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Contributions of Company Stock to Defined Benefit Plans: A Potential Solution to Funding Requirements in a Turbulent Economy

Charles R. Smith, Julie Williams, and Marcia C. Kelson

The stock market collapse of 2008 has left corporate pensions with steep deficits. While in 2007 the S&P 1500 companies' plans were, on average, 104 percent funded, in early 2009 Mercer reported that the 2008 year-end funded status for such companies' plans had dropped to 75 percent. These averages reflect an aggregate pension surplus of $60 billion at the end of 2007 becoming a deficit of $409 billion at the end of 2008—a loss of $469 billion. This trend is not surprising given that many large corporate pensions have more than half of their pension assets invested in equities.

The confluence of the change in financial accounting guidelines, the effectiveness of the Pension Protection Act of 2006 (PPA), and the market collapse has created a complicated set of challenges for many companies.[1] *Not only must they meet*

Charles R. Smith is a partner, and Marcia C. Kelson is an associate, in the employee benefits and executive compensation group of the Pittsburgh office of K&L Gates LLP. Mr. Smith was recognized by *Philadelphia Magazine* as a "Pennsylvania Super Lawyer," and by *Human Resources Executive Magazine* as one of the nation's top 50 employment lawyers, and has been listed as one of the "Best Lawyers in America" for 14 consecutive years. Julie Williams is a vice president at GreatBanc Trust Company, a subsidiary of U.S. Fiduciary Services, Inc. GreatBanc serves as independent fiduciary in transactions involving plan assets, primarily employer stock.

the demands of the PPA and the new accounting rules, plan sponsors must fund their plans at a time when demands on cash are high, balance sheets are already strained, and liquidity is scarce. More than ever before, investors and analysts are placing a much higher level of scrutiny on plan status when assessing a corporation's overall financial condition. Pension obligation is another claim against a shareholder's stake in a company and is largely viewed as another form of debt.

Contributions of company stock to pension plans are subject to specific regulations under the Employee Retirement Income Security Act of 1974, as amended (ERISA)[2] *and the Internal Revenue Code of 1986, as amended (IRC).*[3] *Such regulations aim to ensure that pension plans have enough money in trust to pay promised benefits to employees and that decisions with respect to pension plans are made in the best interests of plan participants. In certain circumstances, a plan sponsor must receive a prohibited transaction exemption from the Department of Labor before contributing company stock to its pension plan. In addition, conflicts of interest and complex valuation issues often exist in such transactions, thus necessitating the services of an independent fiduciary and an investment advisory firm. This article provides guidance for navigating the regulatory framework surrounding contributions of employer securities to defined benefit pension plans.*

IMPLICATIONS OF UNDERFUNDED DEFINED BENEFIT PLANS

Financial Accounting

In 2006, the Financial Accounting Standards Board issued Statement No. 158 (SFAS 158), the stated purpose of which was to improve the financial reporting by companies that sponsor defined benefit plans by requiring them to recognize the overfunded or underfunded status of a defined benefit plan as an asset or a liability on their balance sheets.[4] Also per SFAS 158, the plan sponsor must recognize completely in earnings or other comprehensive income the financial effects of certain events affecting the plan's funded status when those events occur. Finally, the employer is required to measure the defined benefit plan assets and obligations as of the date of the company's fiscal year-end. Prior to SFAS 158, less stringent accounting rules resulted in confusing and often misleading reporting of the funded status of a company's plan. In addition to the previously unclear rules, companies were allowed to disclose information about the funding status of their plans in the footnotes to financial statements, rather than in the actual statements of financial positions themselves, thus making it more difficult for users of the statements to fairly assess the financial position of the company. Under SFAS 158, public companies were obligated to comply with the requirement to recognize the funded status as of the end of the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the sponsor's fiscal year-end is effective for fiscal years ending after December 15, 2008.

Funding Requirements

The minimum funding rules of ERISA and the IRC, as overhauled by the Pension Protection Act of 2006 (PPA), require (among myriad other mandates) that companies fully fund their pension plans over a seven-year period beginning in 2008.[5] PPA requires a minimum contribution for each plan year equal to the present value of benefits earned in such year, plus the amount needed to amortize funding shortfalls over seven years.[6] In addition, PPA's new funding target is 100 percent, meaning that each plan should be funded in an amount equal to the present value of all benefits accrued or earned under the plan as of the beginning of the plan year.[7] Furthermore, plans considered to be "at-risk" (*i.e.*, those funded at less than 80 percent) have even higher funding targets based upon specific "at risk" actuarial assumptions.[8] These new funding requirements (as opposed to the pre-PPA 90 percent funding target, with underfunding amortized over five years) would have been difficult enough to meet in a stable economy. While the Worker, Retiree, and Employer Recovery Act of 2008 provides minimal relief for certain plans that do not reach PPA's transition funding targets, most plans do not qualify for such relief.[9] In today's troubled economy, these strict funding requirements are causing some plan sponsors to take drastic measures, such as freezing or terminating their pension plans.

IS A CONTRIBUTION OF COMPANY STOCK AN OPTION?

Deciding Whether to Contribute Company Stock

A commonly shared concern among companies is that large infusions of cash into their plans could have a materially negative impact on their already weak balance sheets, earnings, and capital investment plans. In the most serious cases, making the required cash payment could trigger defaults under a sponsor's corporate loan agreements and lead to more severe consequences including higher interest rates or even bankruptcy. Some experts fear that a more compelling alternative for employers would be to freeze their plans to avoid further negative impacts. So the big question is: What, if anything, can employers do to meet their funding and reporting obligations without unduly straining the capital resources of the company?

Historically, companies have turned to alternative sources of contributions to mitigate the amount of cash required. Any asset of the company (such as real estate, stock of a subsidiary, or employer stock) may be contributed to a plan to meet funding requirements. However, because noncash assets can be difficult to value and may have higher risk profiles than cash or publicly traded stock, sponsors must comply with strict rules when using them to fund pension liabilities.

The first step in deciding whether to contribute company stock to a plan revolves around the company's overall financial strategy. The primary benefit of contributing employer stock is clear: conserve cash. Other considerations include an assessment of alternative cash needs, the financial reporting impact, compliance with bank loan covenants, liquidity, valuation, and investment policy.

Role of the Independent Fiduciary

A contribution of company stock to a pension plan is treated as a sale of company stock to a plan because the plan is, in effect, giving up its right to a cash contribution in exchange for such stock contribution. The decision of whether to accept the proffered stock in discharge of the funding liability is customarily made by the plan's trustee or an independent fiduciary engaged to make such types of decisions. In fulfilling its duties, a fiduciary must act in a prudent manner and solely in the interest of plan participants and beneficiaries. In addition, a fiduciary must not cause a plan to enter into a nonexempt prohibited transaction (as more fully explained below). An important component of such decision includes the valuation of employer securities. The plan's fiduciary must determine the value of the contribution from the perspective of the plan in order to avoid entering into a non-exempt prohibited transaction.[10]

Company insiders may be hard-pressed to act with the required singular focus on plan participants, and may lack the experience necessary to evaluate whether a particular transaction is a prohibited transaction. In addition, company insiders may be unable to properly value employer securities. As such, plan sponsors are wise to employ an independent fiduciary with experience in such matters to conduct valuations and weigh such a decision, as the penalties for breaching one's fiduciary duty or engaging in a prohibited transaction are steep.

BUSINESS CONSIDERATIONS

Value of Company Stock

Special consideration should be given to any valuation issues that may arise from contributing a block of company stock into a plan.

Valuation issues may include an assessment of the size of the block of stock being contributed and what discount may be appropriate to account for the potential limit on liquidity. In some instances, there may be additional consideration for short-term restrictions on trading. While valuation issues are very unique for any given transaction, they should be weighed carefully to ensure that a prohibited transaction is not created by the contribution. An assessment of these, and other important factors, can be aided by hiring an independent fiduciary with experience in effecting transactions of this nature.

Another important consideration is how the company views its stock value relative to the current trading price. If the stock is deemed by the employer to be undervalued, the investment may have higher expected returns, which would benefit the future funding levels of the plan. Alternatively, if the risks associated with the company's operations are significant, have directly contributed to the deficit of the plan, and are unlikely to reverse in the near term, the additional investment in the stock may not be appropriate for the plan.

LEGAL CONSIDERATIONS

What Constitutes Eligible Company Stock?

ERISA prohibits the acquisition or holding by any employee benefit plan of any employer security that does not constitute "qualifying employer securities."[11] With respect to a pension plan, "qualifying employer securities" include the stock of the plan sponsor provided that:

1. The plan does not hold more than 25 percent of the issued and outstanding shares of such plan sponsor at the time of the acquisition; and

2. At least 50 percent of the issued and outstanding shares of such stock at the time of the acquisition are held by parties that are independent from the plan sponsor.[12]

Prohibited Transaction Exemptions

ERISA and the IRC prohibit certain transactions between an employee benefit plan and the plan sponsor.[13] An employer's contribution of stock to an underfunded pension plan is, by definition, a prohibited transaction. However, there are exemptions from the prohibited transaction rules for acquisitions of "qualifying employer securities." In order to take advantage of such exemption:

1. The plan's acquisition of qualifying employer securities must be for "adequate consideration";

2. No commission may be charged with respect to the acquisition; and

3. The 10 percent rule, discussed below, must not be violated.[14]

Where there is a generally recognized market for a security, such as in the case of publicly traded stock, "adequate consideration" is defined, generally, as the prevailing market price.[15] Where no generally recognized market exists for the security, such as in the case of private company stock, "adequate consideration" must be determined in good faith by a plan's trustee or named fiduciary under the terms of the plan and in accordance with ERISA regulations.[16] As such, public company stock is more likely to meet the definition of qualifying employer securities and therefore is more likely to be contributed to pension plans.

10 Percent Rule

ERISA prohibits an employee benefit plan from acquiring qualifying employer securities if, immediately after such acquisition, the aggregate fair market value of such securities (and other employer property) held by the plan exceeds 10 percent of the fair market value of the assets of the plan.[17] In determining whether this limit is exceeded, the "fair market value" of total plan assets is the fair market value of such assets less the unpaid amount of certain acquisition-related indebtedness.[18] The fair market value of qualifying employer securities is the fair market value of such securities without reduction for the unpaid amount of any indebtedness incurred by the plan in connection with the acquisition of such securities.[19] In determining fair market value, care should be taken to accurately value "hard to value assets," such as real property, and to properly account for all qualifying employer securities held by the plan.

This 10 percent limitation is determined as of the date on which the plan acquires the securities; therefore, post-acquisition changes in the value of the securities and plan assets will not violate this rule. However, while post-acquisition changes may not violate the 10 percent rule, a prudent fiduciary must continually monitor the value of the assets of the plan to determine whether a continued investment in company stock is in the best interest of plan participants.

Private Company Stock

The closely held nature of many private companies makes it more likely that 50 percent or more of the stock of such companies will be held by affiliated parties. Furthermore, due to the lack of a prevailing market price, contributions of private company stock raise complex valuation issues in evaluating whether such contributions will be exempt from the prohibited transaction rules. As such, in order to contribute private company stock to a pension plan, the plan sponsor will often be required to file for a prohibited transaction exemption from the Department of Labor (DOL). The DOL will evaluate whether to allow such a contribution, and will likely impose requirements upon the plan and plan sponsor. For example, the DOL, in an attempt to ensure that the participants' interest in the decision to accept the contribution is given proper weight, will often require that an independent fiduciary be engaged.

Fiduciary Issues

Many plans that hold company stock enlist the services of an independent fiduciary both in the implementation of the initial decision of whether to make a stock contribution, as well as the monitoring of the value of the company stock fund. An independent fiduciary, because it is not a company insider, would not be privy to the types of information that would prohibit an insider from trading in company stock in certain instances. In addition, in certain instances where the independent fiduciary is not an "affiliate" of the company, it will not be subject to the same trading limitations under the Securities Act as an affiliated party, such as an officer or a director. As such, an independent fiduciary is invaluable in situations requiring quick but informed decisions regarding acquisitions and sales of company stock.

CONCLUSION

While a contribution of company stock may be an attractive option for certain employers, the circumstances surrounding each plan are different and therefore require a specifically tailored analysis. As such, employers should work with their attorneys, fiduciaries, advisors, and actuaries to understand the implications of the various funding options before implementing any particular decision.

NOTES

1. Pension Protection Act of 2006, Pub. L. No. 109-280.

2. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406.

3. Internal Revenue Code of 1986, as amended, Title 26, U.S. Code.

4. Fin. Acct. Standards Bd., No. 284-B, Statement of Financial Accounting Standards No. 158: Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans (2006).

5. PPA §§ 101, 102, 111, and 112.

6. PPA §§ 102 and 112.

7. *Id.*

8. *Id.*

9. The Worker, Retiree, and Employer Recovery Act of 2008 (H.R. 7327).

10. ERISA § 404(a)(1).

11. ERISA § 407(a)(1).

12. ERISA § 407(f)(1).

13. ERISA § 406; IRC § 4975.

14. ERISA § 408(e).

15. ERISA § 3(18).

16. *Id.*

17. ERISA § 407(a)(2).

18. Treas. Reg. § 2550.407a-2(1).

19. *Id.*

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