay any unnecessary distributions during the 2020 plan year. Further, if an ESOP provides for only a lump sum payment, the ESOP rules allow for five-year installment payments. Implementing a five-year installment payment (or even lower installment period) would help conserve cash and delay full distributions for the year. Please keep in mind, some distributions cannot be delayed due to specific ERISA and Code limitations. If it is acceptable and feasible to delay certain distributions, an amendment to the plan document is generally necessary to implement such delays.

ESOP Specific Delayed Deadlines Impacted by IRS Extension:

Overview: ESOP distributions and repurchase requirements may be delayed (slightly) under IRS guidance.

The IRS issued Notice 2020-23 to automatically extend certain tax returns or actions whose deadlines fall between April 1 and July 15, 2020 to a deadline of July 15, 2020. The notice impacts and delays certain ESOP actions that are required during this time period. These delays include the following:

- ESOP specific distribution requirements: An ESOP must commence distribution, if a participant elects, during the plan year following a severance due to normal retirement age, death or disability or the sixth plan year following severance before normal retirement age. If any distribution under these ESOP distribution rules is required and falls within the April 1 and July 15th time frame, the distribution is delayed until July 15, 2020.

- Any repurchase obligation following a distribution of company stock from an ESOP: If the 60-day period to repurchase any company stock to which a participant exercises his or her put option falls within the April 1-July 15th time frame, this repurchase obligation is extended to July 15, 2020.

These delays are automatic, so it is unlikely an amendment to the plan document is necessary. However, ESOP administrators should review their plan documents to confirm whether an amendment may be necessary to delay these repurchase obligations.

Rebalancing and Reshuffling Provisions & Options:

Overview: Determine whether to forgo any rebalancing or reshuffling transactions during 2020.

ESOP documents that provide for annual rebalancing or reshuffling are optional provisions and can be revised or delayed, subject to some limitations. ESOP administrators may want to consider whether to suspend these transactions for the 2020 plan year. If the ESOP administrator determines that these provisions should be suspended for the 2020 plan year, an amendment is likely necessary.

Diversification Requirements & Opportunities:

Overview: Review your diversification methods to determine whether other options may be better in light of the current economic situation.

The ESOP rules require that "qualified participants" (age 55 with 10 years of participation) be provided the opportunity to elect to divest a certain percentage of company stock held in the participant's account. The rules allow an ESOP to meet the diversification requirements through different methods – distribution of cash equal to the value of the diversified stock, transfer of cash equal to the value of the diversified stock to another qualified plan by the employer or investing the cash within the ESOP in certain diversified investment opportunities. ESOP administrators may want to review their plan document to see how the diversification rules are met and consider changing the method in which to divest the participant's company stock within the requirements of ERISA. For example, if the plan document only provides that divested company stock will be distributed to the participant, it may want to amend the plan to provide for investment in the 401k portion of a KSOP or transfer to the qualified plan portion instead.

Loan Covenants & Implications:

Overview: Review your loan agreement to determine whether any covenants are triggered due to the current economic environment.

If an ESOP has an outstanding loan, ESOP administrators should review the loan agreement to see if there are any issues or events with respect to the ESOP sponsor that may trigger loan notifications, default or any other negative impact with respect to the loan.

Other Considerations in Implementing ESOP changes in light of COVID-19 pandemic:

Overview: There may be other fiduciary issues or notification requirements an ESOP administrator or fiduciary should consider during this period.

There may be fiduciary implications simply due to these unprecedented times and the impact on company stock prices in the ESOP that should be considered. Any suspension of investments or distributions (if acceptable) would likely require an advanced blackout notice. Further, specific communications to ESOP participants regarding any changes made with respect to these changes are important. Given the nature of ESOPs, the COVID-19 pandemic has unique implications that ESOP administrators and fiduciaries should carefully consider.

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