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Client Alert

Locating Missing Participants

Written by: Jane E. Rogers, QKA

Two questions often asked by ESOP Plan Administrators are, "*How do I find missing former plan participants?*" and "*How do I make a distribution to a participant I cannot locate?*"

As a Plan Administrator, you may have former employees who have terminated employment with a vested balance in the ESOP and now that they are entitled to a distribution from the plan, you are unable to locate them. Distribution notices have been mailed only to be returned by the U.S. Postal Service as "undeliverable."

When a participant does not respond to written requests regarding the distribution of his/her account balance, the participant is deemed missing and the Plan Administrator must take the necessary steps to locate the missing participant.

Search Methods

Plan Administrators are required to take reasonable steps to locate missing participants. Such steps may include the following search methods approved by the Department of Labor (DOL) for terminated defined contribution plans.

1. Send the distribution notice using certified mail.
2. Review the records of other plans sponsored by the Employer, as it is possible that another plan of the Employer, such as a group health plan, may have more up-to-date information for the participant or beneficiary.
3. Contact the beneficiary designated by the participant to obtain a forwarding address for the participant.
4. Use letter forwarding services provided by the Internal Revenue Service (IRS) or Social Security Administration (SSA). The IRS has published guidelines under which they will forward letters for a third party, such as a Plan Administrator's attempting to locate and pay benefits to a plan participant. The SSA also has a letter forwarding service that may be used to locate a missing participant, which is described on their web site (www.ssa.gov). To use either letter forwarding service, a written request must be submitted to the agency with the missing participant's social security number. The agency will search their records for the most recent address and will forward a letter from the Plan Administrator. The letter to the missing participant should provide contact information for claiming the benefit and a date by which the participant must respond, as neither the IRS nor the SSA will notify the Plan Administrator as to whether the participant was located.

If the above methods fail to locate the participant, the Plan Administrator should consider using the following optional search methods:

- internet search tools
- commercial locator services
- credit reporting agencies

The fees attributable to these search options may be charged to the missing participant's account. However, in choosing the appropriate search method, the Plan Administrator will need to consider the size of the participant's account balance in relation to the cost of the service.

Distribution Options

The Plan Administrator should also review the plan document for guidance on how to distribute benefits of missing participants. Options which may be included in the plan document are:

- Safe harbor language for automatic rollovers, in which distributions of $5,000 or less can be automatically rolled over into an IRA without the consent of the participant, if the safe harbor requirements are met (*see inset on page 2 for safe harbor requirements*).
- If the Employer also maintains a 401(k) plan, in the absence of participant consent, distributions are automatically rolled over into the participant's 401(k) account.
- After a specified period of time the Plan Administrator may direct that the participant's account be forfeited and reallocated to other participants as an Employer con-

tribution. If this option is included in the plan, it must provide for reinstatement if a claim is later made by the participant or beneficiary for the forfeited benefit.

Escheat laws require that when an individual cannot be located, the unclaimed funds are transferred to the state. The DOL has taken the position that unless the plan has been terminated, the Plan Administrator may not escheat the missing participant's account under a state's unclaimed property statute.

Terminated Defined Contribution Plan [1]

If plan assets are being distributed from a terminated defined contribution plan, the Plan Administrator must attempt to contact the missing participants through each of the four specific search methods indicated above, keeping a record to prove that each method was ineffective.

If after the search processes the Plan Administrator is unable to locate a missing participant, the DOL has approved the following options for distributing benefits.

Individual Retirement Plan Rollovers. The preferred distribution option is to transfer the missing participant's benefit into an individual retirement plan (IRA). This option is more likely to preserve assets for retirement purposes than any other option. A distribution that is transferred directly into an IRA will not be subject to immediate income taxation, the 20% mandatory income tax withholding requirement, or the 10% additional tax on premature distributions that may be required.

The DOL has indicated that the Plan Administrator will be treated as satisfying its fiduciary duties if it chooses an IRA investment designed to preserve principal and otherwise complies with the automatic rollover safe harbor requirements, even if the amount involved exceeds the $5,000 cash out threshold.

Alternative Arrangements. If the Plan Administrator is unable to locate an IRA provider willing to accept a rollover distribution on behalf of the missing participant, the Plan Administrator may consider the following alternative arrangements:

1. Establish an interest-bearing account in the name of the missing participant with a federally insured bank, provided the participant has an unconditional right to withdraw funds from the account.

2. Transfer missing participant's account balances to state unclaimed property funds in the state of the participant's last known residence or work location. The DOL believes that the transfer of a missing participant's account balance from a terminated defined contribution plan to a state's unclaimed property fund would constitute a plan distribution, which ends both the property owner's status as a plan participant and the property's status as plan assets under ERISA. The transfer to state unclaimed property funds must comply with state law requirements.

The Plan Administrator should be aware that transferring a participant's benefits to either a bank account or state unclaimed property fund will subject the amount to income taxation, mandatory income tax withholding and a possible additional tax for premature distributions.

The DOL notes that Plan Administrators should not use 100% income tax withholding as a means to distribute plan benefits to missing participants. The use of this option would not be in the interest of participants and beneficiaries, and therefore would violate ERISA's fiduciary requirements.

This guidance from the DOL assumes that the terminated plan does not provide an annuity option and that no other appropriate defined contribution plan is maintained by the Employer to which account balances from the terminated plan could be transferred.

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Safe harbor automatic rollover requirements:

1. The amount to be rolled over to the IRA under the automatic rollover rules may not exceed $5,000 (excluding amounts attributable to prior rollovers).
2. A fiduciary must enter into a written agreement with an IRA provider that specifically addresses such issues as the investment of funds and the IRA fees and expenses.
3. Automatic rollover amounts must be invested in investments that are designated to preserve principal while providing for a "reasonable" rate of return.
4. The written agreement with the IRA provider must maintain that IRA fees will not exceed the fees charged by the IRA provider for comparable IRAs established for rollover distributions.
5. Participants must be given information prior to the automatic rollover, in either a summary plan description or summary of material modifications. The information must include a description of the types of investments that will compose the IRA and how fees will be charged and allocated under the IRA. Participants must also be informed of the person to contact to obtain more information about the investment of the automatic rollover, including specific provider information.
6. The fiduciary must not engage in a prohibited transaction in connection with the selection of the IRA provider or investment products.

[1] *On September 30, 2004, the DOL released Field Assistance Bulletin (FAB) 2004-02. This FAB provides guidance on the responsibilities of plan fiduciaries in connection with locating missing participants and distributing the account balances of missing participants when a defined contribution plan is terminated.*

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Preventing the Problem

While there will always be cases in which terminated participants cannot be located, the Plan Administrator should make it clear in exit interviews and on all correspondence that participants should notify the Plan Administrator of any address changes. In addition, if the company has a website for benefit information, a notice could be posted on the website and include a list of "missing participants" in the hope that a current employee may have information as to a missing former employee's whereabouts.

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Selling Your ESOP Company

Written by: Steven B. Greenapple, Esq.

When a corporation owned partially or entirely by an ESOP is sold, the company's board of directors faces the same issues raised in connection with the sale of a non-ESOP company. In addition, the board and the ESOP fiduciaries must consider some special issues raised by the fact that one of the company's stockholders owns shares as an ERISA fiduciary.

Background

Duties of the Board of Directors. Directors have a fiduciary duty to act in the best interests of the corporation and its stockholders. This duty includes a "duty of care" and a "duty of loyalty." In order to protect directors from being judged in hindsight, courts have developed a presumption known as the "Business Judgment Rule (BJR)." Under the BJR, if directors act in good faith (i.e., consistent with their duty of loyalty) and on an informed basis (i.e., consistent with their duty of care), and if the board's decision is supported by a rational business purpose, then the courts will not substitute their business judgment for that of the board. If the board's decision is not within the scope of the BJR, the court would review it under a more stringent standard.

Duties of the ESOP Fiduciaries. ESOP fiduciaries include the trustee, plan administrator, and members of the investment or administrative committees. An ESOP fiduciary must act with the care, skill, prudence and diligence with which a prudent person who is familiar with such matters would act in similar circumstances. They must act prudently for the exclusive benefit of the plan participants and their beneficiaries, and in accordance with the plan documents (provided the documents are consistent with ERISA).

The Sale Transaction

A transaction to sell a corporation can take many forms. In any transaction structure, however, the board and the ESOP fiduciaries must consider the following:

The Initial Proposal. A board or trustee may actively solicit offers to purchase a corporation; more difficult issues arise in the context of unsolicited offers. Most proposed transactions are initially presented to the board, but in some cases a prospective buyer could approach an ESOP trustee directly. In either case, the board must consider whether an offer is a *bona fide* offer worthy of serious consideration. This involves consideration of the proposed purchase price and terms, as well as the ability of the proposed purchaser to consummate the transaction.

Transaction Structure. The board must also consider the form of the proposed transaction (i.e., whether it is a merger, a sale of stock or sale of assets). This will affect the tax impact of the transaction and the process for approval of the transaction. For example, under most state laws, a merger must be approved by the vote of the holders of a majority of the company's stock (subject to procedures for protecting minority shareholders), but a sale of stock must be agreed to by each stockholder. Under ERISA, the ESOP trustee must pass through to the ESOP participants the vote to approve a merger or sale of substantially all of the company's assets, but the decision to sell ESOP stock is discretionary with the trustee unless the ESOP document provides otherwise.

Negotiation and Due Diligence. If the transaction structure involves a sale of stock by the ESOP, the ESOP trustee must:

1. independently negotiate the price and terms on behalf of participants
2. conduct a diligent, independent investigation
3. engage qualified legal and financial advisors and scrutinize their findings

If the transaction is structured as a merger, the trustee's role depends in part on whether the ESOP owns a controlling interest in the company. If so, the trustee has all the responsibilities to investigate and negotiate the transaction. If not, the trustee may be limited to deciding whether to go along with the transaction or to exercise its rights under state statutes for the protection of minority shareholders. If the ESOP owes money on the ESOP note (which is se-

cured by unallocated shares), the negotiations should address the payment of this debt and the allocation of these shares or, alternatively, the cancellation of the debt in exchange for the cancellation of these shares. This is particularly important where the value of the shares is greater than the amount of the debt. The trustee may be able to negotiate an additional contribution or dividend that – subject to limits on contributions and allocations – will result in the allocation of these shares. The trustee should also consider the future of the ESOP (i.e., whether it will be terminated, frozen or merged into another qualified plan) and may negotiate for a commitment to provide a continuing retirement benefit to employees after the closing of the transaction. If the transaction takes place within three years following the date on which the ESOP acquired the stock (in a transaction to which IRC §1042 applied), the sale may result in an excise tax being assessed against the company.

Can – or Must – the Trustee Sell? The fact that an offer is for more than the appraised value of the ESOP stock does not necessarily mean that the trustee must sell. The trustee must consider the best interests of the plan participants *in their capacity as participants in a retirement plan* (i.e., as financial incentives and not based on job security or other non-economic considerations). However, the trustee can take into account the underlying intrinsic value of the company, the likelihood of that value being realized by current management or by a subsequent offer, and the long-term value of the company compared to the value presented by the offer.

Fairness. The trustee must determine whether the proposed transaction is prudent and in the best interests of the plan participants. The decision should be supported by an opinion of an independent financial advisor that the proposed transaction is for at least adequate consideration and is fair to the ESOP from a financial point of view. If other (non-ESOP) shareholders are involved in the transaction, the trustee must also examine whether the consideration the ESOP will receive is fair, relative to the consideration the other shareholders will receive (e.g., employment agreements or synthetic equity grants) in the transaction. Earn-outs, contingent payments, holdbacks and escrows must also be considered, both from the point of view of adequate consideration and fairness, and to be certain that they do not constitute non-exempt prohibited transactions.

Pass-Through Voting. Some transaction structures require that the trustee "pass through" the decision on how to vote the shares owned by the ESOP directly to plan participants. In any pass-through vote, participants must be provided with sufficient information to make an informed decision, sufficient time to consider the information and a method of voting that protects their privacy. However, if the trustee determines that it would be inconsistent with its fiduciary duties to vote the stock as instructed by the participants, the trustee must override those instructions and vote the stock as it determines to be prudent and in the best interests of the participants.

Conclusion

The sale of a business is part of the normal course of a company's life cycle. It is a complex transaction, involving many issues, questions and duties. The fact that a company has an ESOP as a shareholder adds a layer of complexity and requires the fiduciary to obtain the assistance of qualified and experienced professionals.

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Client Q & A

Edited by Meg Shrum, Senior Vice President

Q: We put our ESOP in place a couple of years ago using seller financing. Is it possible that a bank would refinance that seller note at this point?

A: Yes. While the bank environment is a bit more challenging these days, your bank (or a lender well-versed in ESOP lending) should be more than willing to look at taking out the seller note—either completely or in part. Your company now has a track record of paying off an ESOP note, your management team should be transitioning nicely, and assuming your financial outlook and cash flows remain sound, there's every reason to think refinancing would be an option for you. One word of caution, however—if the seller note is directly to the ESOP trust rather than to the company, care must be taken not to refinance under terms less favorable to the ESOP participants.

Look for an in-depth article on this topic in our next issue!

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